MISCELLANEOUS TAX BILLS III

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. 1021, S. 1078, S. 1435, and S. 1467

OCTOBER 22, 1979

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MISCELLANEOUS TAX BILLS III

MONDAY, OCTOBER 22, 1979

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

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

Present: Senators Byrd, Long, Bentsen, Nelson, and Chafee.

[The press release announcing this hearing and the bills S. 1021, S. 1078, S. 1435, and S. 1467 follow:]

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT SETS HEARING ON MISCELLANEOUS TAX BILLS

Senator Harry F. Byrd, Jr. (I-Va.) Chairman of the Subcommittee on Taxation and Debt Management announced today that a hearing will be held on October 22, 1979, on miscellaneous tax bills.

The hearing will begin at 9:00 a.m. in Room 2221 of the Dirksen Senate Office Building.

The following pieces of legislation will be considered:

S. 1435, sponsored by Senators Nelson, Bentsen, Packwood and Chafee. The bill provides for the more rapid depreciation by businesses of investments in machinery equipment and buildings. Revenue estimates on this measure are not available at this time. The measure will benefit virtually all businesses.

S. 1021, sponsored by Senator Danforth. The bill would provide the holders of municipal bonds with an option to either exclude the bond interest from taxable income as under present law or to claim a Federal tax credit of 67 percent of the amount of interest. This measure is estimated to decrease revenues by $6 million in 1980; $74 million in 1981; $244 million in 1982; $403 million in 1983; and $526 million in 1984. The measure will benefit purchasers of municipal bonds.

S. 1078, sponsored by Senators Javits, Goldwater, Domenici, Williams and Pell. The bill would provide a credit against taxes on an artist's estate for testamentary transfers of his art to the Federal Government. The bill would also provide a credit against an artist's income taxes for donations of his artwork to charitable organizations and amend other sections of the Internal Revenue Code relating to "hobby losses" and the capital gains treatment for copyrights. This measure is estimated to decrease revenues by $20 million per year. The measure will benefit artists.

S. 1467, sponsored by Senators Dole and Bentsen. The bill would provide that the retirement-replacement-betterment method of accounting for property used by a common carrier is an acceptable method for determining depreciation allowances for income tax purposes. This measure is estimated to have no revenue effect. The measure will benefit common carriers.

Witnesses who desire to testify at the hearing should submit a written request to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510, by no later than the close of business on October 18, 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 witnesses 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 statements 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) Not more than ten minutes will be allowed for oral presentation.

(5) 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.

WRITTEN TESTIMONY

Senator Byrd stated that the Subcommittee would be pleased to receive written testimony from those persons or organizations who wish to submit statments 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 November 16, 1979, to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C., 20510.

96TH CONGRESS
1ST SESSION

S. 1021

To amend the Internal Revenue Code of 1954 to provide holders of certain governmental obligations a taxable bond option and credit.

IN THE SENATE OF THE UNITED STATES

APRIL 26 (legislative day, APRIL 9), 1979

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 to provide holders of certain governmental obligations a taxable bond option and credit.

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

1 "SEC. 11D. CREDIT FOR EXEMPT INTEREST INCLUDED IN
2 INCOME.
3 "(a) GENERAL RULE.—In the case of a United States
4 person who elects to include in gross income for the taxable
5 year the entire amount of—
6 "(1) interest on obligations described in section
7 103(a), other than industrial development bonds (de-
8 scribed in section 103(b)(2)) and
9 "(2) exempt-interest dividends (as defined in sec-
10 tion 852(b)(5)) attributable to interest on obligations
11 described in subparagraph (1),
12 there is allowed as a credit, subject to the limitations of sub-
13 section (b), an amount equal to 67 percent of the sum of such
14 interest and dividends for the taxable year.
15 "(b) LIMITATIONS, APPLICATION WITH OTHER CRED-
16 ITS, ETC.—
17 "(1) IN GENERAL.—Except as provided in para-
18 graph (2), the credit allowable under subsection (a) for
19 the taxable year shall not exceed the tax imposed by
20 this chapter for such year reduced by the credit al-
21 lowable under section 37 (relating to credit for the
22 elderly).
23 "(2) CERTAIN TAX-EXEMPT ENTITIES.—In the
24 case an organization described in section 501(c)(3) or a
25 trust qualifying under section 401(a) other than a trust
26 forming part of a governmental plan, the amount of

1 credit allowable under subsection (a) for the taxable
2 year shall be applied against the tax imposed by this
3 subtitle.

4 "(3) DENIAL OF CREDIT FOR OBLIGATIONS NOT
5 ISSUED PURSUANT TO A PUBLIC UNDERWRITING
6 WHICH ARE HELD BY RELATED ENTITIES.—An elec-
7 tion under this section shall not apply to any obligation
8 not issued pursuant to a public underwriting for any
9 period which such obligation is held by a related
10 entity.".

11 "(c) DEFINITIONS: SPECIAL RULES.—For purposes of
12 this section—

13 "(1) ORIGINAL ISSUE DISCOUNT INTEREST;
14 AMORTIZABLE BOND PREMIUM.—In the case of obli-
15 gations described in section 103(a), other than industri-
16 al development bonds, the amount of interest shall be
17 adjusted, under regulations prescribed by the Secre-
18 tary, for any original issue discount or amortizable
19 bond premium attributable to the taxable year.

20 "(2) TIME AND MANNER OF ELECTION.—The
21 election to claim this credit shall be made with the tax
22 return for the taxable year for which the inclusion is
23 elected. The election shall be made not later than the
24 time prescribed by law for filing the return for such
25 year (including extensions thereof). Such election may

1 be changed at any time before the expiration of the
2 period prescribed for making a claim for credit or
3 refund of the tax imposed by this chapter for the tax-
4 able year. The election shall include a statement set-
5 ting forth, in such manner as the Secretary may re-
6 quire, the identification of the payor of the interest or
7 dividend, together with such additional information as
8 the Secretary may require.
9 "(3) TAXES IMPOSED BY THIS CHAPTER.—The
10 taxes imposed by the following provisions of this chap-
11 ter shall not be considered to be taxes imposed by this
12 chapter:
13 "(A) The taxes imposed by sections 55 and
14 56 (relating to minimum taxes).
15 "(B) The tax imposed by section 72(m)(5)(B)
16 (relating to 10 percent on premature distributions
17 to owner-employees).
18 "(C) The tax imposed by section 408(f) (re-
19 lating to additional tax on income from certain re-
20 tirement accounts).
21 "(D) The tax imposed by section 531 (relat-
22 ing to accumulated earnings tax).
23 "(E) The tax imposed by section 1378 (relat-
24 ing to tax on certain capital gains of subchapter S
25 corporations).

1 "(F) Any additional tax imposed for the tax-
2 able year by section 1351(d)(1) (relating to recov-
3 eries of foreign expropriation losses).
4 "(4) APPLICATION IN THE CASE OF ESTATES
5 AND TRUSTS, ETC.—In the case of an estate or trust
6 or other person which may distribute income which re-
7 tains the characteristic of being excludible from gross
8 income under section 103(a), the Secretary shall by
9 regulations prescribe rules relating to the election
10 under this section.
11 "(5) PUBLIC UNDERWRITING.—The term 'public
12 underwriting' means a procedure for selling the obliga-
13 tions in which—
14 "(A) competitive bids for the right to sell the
15 obligations to the general public are solicited from
16 independent parties, and
17 "(B) 25 percent or more of the obligations
18 sold are acquired by persons who are not related
19 entities.
20 "(6) RELATED ENTITY.—The term 'related
21 entity' means—
22 "(A) in the case of obligations issued by a
23 State, such State and any political subdivisions
24 thereof,

1 "(B) in the case of obligations issued by a
2 political subdivision of a State, such State and
3 any political subdivision thereof, and
4 "(C) in the case of obligations issued by an
5 instrumentality of two or more States or two or
6 more political subdivisions each such State (of
7 which the political subdivision is a part) and each
8 political subdivision thereof. For purposes of this
9 provision, any agency or instrumentality of a
10 State or political subdivision shall be treated as
11 such State or political subdivision and any trust or
12 plan for the benefit of the employees of a State or
13 political subdivision shall be treated as an instru-
14 mentality of such State or political subdivision, as
15 the case may be.".
16 (b) INCLUSION IN GROSS INCOME OF INDIVIDUAL
17 BOND OPTION CREDIT.—
18 (1) Part II of subchapter B (relating to items spe-
19 cifically included in gross income) is amended by in-
20 serting at the end thereof, the following new section:
21 "SEC. 86. CREDIT FOR EXEMPT INTEREST INCLUDED IN
22 INCOME.
23 "An amount equal to the credit allowed under section
24 44D shall be treated as interest or dividend, as the case may
25 be, received in the taxable year in which the interest or divi-

1 dend (on which the allowance of the credit is based) is re-
2 ceived. Such amount shall be included in gross income solely
3 for purposes of determining the tax imposed by this
4 chapter.".
5 (2) The table of sections for such part is amended
6 by inserting at the end thereof the following new
7 items:

"Sec. 86. Credit for exempt interest included in income.".

8 (c) CONFORMING AMENDMENTS.—
9 (1) Subsection (b)(2) of section 41 (relating to con-
10 tributions to candidates for public office) is amended—
11 (A) by striking out "and";
12 (B) by striking out the period at the end of
13 the paragraph and inserting in lieu thereof ", and
14 section 44D (relating to credit for exempt interest
15 included in income).".
16 (2) Subsection (b) of section 44A (relating to ex-
17 penses for household and dependent care services nec-
18 essary for gainful employment) is amended—
19 (A) by striking out "and" at the end of para-
20 graph (6);
21 (B) by striking out the period at the end of
22 paragraph (7) and inserting in lieu thereof ",
23 and"; and

1 (C) by adding at the end thereof the following new paragraph:

3 "(8) section 44D (relating to credit for exempt interest included in income).".

5 (3) Subsection (a)(4) of section 46 (relating to amount of credit) is amended—

7 (A) by striking out "and" at the end of subparagraph (A);

9 (B) by striking out the period at the end of subparagraph (B) and inserting in lieu thereof ", and"; and

12 (C) by adding at the end thereof the following new subparagraph:

14 "(C) section 44D (relating to credit for exempt interest included in income), except in the case of a tax-exempt entity referred to in section 44D(b)(2)."

18 (4) Subsection (a)(3) of section 50A (relating to amount of credit) is amended—

20 (A) by striking out "and" at the end of subparagraph (C);

22 (B) by striking out the period at the end of subparagraph (D) and inserting in lieu thereof ", and"; and

1 (C) by adding at the end thereof the follow-
2 ing new subparagraph:
3 "(E) section 44D (relating to credit for
4 exempt interest included in gross income), except
5 in the case of a tax-exempt entity referred to in
6 section 44D(b)(2).".
7 (5) Subsection (a) of section 53 (relating to limita-
8 tion based on amount of tax) is amended—
9 (A) by striking out "and" at the end of para-
10 graph (6);
11 (B) by striking out the period at the end of
12 paragraph (7) and inserting in lieu thereof ",
13 and"; and
14 (C) by adding after paragraph (7) the follow-
15 ing new paragraph:
16 "(8) section 44D (relating to credit for exempt in-
17 terest included in income).".
18 (6) Subsection (b)(1) of section 75 (relating to
19 dealers in tax-exempt securities) is amended by insert-
20 ing after "excludible from gross income" the following:
21 "(without regard to the operation of section 44D)".
22 (7) So much of section 103(a) (relating to interest
23 on certain governmental obligations) as precedes para-
24 graph (1) is amended to read as follows:

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1 "(a) GENERAL RULE.—Except as provided in section
2 44D and section 86 (relating to credit for exempt interest
3 included in income), gross income does not include interest
4 on—".

5 (8) Section 171 (relating to amortizable bond pre-
6 mium) is amended—

7 (A) by striking out "(other than a bond the
8 interest on which is excludible from gross
9 income)" from subsection (a)(1) and by inserting
10 in lieu thereof, "(other than a bond described in
11 paragraph (2))";

12 (B) by amending subsection (a)(2) to read as
13 follows:

14 "(2) TAX-EXEMPT BONDS.—In the case of any
15 bond the interest on which is excludible from gross
16 income (without regard to the operation of section
17 44D), no deduction shall be allowed for the amortizable
18 bond premium for the taxable year."; and

19 (C) by amending subsection (c)(1) to read as
20 follows:

21 "(1) ELIGIBILITY TO ELECT; BONDS WITH RE-
22 SPECT TO WHICH ELECTION PERMITTED.—In the
23 case of bonds other than bonds described in subsection
24 (a)(2), this section shall apply only if the taxpayer has
25 so elected.".

1 (9) Paragraphs (1), (2), and (3) of section 265 (re-
2 lating to interest relating to tax-exempt income) are
3 amended by inserting after "subtitle" each place it ap-
4 pears the following: "(without regard to the election
5 under section 44D)".
6 (10) Section 593(b)(2)(E)(iii) (relating to reserves
7 for losses on loans) is amended by striking out "the in-
8 terest on which is excludible under section 103" and
9 inserting in lieu thereof "described in section 103(a)".
10 (11) Subparagraph (A) of section 818(b)(3) (relat-
11 ing to exception from requirement of accrual of dis-
12 count) is amended to read as follows:
13 "(A) interest which is excluded from gross
14 income under section 103, or".
15 (12) Section 832(e)(6) (relating to insurance com-
16 pany taxable income) is amended by striking out "the
17 interest on which is excludible from gross income
18 under section 103" each place it appears and inserting
19 in lieu thereof "described in section 103(a)".
20 (13) Section 852(b) (relating to taxation of regu-
21 lated investment companies and their shareholders) is
22 amended—
23 (A) by deleting "section 103(a)(1)" each
24 place it appears in paragraph (5) and inserting in
25 lieu thereof "section 103(a)"; and

1 (B) by inserting at the end of subsection (b)
2 the following new paragraph:
3 "(6) CREDIT FOR EXEMPT INTEREST INCLUDED
4 IN INCOME.—An investment company may elect to
5 claim the credit under section 44D but not in an
6 amount in excess of—
7 "(A) the amount of interest received on obli-
8 gations described in 103(a) other than industrial
9 development bonds over
10 "(B) the amount designated as exempt-inter-
11 est dividends (including exempt-interest dividends
12 paid after close of the taxable year as described in
13 section 855) attributable to such obligations.
14 The election shall not be taken into account for pur-
15 poses of determining the distribution requirement in
16 subsection (a).".
17 (14) Subsection (g) of section 904 (relating to co-
18 ordination with credit for the elderly) is amended to
19 read as follows:
20 "(g) COORDINATION WITH CERTAIN OTHER CRED-
21 ITS.—For purposes of subsection (a), the tax against which
22 the credit is taken is reduced by the amount of the credit (if
23 any) for the taxable year allowable under—
24 (1) section 37 (relating to credit for the elderly) in
25 the case of an individual, and

1 (2) section 44D (relating to credit for exempt in-
2 terest included in income) in the case of a United
3 States person other than a tax-exempt entity referred
4 to in section 44D(b)(2).".
5 (15) Paragraph (5) of section 1016(a) (relating to
6 adjustments to basis) is amended by inserting after
7 "subtitle" the following: "(determined without regard
8 to the operation of section 44D)".
9 (16) Clause (i) of section 1232(a)(2)(C) (relating to
10 the sale or exchange of bonds and other evidences of
11 indebtedness) is amended to read as follows:
12 "(i) obligations described in section
13 103(a) (relating to certain governmental obli-
14 gations) unless the bondholder has made an
15 election for the taxable year under section
16 44D (relating to credit for exempt interest
17 included income) with respect to the obliga-
18 tion, or",
19 (17) Paragraph (4) of section 6201(a) (relating to
20 erroneous credit under section 39 or 43) is amended—
21 (i) by striking out "section 39 or 43" from
22 the heading and inserting in lieu thereof "certain
23 refundable credits", and
24 (ii) by adding at the end thereof the following
25 new sentence: "If on any return or claim for

1 refund of income taxes under subtitle A by tax-
2 exempt entity referred to section 44D(b)(2), there
3 is an overstatement of the credit allowable by sec-
4 tion 44D, the amount so overstated which is al-
5 lowed as a credit or refund may be assessed by
6 the Secretary in the same manner as in the case
7 of a mathematical or clerical error appearing upon
8 the return, except the provisions of section
9 6213(b)(2) (relating to abatement of mathematical
10 or clerical error assessments) shall not apply with
11 respect to any assessment under this paragraph.".
12 (18) Subparagraph (A) of section 6362(b)(1) (relat-
13 ing to qualified resident tax based on taxable income)
14 is amended to read as follows:
15 "(A) by subtracting an amount equal to the
16 sum of—
17 "(i) the amount of his interest on obliga-
18 tions to the United States which was includ-
19 ed in his gross income for the taxable year,
20 and
21 "(ii) the amount included in his gross
22 income for the taxable year by reason of sec-
23 tion 44D,".
24 (19) Subsection (b) of section 6401 (relating to ex-
25 cessive credits) is amended by adding at the end there-

1 of the following new sentence: "In the case of an orga-
2 nization described in section 501(c)(3) which is exempt
3 from tax under section 501(a), and in case of a trust
4 which meets the requirements of section 401(a) (other
5 than a trust forming a part of the governmental plan
6 as defined in section 414(d)), if the amount allowable
7 as a credit under section 44D exceeds the tax imposed
8 by subtitle A reduced by the credits allowable under
9 subpart A of part IV of subchapter A of chapter 1
10 (other than the credit allowed by section 44D), then
11 the amount of such excess shall be considered an over-
12 payment.".

13 (d) EFFECTIVE DATE.—The amendments made by this
14 section apply to obligations issued after December 31, 1979,
15 other than an obligation any of the proceeds of which is used
16 to refund obligations to which the amendments made by this
17 section do not apply.

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96TH CONGRESS
1ST SESSION

S. 1078

To amend the Internal Revenue Code of 1954 to provide for the taxation of artists' income and estates.

IN THE SENATE OF THE UNITED STATES

MAY 7 (legislative day, APRIL 9), 1979

Mr. JAVITS (for himself, Mr. GOLDWATER, Mr. DOMENICI, Mr. WILLIAMS, and Mr. PELL) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to provide for the taxation of artists' income and estates.

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. SHORT TITLE, AMENDMENT OF 1954 CODE.**
4 (a) SHORT TITLE.—This Act may be cited as the "Art-
5 ists Tax Equity Act of 1979".
6 (b) AMENDMENT OF 1954 CODE.—Except as otherwise
7 expressly provided, whenever in this Act an amendment or
8 repeal is expressed in terms of an amendment to, or repeal of,
9 a section of other provision, the reference shall be considered

1 to be made to a section or other provision of the Internal
2 Revenue Code of 1954.
3 **SEC. 2.**
4 Subchapter B of chapter 64 (relating to collection of
5 internal revenue taxes) is amended by inserting after section
6 6311 the following new section:
7 **"SEC. 6312. CREDIT AGAINST ESTATE TAX FOR CERTAIN**
8 **ARTWORKS.**
9 "(a) IN GENERAL.—A credit against the tax imposed
10 by chapter 11 (relating to estate tax) shall be allowed by the
11 the Secretary for the transfer of property subject to the pro-
12 visions of subsections (b), (c), (d), (e), and (f).
13 "(b) AMOUNT OF CREDIT.—The amount treated as a
14 credit shall be equal to the fair market value of the property
15 transferred as of the valuation date used for purposes of the
16 tax imposed (and interest thereon) by chapter 11 (relating to
17 estate tax).
18 "(c) ELIGIBLE PROPERTY.—A literary, musical, or ar-
19 tistic property, or similar property, shall qualify as property
20 whose transfer is eligible for the credit allowed by subsection
21 (a), provided,
22 "(1) the property is included in the gross estate of
23 the decedent (as defined in section 2031), whose per-
24 sonal efforts created the property,

1 "(2) the property is transferred without restric-
2 tions to a branch or department of the Government of
3 the United States or to an institution established under
4 chapter 3, sections 41 through 80 of title 20, United
5 States Code, for the purpose of making the property
6 available to the general public by display or access,
7 "(3) the transferee signs a written statement
8 that—
9 "(A) the property is material of artistic, musical,
10 or literary significance, and
11 "(B) the use of the property by the trans-
12 feree will be in accordance with paragraph (2),
13 "(d) GOVERNMENTAL ACCOUNTS.—A credit for trans-
14 fers under this section shall be allowed without reimburse-
15 ment or payment from the transferee to the Secretary.
16 "(e) INTEREST.—Unless the transferee determines and
17 certifies to the Secretary that there has been an expeditious
18 transfer of the property under this section, no interest pay-
19 able with respect to the tax imposed by chapter 11 shall be
20 deemed to be waived by reason of the provisions of this sec-
21 tion for any period before the date of such transfer.
22 "(f) DISALLOWANCE OF CREDIT OR DEDUCTION FOR
23 TRANSFERS ALLOWED AS ESTATE TAX CREDIT.—No
24 other credit or deduction shall be allowed under any other

1 section for any amount allowed as a credit by reason of this
2 section.
3 **SEC. 3.**
4 Subpart A of part IV of subchapter A of Chapter 1
5 (relating to credits allowable) is amended by inserting before
6 section 45 the following new section:
7 **"SEC. 44D. CERTAIN CONTRIBUTIONS OF LITERARY, MUSICAL,**
8 **OR ARTISTIC COMPOSITIONS.**
9 "(a) GENERAL RULE.—In the case of an individual,
10 there shall be allowed as a credit against the tax imposed by
11 this chapter for the taxable year an amount equal to 30 per-
12 cent of the fair market value of a literary, musical, or artistic
13 composition created by the personal efforts of that individual
14 and contributed by that individual to an organization de-
15 scribed in section 501(c)(3) which is exempt from tax under
16 section 501(a) or to a government unit described in 170(c)(1).
17 "(b) LIMITATIONS.—
18 "(1) INCOME FROM LITERARY, MUSICAL, OR AR-
19 TISTIC COMPOSITION.—The amount of the credit al-
20 lowed by subsection (a) for the taxable year may not
21 exceed the amount of tax under this chapter attributa-
22 ble to the gross income of the individual for the taxable
23 year attributable to the sale of literary, musical, or ar-
24 tistic compositions in that taxable year and in previous
25 taxable years.

1 "(2) AMOUNT OF CREDIT.—The amount of the
2 credit allowed under subsection (a) to the taxpayer for
3 the taxable year, after the application of paragraph (1),
4 shall not exceed the greater of—
5 "(A) so much of the taxpayer's liability for
6 tax under this chapter for the taxable year as
7 does not exceed $2,500, or
8 "(B) 50 percent of the taxpayer's liability for
9 tax under this chapter for the taxable year.
10 "(3) LIMITATION OF CONTRIBUTIONS.—No credit shall
11 be allowed under subsection (a) of any literary, artistic, or
12 musical composition to the extent that the total of such com-
13 positions contributed by such individual for the taxable year
14 to organizations described in subsection 501(c)(3) exceeds
15 $35,000.
16 "(4) CREDIT DENIED FOR CERTAIN LETTERS, MEMO-
17 RANDUMS, OR SIMILAR PROPERTY.—The credit allowed by
18 subsection (a) shall not be allowed for the contribution of a
19 letter, memorandum, or similar property which was written,
20 prepared, or produced by or for the individual while he held
21 an office under the Government of the United States or of
22 any State or political subdivision thereof if the writing, prep-
23 aration, or production of such property was related to, or
24 arose out of, the performance of the duties of such office.

1 "(c) CERTIFICATION REQUIRED.—No credit is allow-
2 able under subsection (a) for the contribution of a literary,
3 musical, or artistic composition by the taxpayer unless the
4 taxpayer receives from the donee a written statement that
5 the donated property represents material of artistic, musical,
6 or literary significance and that the use of such property by
7 the donee will be related to the purpose or function constitut-
8 ing the basis for its exemption under section 501 (or, in the
9 case of a governmental unit, to any purpose or function de-
10 scribed in section 170(c)(2)(B)).

11 "(d) CARRYOVER OF EXCESS CREDIT.—If the amount
12 of the credit determined under subsection (a) for any taxable
13 year exceeds the limitations provided by subsections (b)(2)
14 and (b)(4) for the taxable year, the excess shall be added to
15 the amount allowable as a credit under subsection (a) for the
16 next five succeeding taxable years to the extent it may be
17 used in those years.".

18 (b) Section 170(e) of such Code (relating to certain con-
19 tributions of ordinary income and capital gain property) is
20 amended by inserting at the end thereof the following:

21 "(4) DENIAL OF DEDUCTION FOR CERTAIN CON-
22 TRIBUTIONS OF LITERAL, MUSICAL, OR ARTISTIC
23 COMPOSITIONS.—No deduction shall be allowed under
24 this section for any contribution for which a credit is
25 claimed under section 44B.".

1 (c)(1) The table of sections for such subpart A is
2 amended by inserting immediately before the item relating to
3 section 45 the following:

"Sec. 44D. Certain contributions of literary, musical, or artistic compositions.".

4 (2) Section 42(b) of such Code (relating to the taxable
5 income credit) is amended by striking out "and" at the end of
6 paragraph (4), by inserting "and" at the end of paragraph
7 (5), and by inserting after paragraph (5) the following new
8 paragraph:
9 "(6) section 44D (relating to credit for certain
10 contributions of literary, musical, or artistic composi-
11 tions),".
12 **SEC. 4. LONGER PRESUMPTION PERIOD ALLOWED ARTISTS**
13 **AGAINST HOBBY LOSS TREATMENT.**
14 The last sentence of subsection (d) of section 183 (relat-
15 ing to activities not engaged in for profit) is amended by in-
16 serting after the second sentence the following new sentence:
17 "In the case of an activity which consists in major part of the
18 creation of literary, musical, or artistic property, or similar
19 property, by the personal efforts of the taxpayer, the first
20 sentence of this subsection shall be applied by substituting
21 the period of 10 consecutive taxable years for the period of 5
22 consecutive taxable years."

1 SEC. 5. CAPITAL GAIN TREATMENT FOR INHERITED COPY-
2 RIGHTS, ARTWORKS, ETC.
3 Subparagraph (C) of section 1221(3) (defining capital
4 asset) is amended by inserting "(other than by reason of sec-
5 tion 1023)" after "is determined".
6 SEC. 6. EFFECTIVE DATE.
7 The amendments made by this Act shall apply to tax-
8 able years beginning after December 31, 1978.

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96TH CONGRESS
1ST SESSION

S. 1435

To amend the Internal Revenue Code of 1954 to provide a system of capital recovery for investment in plant and equipment, and to encourage economic growth and modernization through increased capital investment and expanded employment opportunities.

IN THE SENATE OF THE UNITED STATES

JUNE 27 (legislative day, JUNE 21), 1979

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

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A BILL

To amend the Internal Revenue Code of 1954 to provide a system of capital recovery for investment in plant and equipment, and to encourage economic growth and modernization through increased capital investment and expanded employment opportunities.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

1 **SECTION 1. SHORT TITLE; TABLE OF CONTENTS; AMENDMENT**
2 **OF 1954 CODE.**

3 (a) SHORT TITLE.—This Act may be cited as the "Cap-
4 ital Cost Recovery Act of 1979".

5 (b) TABLE OF CONTENTS.—

Sec. 1. Short title; table of contents; amendment of 1954 Code.
Sec. 2. Capital cost recovery allowance.
Sec. 3. Changes in investment tax credit.
Sec. 4. Amendments related to depreciation.
Sec. 5. Disposition of recovery property subject to recapture under section 1245.
Sec. 6. Minimum tax amendment.
Sec. 7. Technical amendments.
Sec. 8. Effective date.

6 (c) AMENDMENT OF 1954 CODE.—Except as otherwise
7 expressly provided, whenever in this Act an amendment or
8 repeal is expressed in terms of an amendment to, or repeal of,
9 a section or other provision, the reference shall be considered
10 to be made to a section or other provision of the Internal
11 Revenue Code of 1954.

12 **SEC. 2. CAPITAL COST RECOVERY ALLOWANCE.**

13 (a) IN GENERAL.—Part VI of subchapter B of chapter
14 1 (relating to itemized deductions for individuals and corpora-
15 tions) is amended by inserting after section 167 the following
16 new section:

17 **"SEC. 168. CAPITAL COST RECOVERY DEDUCTION.**

18 "(a) ALLOWANCE OF DEDUCTION.—In the case of re-
19 covery property, there shall be allowed the recovery deduc-
20 tion provided by this section.

21 "(b) AMOUNT OF DEDUCTION.—

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1 "(1) IN GENERAL.—The recovery deduction for
2 the taxable year shall be the aggregate amount deter-
3 mined by applying to the capital cost of recovery prop-
4 erty the applicable percentage determined in accord-
5 ance with the following table:

"Capital Cost Recovery Table

"If the recovery year is—	The applicable percentage for the class of property is:		
	Class 1	Class 2	Class 3
1	10	20	33
2	18	32	45
3	16	24	22
4	14	16	
5	12	8	
6	10		
7	8		
8	6		
9	4		
10	2		

6 "(2) TRANSITIONAL APPLICABLE PERCENT-
7 AGES.—
8 "(A) For transitional applicable percentages
9 for additions to capital account of class 1 property
10 before 1984, see subsection (h)(2).
11 "(B) For transitional applicable percentages
12 for additions to capital account of certain class 2
13 property before 1984, see subsection (h)(3).
14 "(c) RECOVERY PROPERTY.—For purposes of this
15 title—
16 "(1) RECOVERY PROPERTY DEFINED.—Except as
17 otherwise provided in subsection (g), the term 'recov-

1 ery property' means tangible property (other than
2 land)—
3 "(A) used in a trade or business, or
4 "(B) held for the production of income.
5 "(2) CLASSES OF RECOVERY PROPERTY.—
6 "(A) CLASSIFICATION TABLE.—The classifi-
7 cation of recovery property shall be determined in
8 accordance with following table:

"Classification of Recovery Property

"Class 1	Class 2	Class 3
Buildings and structural components of buildings.	Recovery property not taken into account under class 1 or class 3.	Automobiles, taxis, and light-duty trucks.

9 "(B) $100,000 LIMIT FOR CLASS 3.—In the
10 case of any taxpayer for any taxable year, the
11 capital cost (for which such year is recovery year
12 1) taken into account under class 3 shall not ex-
13 ceed $100,000.
14 "(C) SPECIAL RULES FOR APPLYING THE
15 $100,000 LIMIT.—

"For special rules relating to the $100,000 limit, see subsection (i)(2).

16 "(d) CAPITAL COST.—
17 "(1) IN GENERAL.—For purposes of this section,
18 the term 'capital cost' means, with respect to any
19 property, the net addition to capital account for the

1 taxable year (determined without regard to the section
2 1016(a)(2) adjustment for such year).
3 "(2) SPECIAL RULES FOR PROPERTY NOT YET
4 PLACED IN SERVICE.—In the case of property which
5 has not been placed in service before the close of the
6 taxable year—
7 "(A) PAYMENT RULE.—Except as provided
8 in subparagraph (B), the addition to capital ac-
9 count shall be treated as made when payment of
10 an amount is made.
11 "(B) SELF-CONSTRUCTED PROPERTY.—If
12 the property is constructed (in whole or in part)
13 by the taxpayer, capital cost shall be determined
14 under paragraph (1) without regard to subpara-
15 graph (A) of this paragraph.
16 "(3) AMOUNTS MUST BE FOR PERIOD AFTER
17 1979.—For purposes of this section, capital cost does
18 not include any amount paid or properly charged to
19 capital account for any period before January 1, 1980.
20 "(4) SPECIAL RULES.—
21 "(A) PUBLIC UTILITY PROPERTY ELEC-
22 TION.—For election to determine capital cost of
23 public utility property by treating advance pay-
24 ments as made when property is placed in service,
25 see subsection (i)(3).

1 "(B) TRANSITIONAL RULE FOR FISCAL
2 YEAR TAXPAYERS.—For special transitional rule
3 for determining capital cost of fiscal year taxpay-
4 ers, see subsection (i)(5).
5 "(e) TAXPAYER MAY DEDUCT LESS THAN FULL AL-
6 LOWANCE.—
7 "(1) IN GENERAL.—For any taxable year the tax-
8 payer may deduct all or any portion of the amount al-
9 lowable under subsection (a). The deduction for any
10 taxable year may be increased or decreased at any
11 time before the expiration of the period prescribed for
12 making a claim for refund of the tax imposed by this
13 chapter for such taxable year.
14 "(2) CARRYOVER OF UNUSED DEDUCTIONS.—
15 Any amount allowable for the taxable year by subsec-
16 tion (a) but not deducted for such taxable year shall be
17 carried forward and may be claimed as a deduction for
18 any succeeding taxable year. Any deduction so claimed
19 shall be treated as an addition to the capital cost re-
20 covery deduction allowable under subsection (a) for
21 such succeeding taxable year.
22 "(3) ALLOCATION OF DEDUCTIONS.—If by reason
23 of paragraph (1) the taxpayer deducts less than the
24 amount allowable for any taxable year, the amount de-
25 ducted shall be apportioned among the taxpayer's re-

1 covery property in the same proportion as the amount
2 allowable in respect of the recovery property bears to
3 the total amount allowable in respect of recovery prop-
4 erty. A similar rule shall be applied in the case of the
5 allowance of a deduction in a succeeding taxable year
6 under paragraph (2).

7 "(4) ADJUSTMENTS TO BASIS.—For purposes of
8 section 1016(a)(2), in the case of recovery property the
9 amount allowable under this subtitle for exhaustion,
10 wear and tear, and obsolescence shall be the amount
11 allowable by subsection (a) of this section.

12 "(f) RECOGNITION OF GAIN OR LOSS AND ADJUST-
13 MENT TO CAPITAL COSTS ON RETIREMENT OR OTHER
14 DISPOSITION.—

15 "(1) GENERAL RULE.—Gain or loss shall be rec-
16 ognized on the disposition of recovery property, unless
17 nonrecognition is specifically required or permitted by
18 another provision of this chapter.

19 "(2) MASS ASSET ACCOUNTS.—In lieu of recog-
20 nizing gain or loss, a taxpayer who maintains mass
21 asset accounts of recovery property may, under regula-
22 tions prescribed by the Secretary, elect to include in
23 income all proceeds realized on the disposition of such
24 property.

1 "(3) Adjustment to capital cost.—For pur-
2 poses of this section, if gain or loss is recognized on
3 the disposition of recovery property, the capital cost of
4 such property shall cease to be capital cost as of the
5 beginning of the taxable year in which such disposition
6 occurs.
7 "(4) Disposition includes retirement.—For
8 purposes of this subsection, the term 'disposition' in-
9 cludes retirement.
10 "(g) Property Excluded From Application of
11 Section.—
12 "(1) Certain property excluded.—The term
13 'recovery property' does not include—
14 "(A) property placed in service by the tax-
15 payer before January 1, 1980,
16 "(B) residential rental property (within the
17 meaning of section 167(j)), and
18 "(C) property with respect to which the tax-
19 payer—
20 "(i) is entitled to elect amortization (in
21 lieu of depreciation), and
22 "(ii) elects such amortization.
23 "(2) Certain methods of depreciation.—
24 The term 'recovery property' does not include property
25 if—

1 "(A) the taxpayer elects to exclude such
2 property from the application of this section, and
3 "(B) for the first taxable year for which a
4 deduction would be allowable under this section
5 with respect to such property—
6 "(i) the property is properly depreciated
7 under the unit-of-production method, the re-
8 tirement-replacement method, or any other
9 method of depreciation not expressed in a
10 term of years, or
11 "(ii) the property is a leasehold im-
12 provement which is properly depreciated
13 over the term of the leasehold.
14 "(3) SPECIAL RULE FOR CERTAIN PUBLIC UTIL-
15 ITY PROPERTY.—
16 "(A) IN GENERAL.—In the case of public
17 utility property (within the meaning of section
18 167(l)(3)(A)), such property shall be treated as re-
19 covery property only if the taxpayer uses a nor-
20 malization method of accounting.
21 "(B) USE OF NORMALIZATION METHOD DE-
22 FINED.—For purposes of subparagraph (A), a tax-
23 payer uses a normalization method of accounting
24 with respect to any public utility property if both
25 the taxpayer's rates and its operating results on

1 its regulated books of account reflect a tax ex-
2 pense determined by—
3 "(i) a method of depreciation on the
4 property which is the same as, and
5 "(ii) a depreciation period for the prop-
6 erty which is no shorter than,
7 the method and period used to determine its de-
8 preciation expense on the property for purposes
9 of establishing its cost of service for ratemaking
10 purposes.
11 "(C) SECRETARY TO PRESCRIBE REGULA-
12 TIONS.—The Secretary shall provide such regula-
13 tions as may be necessary or appropriate to pre-
14 vent the reflection (directly or indirectly) in rates
15 or operating results of an amount of tax expense
16 which is inconsistent with either the depreciation
17 method described in subparagraph (B)(i) or the de-
18 preciation period described in subparagraph (B)(ii).
19 "(4) CERTAIN SALES, LEASES, AND OTHER
20 TRANSACTIONS IN PROPERTY PLACED IN SERVICE
21 BEFORE 1980.—The term 'recovery property' does not
22 include property acquired directly or indirectly from a
23 person who used such property before January 1,
24 1980, if—

1 "(A) within 1 year after the property is so
2 acquired, the property is leased back to such
3 person, or
4 "(B) the person so acquiring the property
5 bears a relationship specified in section 267(b) to
6 the person using such property before January 1,
7 1980.
8 "(h) TRANSITIONAL APPLICABLE PERCENTAGES FOR
9 CLASS 1 PROPERTY AND CLASS 2 PROPERTY.—
10 "(1) IN GENERAL.—The Secretary shall pre-
11 scribe tables setting forth transitional applicable
12 percentages—
13 "(A) for additions to capital account of class
14 1 property before January 1, 1984, and
15 "(B) for additions to capital account of class
16 2 property before January 1, 1984.
17 If for any taxable year for any property there is a
18 transitional applicable percentage, such transitional
19 percentage shall be substituted for the applicable per-
20 centage set forth in subsection (b).
21 "(2) TRANSITIONAL APPLICABLE PERCENTAGES
22 FOR CLASS 1 PROPERTY.—The transitional applicable
23 percentages for class 1 property shall be determined
24 in accordance with the following assigned recovery
25 periods:

"Transitional Recovery Periods for Class 1 Property

"For additions to capital account in—	The transitional applicable percentage shall be based on a capital cost recovery period of the following number of years.
1980	18
1981	16
1982	14
1983	12

1 "(3) TRANSITIONAL APPLICABLE PERCENTAGES
2 FOR CERTAIN CLASS 2 PROPERTY.—The transitional
3 applicable percentages for class 2 property shall be de-
4 termined in accordance with the following assigned re-
5 covery periods:

"Transitional Recovery Periods for Certain Class 2 Property

"For additions to capital account in—	The transitional applicable percentage shall be based on a capital cost recovery period of the following number of years:
1980	ADR lower limit.
1981	ADR lower limit minus 1 year.
1982	ADR lower limit minus 2 years.
1983	ADR lower limit minus 3 years.

6 The capital cost recovery period determined under this
7 paragraph shall in no case be less than 5 years.
8 "(4) ADR LOWER LIMIT DEFINED.—For pur-
9 poses of paragraph (3), the ADR lower limit for any
10 class of property is the lower limit of the asset depreci-
11 ation range in effect on June 27, 1979, for such class
12 of property under section 167(m). For purposes of the
13 preceding sentence, lower limits in excess of 9 years
14 shall be treated as equal to 9 years, and any lower

1 limit which is not a whole number of years shall be
2 rounded down to the next lower whole number of
3 years.
4 "(5) TABLES TO BE SIMILAR TO SUBSECTION (b)
5 TABLE.—The tables prescribed under paragraph (1) for
6 any class of property for any assigned recovery period
7 shall be based on principles similar to those used in the
8 construction of the table under subsection (b) for that
9 class of property.
10 "(i) DEFINITIONS AND SPECIAL RULES.—For pur-
11 poses of this section—
12 "(1) RECOVERY YEAR 1, ETC.—The term 'recov-
13 ery year 1' means, with respect to any capital cost, the
14 first taxable year for which a deduction with respect to
15 such cost is allowable under subsection (a). The imme-
16 diately following taxable year shall be recovery year 2,
17 and the taxable years which follow shall be numbered
18 accordingly.
19 "(2) SPECIAL RULES FOR APPLYING THE
20 $100,000 LIMIT FOR CLASS 3 PROPERTY.—
21 "(A) IN GENERAL.—If for any taxable year
22 the capital cost (for which such year is recovery
23 year 1) of automobiles, taxis, and light-duty
24 trucks exceeds $100,000, the taxpayer shall
25 select the items to be treated as class 3 property,

1 but only to the extent of an aggregate capital cost
2 of $100,000. Such a selection, once made, may be
3 changed only in the manner, and to the extent,
4 provided by such regulations.

5 "(B) MARRIED INDIVIDUALS.—In the case
6 of a husband or wife who files a separate return,
7 the limitation under subparagraph (A) and under
8 subsection (c)(2)(B) shall be $50,000 in lieu of
9 $100,000. This subparagraph shall not apply if
10 the spouse of the taxpayer has no property which
11 may be taken into account as class 3 property (for
12 which this is recovery year 1) for the taxable year
13 of such spouse which ends within or with the tax-
14 payer's taxable year.

15 "(C) CONTROLLED GROUPS.—In the case of
16 a controlled group, the $100,000 amount specified
17 under subparagraph (A) and under subsection
18 (c)(2)(B) shall be reduced for each component
19 member of the group by apportioning $100,000
20 among the component members of such group in
21 accordance with their respective amounts of capi-
22 tal cost of automobiles, taxis, and light-duty
23 trucks.

24 "(D) PARTNERSHIPS.—In the case of a
25 partnership, the limitation contained in subpara-

1 graph (A) and in subsection (c)(2)(B) shall apply
2 with respect to the partnership and with respect
3 to each partner.
4 "(E) CONTROLLED GROUP.—For purposes of
5 this paragraph, the term 'controlled group' has
6 the meaning assigned to such term by section
7 1563(a), except that the phrase 'more than 50
8 percent' shall be substituted for the phrase 'at
9 least 80 percent' each place it appears in section
10 1563(a)(1).
11 "(3) PUBLIC UTILITY MAY ELECT NOT TO TAKE
12 INTO ACCOUNT ADVANCE PAYMENTS.—
13 "(A) IN GENERAL.—In the case of public
14 utility property (within the meaning of section
15 167(l)(3)), the taxpayer may elect to treat all ad-
16 ditions to capital account for the period before
17 property is placed in service as made during the
18 taxable year in which the property is placed in
19 service.
20 "(B) EFFECT OF ELECTION.—An election
21 under subparagraph (A) shall apply to all public
22 utility property of the taxpayer for the taxable
23 year for which the election is made and all subse-
24 quent taxable years unless the Secretary consents
25 to a revocation of such election.

1 "(4) MAKING OF ELECTIONS.—Any election (or
2 selection) under this section shall be made at such time
3 and in such manner as the Secretary may by regula-
4 tions prescribe.
5 "(5) TRANSITIONAL RULE FOR DETERMINING
6 CAPITAL COST OF FISCAL YEAR TAXPAYERS.—If—
7 "(A) the taxpayer's taxable year is a period
8 other than the calendar year, and
9 "(B) a transitional applicable percentage ap-
10 plies to additions to capital account in any portion
11 of the taxable year,
12 then the capital cost for such taxable year shall be sep-
13 arately computed for each portion of a calendar year
14 included within the taxable year.
15 "(j) CROSS REFERENCE.—

"For special rule with respect to certain gain derived from disposition of property the adjusted basis of which is determined with regard to this section, see section 1245."

16 **SEC. 3. CHANGES IN INVESTMENT TAX CREDIT.**

17 (a) APPLICABLE PERCENTAGE.—Subsection (c) of sec-
18 tion 46 (relating to qualified investment) is amended by
19 adding at the end thereof the following new paragraph:
20 "(7) APPLICABLE PERCENTAGE FOR RECOVERY
21 PROPERTY.—Notwithstanding paragraph (2), the appli-
22 cable percentage for purposes of paragraph (1) shall
23 be—

1 "(A) in the case of class 1 or class 2 recov-
2 ery property (within the meaning of section 168),
3 100 percent, or
4 "(B) in the case of class 3 recovery property
5 (within the meaning of section 168), 60 percent."
6 (b) CREDIT FOR EXPENDITURES BEFORE PROPERTY
7 IS PLACED IN SERVICE.—Subsection (d) of section 46 is
8 amended to read as follows:
9 "(d) QUALIFIED PROGRESS EXPENDITURES.—
10 "(1) IN GENERAL.—The amount of the qualified
11 investment of any taxpayer for the taxable year (deter-
12 mined under subsection (c) without regard to this sub-
13 section) shall be increased by the aggregate of the ap-
14 plicable percentage of each qualified capital cost of the
15 taxpayer for the taxable year.
16 "(2) QUALIFIED CAPITAL COST.—For purposes
17 of paragraph (2), the term 'qualified capital cost' means
18 the capital cost described in section 168(d)(1) for the
19 taxable year with respect to any property which has
20 not been placed in service before the close of such tax-
21 able year if such property, when placed in service, can
22 reasonably be expected to be recovery property which
23 is section 38 property.

1 "(3) APPLICABLE PERCENTAGE.—For purposes
2 of paragraph (1), the term 'applicable percentage' has
3 the meaning given to such term by subsection (c)(7).
4 "(4) NO QUALIFIED PROGRESS EXPENDITURES
5 FOR PROPERTY FOR YEAR OF RECAPTURE.—In the
6 case of any property, no qualified progress expendi-
7 tures shall be taken into account under this subsection
8 for the first taxable year for which recapture is re-
9 quired under section 47(a)(3) with respect to such prop-
10 erty, or for any taxable year thereafter."
11 (c) AMENDMENT OF RECAPTURE RULES.—
12 (1) IN GENERAL.—Subsection (a) of section 47
13 (relating to certain dispositions, etc., of section 38
14 property) is amended by redesignating paragraphs (5),
15 (6), and (7) as paragraphs (6), (7), and (8), respectively,
16 and by inserting after paragraph (4) the following new
17 paragraph:
18 "(5) SPECIAL RULES FOR RECOVERY
19 PROPERTY.—
20 "(A) GENERAL RULE.—If during any tax-
21 able year section 38 recovery property is disposed
22 of, or otherwise ceases to be section 38 property
23 with respect to the taxpayer, before the close of
24 the recapture period, then the tax under this
25 chapter for such taxable year shall be increased

1 by the recapture percentage of the aggregate de-
2 crease in the credits allowed under section 38 for
3 all prior taxable years which would have resulted
4 solely from reducing to zero the qualified invest-
5 ment taken into account with respect to such
6 property.

7 "(B) RECAPTURE PERCENTAGE.—For pur-
8 poses of subparagraph (A), the recapture percent-
9 age shall be determined in accordance with the
10 following table:

"If the taxable year in which the recovery property ceases to be section 38 property is:	The recovery percentage for each class of property is:	
	Class 1 and Class 2	Class 3
The taxable year in which placed in in service	100 percent	100 percent.
The first taxable year after the year in which placed in service	80 percent	66 percent.
The second taxable year after the year in which placed in service	60 percent	33 percent.
The third taxable year after the year in which placed in service	40 percent	0 percent.
The fourth taxable year after the year in which placed in service	20 percent	0 percent.

11 "(C) DEFINITIONS AND SPECIAL RULES.—

12 "(i) SECTION 38 RECOVERY PROPERTY.—
13 For purposes of this paragraph, the term 'section
14 38 recovery property' means any section 38 prop-
15 erty which is recovery property (within the mean-
16 ing of section 168).

1 "(ii) RECAPTURE PERIOD.—For purposes of
2 this paragraph, the term 'recapture period' means,
3 with respect to any property, the period consisting
4 of the taxable year in which such property is
5 placed in service and the 4 succeeding taxable
6 years (the 2 succeeding taxable years in the case
7 of class 3 property).

8 "(iii) CLASSIFICATION OF PROPERTY.—For
9 purposes of this paragraph, property shall be clas-
10 sified as provided in section 168.

11 "(iv) PARAGRAPH (1) NOT TO APPLY.—
12 Paragraph (1) shall not apply with respect to any
13 recovery property."

14 (2) TECHNICAL AMENDMENTS.—

15 (A) Subparagraph (D) of section 47(a)(3) is
16 amended—

17 (i) by striking out "paragraph (1), para-
18 graph (1)" and inserting in lieu thereof
19 "paragraph (1) or (5), as the case may be,
20 such paragraph", and

21 (ii) by striking out "PARAGRAPH (1)" in
22 the subparagraph heading and inserting in
23 lieu thereof "PARAGRAPH (1) OR (5)".

24 (B) Paragraph (6) of section 47(a) (as redes-
25 ignated by paragraph (1)) is amended by striking

1 out "paragraph (1) or (3)" and inserting in lieu
2 thereof "paragraph (1), (3), or (5)".
3 (C) Subparagraph (B) of section 47(a)(7) (as
4 redesignated by paragraph (1)) is amended by
5 striking out "paragraph (5)" and inserting in lieu
6 thereof "paragraph (6)".
7 (d) AMENDMENT OF SECTION 48.—The last sentence
8 of section 48(a)(1) (defining section 38 property) is amended
9 by striking out "includes only property" and inserting in
10 lieu thereof "includes only recovery property and any other
11 property".

12 **SEC. 4. AMENDMENTS RELATED TO DEPRECIATION.**

13 (a) RECOVERY DEDUCTION TREATED AS DEPRECI-
14 ATION.—Subsection (a) of section 167 (relating to depreci-
15 ation) is amended by adding at the end thereof the following
16 new sentence: "In the case of recovery property (within the
17 meaning of section 168), the recovery deduction allowable
18 under section 168 shall be deemed to constitute the reason-
19 able allowance provided by this section, and such property
20 shall be considered for purposes of this title as property of a
21 character subject to the allowance provided under this sec-
22 tion."
23 (b) NO ADDITIONAL FIRST-YEAR DEPRECIATION FOR
24 RECOVERY PROPERTY.—Paragraph (1) of section 179(d)
25 (defining section 179 property) is amended by striking out

1 "and" at the end of subparagraph (B), by striking out the
2 period at the end of subparagraph (C) and inserting in lieu
3 thereof ", and", and by adding at the end thereof the follow-
4 ing new subparagraph:
5 "(D) which is not recovery property (within
6 the meaning of section 168)."
7 (c) TERMINATION OF CLASS LIFE SYSTEM.—Subsec-
8 tion (m) of section 167 (relating to class lives) is amended by
9 adding at the end thereof the following new paragraph:
10 "(4) TERMINATION.—This subsection shall not
11 apply with respect to property placed in service after
12 December 31, 1979."
13 **SEC. 5. DISPOSITION OF RECOVERY PROPERTY SUBJECT TO**
14 **RECAPTURE UNDER SECTION 1245.**
15 Paragraph (3) of section 1245(a) (defining section 1245
16 property) is amended by striking out "or" at the end of sub-
17 paragraph (C), by striking out the period at the end of sub-
18 paragraph (D) and inserting in lieu thereof ", or", and by
19 adding at the end thereof the following new subparagraph:
20 "(E) recovery property (within the meaning
21 of section 168)."
22 **SEC. 6. MINIMUM TAX AMENDMENT.**
23 Subsection (a) of section 57 (defining items of tax prefer-
24 ence) is amended by inserting after paragraph (11) the follow-
25 ing new paragraph:

1 "(12) CAPITAL COST RECOVERY DEDUCTION.—
2 "(A) IN GENERAL.—With respect to each
3 property which is class 1 or class 2 recovery
4 property (as determined under section 168) and
5 which is subject to a lease, the amount (if any) by
6 which the recovery deduction allowed for the tax-
7 able year is greater than the straight-line capital
8 cost recovery amount determined in accordance
9 with subparagraph (B).
10 "(B) STRAIGHT-LINE CAPITAL COST RECOV-
11 ERY AMOUNT.—For purposes of this paragraph,
12 the straight-line capital cost recovery amount
13 shall be the amount of the depreciation deduction
14 which would have been allowed for the taxable
15 year had the taxpayer depreciated the property,
16 beginning with the middle of the taxable year in
17 which placed in service, under the straight-line
18 method for each year of its useful life assuming—
19 "(i) a useful life of 10 years in the case
20 of class 1 recovery property, and
21 "(ii) a useful life of 5 years in the case
22 of class 2 recovery property.
23 "(C) LIMITATIONS.—
24 "(i) CORPORATIONS.—This paragraph
25 shall not apply to any taxpayer which is a

1 corporation (other than an electing small
2 business corporation as defined in section
3 1371(b)) and a personal holding company (as
4 defined in section 542).
5 "(ii) PROPERTY MANUFACTURED OR
6 PRODUCED BY TAXPAYER.—This paragraph
7 shall not apply with respect to any property
8 which is manufactured or produced by the
9 taxpayer.
10 "(D) PARAGRAPHS (2) AND (3) DO NOT
11 APPLY TO RECOVERY PROPERTY.—Paragraphs
12 (2) and (3) shall not apply to recovery property
13 (within the meaning of section 168)."
14 **SEC. 7. TECHNICAL AMENDMENTS.**
15 (a) EARNINGS AND PROFITS.—
16 (1) Subsection (k) of section 312 is amended by
17 redesignating paragraph (3) as paragraph (4) and by
18 inserting after paragraph (2) the following new
19 paragraph:
20 "(3) EXCEPTION FOR RECOVERY DEDUCTION.—
21 If for any taxable year a recovery deduction is allow-
22 able under section 168 with respect to any recovery
23 property, then the adjustment to earnings and profits
24 for depreciation of such property for such year shall be
25 the amount so allowable (but not in excess of the

1 straight-line capital cost recovery amount determined
2 under section 57(a)(12)(B))."
3 (2) The paragraph heading of paragraph (2) of
4 section 312(k) is amended to read as follows:
5 "(2) EXCEPTION FOR CERTAIN METHODS OF DE-
6 PRECIATION.—".
7 (b) AMENDMENT OF SECTION 381.—Subsection (c) of
8 section 381 is amended by adding at the end thereof the fol-
9 lowing new paragraph:
10 "(27) UNUSED DEDUCTIONS UNDER SECTION
11 168.—The acquiring corporation shall take into ac-
12 count (to the extent proper to carry out the purposes of
13 this section and section 168, and under such regula-
14 tions as may be prescribed by the Secretary) the items
15 required to be taken into account for purposes of
16 section 168 in respect of the distributor or transferor
17 corporation."
18 (c) AMENDMENT OF SECTION 383.—Section 383 (relat-
19 ing to special limitations on certain carryovers) is amended
20 by striking out "and to any net capital loss" and inserting in
21 lieu thereof "to any unused deductions under section 168(e),
22 and to any net capital loss".
23 **SEC. 8. EFFECTIVE DATE.**
24 The amendments made by this Act shall apply to tax-
25 able years ending after December 31, 1979.

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II

96TH CONGRESS
1ST SESSION

S. 1467

To amend the Internal Revenue Code of 1954 to provide that the retirement-replacement-betterment method of accounting for property used by a common carrier (including a railroad switching company or a terminal company) is an acceptable method for determining depreciation allowances for income tax purposes.

IN THE SENATE OF THE UNITED STATES

JULY 9 (legislative day, JUNE 21), 1979

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

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A BILL

To amend the Internal Revenue Code of 1954 to provide that the retirement-replacement-betterment method of accounting for property used by a common carrier (including a railroad switching company or a terminal company) is an acceptable method for determining depreciation allowances for income tax 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 (a) part VI of subchapter B of chapter 1 (relating to
4 itemized deductions for individuals and corporations) is
5 amended by numbering section 167(b)(4) as section 167(b)(5).

1 (b) Adding as a new subparagraph:

2 "(4) The retirement-replacement-betterment
3 method for property used by a common carrier by rail-
4 road (including a railroad switching company or a ter-
5 minal company).".

6 (c) The amendments made by subsections (a) and (b)
7 shall apply with respect to taxable years ending after Decem-
8 ber 31, 1953.

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

The subcommittee will today consider S. 1435, S. 1021, S. 1078 and S. 1467. A Joint Committee on Taxation bulletin describing these measures in greater detail has been prepared and will be included as a part of the record of these hearings.

[The material referred to follows:]

I. SUMMARY

1. S. 1021—Senator Danforth

Bondholder Taxable Bond Option and Credit

Under present law, interest received on obligations of State and local governments is generally exempt from Federal tax. Special exceptions and limitations apply to industrial development bonds and arbitrage bonds.

Under the bill, a taxpayer could elect to include interest received on a State or local government obligation in gross income. If taxable treatment is elected, the amount includible in gross income would be 167 percent of the interest received and a credit against tax would be allowed for an amount equal to 67 percent of the interest actually received. The rate of the credit generally provides the same benefit as a tax exemption provides for a taxpayer in the 40-percent tax bracket and a greater benefit for a taxpayer in a bracket below the 40-percent bracket.

2. S. 1078—Senators Javits, Goldwater, Domenici, Williams and Pell

Artists Tax Equity Act of 1979

This bill would provide several changes in Federal taxation of income and estates to benefit artists and their heirs.

Present law does not allow in-kind payment of Federal taxes. This bill would provide a credit against artists' estate tax liabilities for certain transfers of artists' work to the Federal Government.

The bill would allow artists to claim a 30-percent income tax credit for contributions of their own works to charitable organizations and certain United States government entities.

The bill also would liberalize the "hobby loss" rules for artists. The bill would double the present law five-year base period, so that artistic activity would be presumed engaged in for profit, if gross income from the creation of artworks exceeds deductions attributable to that activity for two or more of ten consecutive taxable years, unless the Internal Revenue Service can establish the contrary.

In addition, the pre-1976 capital gain treatment on the sale or exchange of certain artworks inherited from the artist would be restored.

3. S. 1435—Senators Nelson, Bentsen, Packwood, and Chafee

Capital Cost Recovery Act of 1979

For most depreciable assets, the Capital Cost Recovery Act of 1979 would replace existing depreciation rules with a system which provides an accelerated method of depreciation and useful lives which are

generally substantially shorter than present useful lives for most eligible depreciable real and personal property (although the lives of some items of personal property would be lengthened). The bill would generally permit a 10-year writeoff for plants and buildings (other than residential real estate), a 5-year writeoff for machinery and equipment, and a 3-year writeoff for a limited amount of investment in automobiles and light trucks. In general, the bill would allow accelerated deductions in the early years of the recovery period, roughly equivalent to using double declining balance depreciation for the first few years and then switching to sum-of-the-years'-digits depreciation. This system of accelerated deductions would apply to both new and used property. Also, the period over which the cost of an asset could be recovered would begin with the earlier of the year in which such costs are paid or incurred or the year in which the asset is placed in service (rather than only with the year in which the asset is placed in service, as under current law). The bill contains transitional rules to phase-in the application of the 10-year and 5-year writeoffs (in certain cases) over the period 1980–1983 so that the provisions would not be fully effective until 1984.

The bill also would shorten the useful life requirement for eligibility for the full 10-percent investment credit from 7 years to 5 years and would provide that assets qualifying for a 3-year writeoff would be eligible for a 6-percent investment credit (instead of a 3⅓ percent credit under existing law). The rules for the recapture of investment credit also would be liberalized.

Under the bill, the depreciation recapture rules for real estate covered by the new provisions would be revised to provide for a recapture of all depreciation (rather than only accelerated depreciation) upon sale or other disposition. The bill also would revise the "add-on" minimum tax so that, in the case of real property subject to the new rules, the tax preference for accelerated depreciation on real property would apply only to leased property.

4. S. 1467—Senators Dole and Bentsen

Method of Accounting for Railroad Track Assets

Under present law, the Internal Revenue Service allows the railroad industry to use the retirement-replacement-betterment (RRB) method of accounting for railroad track assets, which is the same method required for these assets by the Interstate Commerce Commission. Under the RRB method, when a new railroad line is laid, the costs (for rail, ties, ballast, fasteners, and labor) are capitalized, and these costs are not depreciated, but when replacements are made to an existing line, the replacement costs are deducted currently.

The RRB method is not codified as part of the Internal Revenue Code, but is recognized as an acceptable method in court decisions and Internal Revenue Service rulings. The bill would codify the RRB method, effective for taxable years ending after December 31, 1953.

II. DESCRIPTION OF BILLS

1. S. 1021—Senator Danforth

Bondholder Taxable Bond Option and Credit

Present law

Present law provides that interest on State and local obligations is generally exempt from Federal tax. However, with certain exceptions, tax-exempt status is denied to industrial development bonds (sec. 103(b) of the Code) and arbitrage bonds (sec. 103(c) of the Code).

Background

From the viewpoint of State and local governments which must attract the individual investor into the tax-exempt market, interest yields on tax-exempt issues must rise until they are equal to the yield after taxes on comparable risk taxable investments, e.g., corporate bonds. Individual taxpayers in the 70-percent marginal tax bracket, for example, would find that a tax-exempt bond yield which is 30 percent of a taxable bond yield is equal to the after-tax yield on the taxable bond. For an individual in the 50-percent marginal tax bracket, the ratio must be at least 50 percent, and the ratio must be 72 percent for a taxpayer in the 28-percent bracket.

Because there are relatively few persons in the highest marginal tax bracket,[1] the increasing volume of tax-exempt issues makes it necessary for State and local governments to increase the yield on tax-exempt issues relative to taxable corporate issues substantially above the 30-percent ratio in order to attract additional investors. The higher yield on tax-exempt bonds, relative to the after-tax yields on taxable issues, attracts some of the more numerous taxpayers in lower marginal tax brackets who then find tax-exempt issues desirable investments at these higher interest rates.

As this happens, the differential between tax-exempt and taxable bonds is reduced, and higher tax-bracket investors can be viewed as receiving a "bonus" return since they would hold tax-exempt bonds even at a lower rate of interest. The amount of the bonus is the difference between the interest yield that would be sufficient to stimulate the purchase of a tax-exempt issue by a high-bracket taxpayer and the higher current market interest yield that is necessary to bring the additional investors from lower tax rate brackets into the tax-exempt bond market. The greater the difference between the current market interest rate and the interest rate which would just induce an investor to purchase tax-exempt issues, the greater is the bonus return to the investor in high marginal tax brackets.

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[1] The highest marginal tax rate for individuals presently is 70 percent. For corporations, the highest marginal tax rate is 46 percent. The analysis for both tax structures is identical.

As a result of this bonus, it has been argued that the cost to the Federal Government in foregone tax revenue substantially exceeds the resulting reduction in the borrowing costs of State and local governments.

Issue

The issue is whether a bondholder taxable bond option and credit should be enacted to attract investments by taxpayers (whose income is subject to a marginal tax rate of less than 40 percent) and tax-exempt organizations and thereby broaden the tax-exempt bond market.

Explanation of bill

General

Under the bill, holders of certain tax-exempt bonds would be given an election either (1) to exclude from gross income the interest on the empt organizations and thereby broaden the tax-exempt bond market. tax-exempt bonds as under present law, or (2) to include in gross income 167 percent of such interest and claim a tax credit equal to 67 percent of the amount of the tax-exempt interest on the bond. The 67-percent rate for the credit generally provides a bondholder in the 40-percent tax bracket, who elects the credit, the same tax benefit as tax exemption provides.

The bill also makes the election available to shareholders of regulated investment companies with respect to exempt interest dividends attributable to interest on certain tax-exempt obligations.

The bill would not affect the method in which tax-exempt bonds are issued and would not subject issues of tax-exempt bonds to any additional regulation by the Department of the Treasury.

Under the bill, any U.S. person would be eligible to make the bondholder election. Thus, tax-exempt organizations (such as charities and qualified pension and profit sharing plans) also would be eligible for the bondholder election. Generally, the credit would be refundable for organizations exempt from the Federal income tax (such as charities and qualified pension and profit sharing plans) and would be nonrefundable for others.

In general, all obligations issued after the effective date which, under present law, would be exempt from tax under the Internal Revenue Code would be eligible for the bondholder election. This includes general obligation bonds, revenue bonds, and short-term obligations such as tax anticipation notes. However, industrial development bonds, as that term is presently defined in the Internal Revenue Code, are not to be eligible for the election even if those bonds are eligible for tax exemption under the Code.

In addition, any obligation which is held by a related entity if the obligation is not issued pursuant to a public underwriting would not be eligible for the election.

The bill establishes two tests to define a public underwriting. First, competitive bids for the rights to sell the obligation to the general public must be solicited from independent parties, such as underwriters. Second, 25 percent or more of the obligations sold must be acquired by persons which are not related entities.

The bill defines related entities to include, in the case of obligations of either a State or a municipality of that State, that State and any

political subdivision of that State. In the case of obligations issued by an instrumentality of two or more States, all of the States involved and political subdivisions within those States are considered to be related entities to the instrumentality. Under this provision, any agency or instrumentality of a State or political subdivision (including any trust or plan for the benefit of the employees of a State or political subdivision) is treated as part of the State or political subdivision. Thus, a municipality's pension fund is a related entity of that municipality, of all other municipalities in that State and of that State government.

Regulated investment companies and certain other entities

Under present law, mutual funds may, under certain circumstances, distribute to their shareholders dividends which are excludible from gross income, but only to the extent of the amount of the mutual fund's interest income which is excluded from gross income under 103(a). The bill provides that mutual funds may elect the credit with respect to qualified tax-exempt interest to the extent that it is not attributable to amounts designated as exempt-interest dividends. The treatment of certain other entities, such as subchapter S corporations, partnerships, estates and trusts is to be determined pursuant to regulations prescribed by the Secretary.

Time and manner of making election

The election to claim the credit is to be made with the Federal income tax return filed for the taxable year in which the interest or dividend is received. The bondholder may make the election to include the tax-exempt interest in gross income for one year and to exclude the interest on the bond for another taxable year. In addition, an election once made for a taxable year may be changed at any time before expiration of the period for making a claim for a credit or refund.

Interest on indebtedness incurred to hold municipal bonds

The bill also provides that interest or expenses paid or incurred in order to purchase or carry any tax-exempt bond for which an election is made remains subject to the interest disallowance rules (sec. 265), and other rules which apply to tax-exempt income.

Effective date

This provision would apply to tax-exempt bonds issued after December 31, 1979. Any refunding of an ineligible obligation will also be ineligible for the election.

Revenue effect

It is estimated that the bill would reduce budget receipts by $6 million in fiscal year 1980, by $74 million in fiscal year 1981, by $244 million in fiscal year 1982, by $403 million in fiscal year 1983, and by $526 million in fiscal year 1984.

Prior Congressional action

The provisions of this bill were included as a Senate Finance Committee amendment to the Revenue Act of 1978 (sec. 336 of H.R. 13511). The amendment was deleted from the bill on the Senate floor to provide additional time to evaluate the proposal.

2. S. 1078—Senators Javits, Goldwater, Domenici, Williams, and Pell

Artists Tax Equity Act of 1979

This bill would amend the Internal Revenue Code to make several changes in Federal taxation of income and estates to benefit artists and their heirs.

A. Artists Estate Tax Credit

Present law

Under present law, the Secretary of the Treasury may accept legal tender checks or money orders in payment of an estate tax liability. There is no provision authorizing the Secretary of the Treasury to accept other forms of payments, such as the conveyance of real or personal property.[1]

Issue

The issue is whether artists' estates should be allowed a credit against the Federal estate tax for the fair market value of artworks transferred to the Federal Government or the Smithsonian Institution.

Explanation of provision

Under the bill, a credit would be allowed against the Federal estate tax liability of an artist's estate for certain transfers of artworks to the Federal Government. Qualifying property would be literary, musical, or artistic property, or similar property, which is included in the gross estate of the artist who created the property. The property would be required to be transferred without restrictions to a Branch or Department of the Federal Government or to the Smithsonian Institution. The bill would require that property be transferred and accepted for the purpose of making it available to the general public.

In order to insure that credit be allowed only for property of artistic merit and that the property be available to the general public, the bill would require the recipient of the property to sign a statement attesting that the property has artistic, musical, or literary significance and that the recipient will make it available to the public.

The amount of the credit allowed under the bill would be equal to the fair market value of the property transferred, determined as of the valuation date used for Federal estate tax purposes. The credit would reduce Federal estate tax liability on a dollar-for-dollar basis. However, no amount of the credit would be refundable. The bill provides that interest would accrue if the property is not transferred expeditiously.

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[1] Under section 2010 of the Tax Reform Act of 1976, the Secretary of the Treasury was authorized to accept conveyance of real property bordering the Toiyabe National Forest as payment of estate tax imposed on the estate of La Vere Redfield.

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The bill also contains an "anti-double dipping" rule to disallow a credit or deduction with respect to the transferred property under any other Code provision, if the estate tax credit is claimed. The bill would allow Governmental units which receive creditable transfers of property to accept the property without making reimbursement or payment to the Treasury for the estate tax liability offset by the transfer.

Revenue effect

It is estimated that this provision will reduce budget receipts by $5 million annually.

B. Artists Income Tax Credit

Present law

Present law allows taxpayers an income tax deduction for contributions of property to charitable organizations. Generally, the amount deductible for contributions of ordinary income property is limited to the donor's adjusted basis. Correspondingly, artists who donate their own works to a charity may claim a deduction equal to the cost of the materials used in the creation of the work. Generally, donors, other than the creators of the donated artwork, may claim an income tax deduction equal to the fair market value of the donated work. However, if the use of the artwork by the charity is unrelated to its exempt function, the amount taken into account as a charitable contribution by an individual donor is reduced by 40 percent of the unrealized appreciation in the artwork. In addition, this reduction is made in the case of contributions of appreciated artwork to certain private foundations. Similiar rules apply to charitable transfers of appreciated property by corporate taxpayers.

Issue

The issue is whether income tax deductions claimed by artists for charitable contributions of their own works should be treated in the same manner as contributions of other ordinary income property, and thus limited to the artists' costs for materials used in the work, or should be treated differently.

Explanation of provision

The bill would provide a nonrefundable income tax credit equal to 30 percent of the fair market value of literary, musical, or artistic compositions which were created by the artist's personal efforts and which the artist contributes to a charitable organization or to Federal, State, or local governments.

No credit would be allowed for contributions in excess of $35,000 in any year. The credit would be limited to 50 percent of the artist's income tax liability for the year, unless the liability is less than $2,500, in which case the credit would be available up to the full amount of the liability. A taxpayer would be allowed to carry forward any credits in excess of these limitations for the 5 years succeeding the taxable year. No credit would be allowed for Federal, State, or local government officials' contributions of official papers, memoranda, or similar property, prepared in connection with the performance of their duties of office.

In order to claim a credit for a contribution, the taxpayer must obtain from the donee a written statement that the donated property

represents material of artistic, musical, or literary significance and that the donee's use of the property will be related to the donee's exempt purpose. No income tax deduction would be allowed with respect to any contribution for which this credit is claimed.

Revenue effect

It is estimated that this provision will reduce budget receipts by $10 million annually.

C. Ten-Year Hobby Loss Base

Present law

A taxpayer may not claim deductions for losses arising from activities not engaged in for profit. Under Code section 183(d), a taxpayer is presumed to be engaged in an activity for profit for the current taxable year if, in two or more years of the period of five consecutive taxable years ending with the current taxable year, the activity was carried on at a profit.[8] If the presumption applies, the burden of establishing that the activity was not engaged in for profit shifts to the Internal Revenue Service.

Issue

The issue is whether an artist should be allowed a base period longer than 5 years for establishing that the artist's creation of artworks is engaged in for profit.

Explanation of provision

The bill would liberalize the presumption under Code section 183(d) by doubling the base period. The bill would provide that, if gross income from the creation of literary, musical, or artistic property, or similar property, for 2 or more taxable years during a period of 10 consecutive taxable years exceeds deductions attributable to the activity, the activity would be presumed to be engaged in for profit, unless the Internal Revenue Service can establish to the contrary.

Revenue effect

It is estimated that this provision will reduce budget receipts by less than $5 million annually.

D. Capital Gain Treatment for Inherited Artworks

Present law

Prior to the estate and gift tax changes made by the Tax Reform Act of 1976, gain from the sale or exchange of a copyright, literary, musical, or artistic composition, letter or memoranda, and similar property which had been inherited from the artist who created the property was taxed as a capital gain. Under the carryover basis rules adopted by the Tax Reform Act of 1976, such inherited property will be excluded from the definition of a "capital asset" because its basis was determined by reference to (carried over from) the decedent's basis.

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[8] In the case of an activity consisting primarily of breeding, training, showing or racing horses, the test is made on the basis of a 7-year period rather than the 5-year period.

Presently, the carryover basis rules are scheduled to apply to property passing from a decedent dying after December 31, 1979.

Issue

The issue is whether an artwork, which is inherited from the artist who created it and which is carryover basis property, should be treated as capital gain or ordinary income property when held by the artist's heir.

Explanation of provision

The bill would classify copyrights, literary, musical, or artistic compositions, letters or memoranda, and similar property as capital assets if held by a heir of a taxpayer who created the property or in the case of a letter or memorandum or similar property, if held by a heir of the taxpayer for whom the property was prepared or produced.

Revenue effect

It is estimated that this provision will reduce budget receipts by less than $5 million annually.

E. Effective Date of Bill

All provisions of the bill would apply to taxable years beginning after December 31, 1978. (The amendment relating to capital gain treatment for inherited artworks would only affect property passing from decedents dying after 1979 since the carryover basis rule does not apply before then.)

3. S. 1435—Senators Nelson, Bentsen, Packwood, and Chafee

Capital Cost Recovery Act of 1979

PRESENT LAW

A. Depreciation

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.

Depreciation of personal property

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.). Administrative practice has permitted the 150-percent declining balance method to be used for used tangible personal property.[3]

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 cir-

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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).

[3] Rev. Rul. 57-352, 1957-2 C.B. 150; Rev. Rul. 59-389, 1959-2 C.B. 89. Accelerated methods are not allowed for intangible assets (sec. 167(c)).

cumstances 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, declining balance (up to 200 percent), or sum-of-the-years-digits 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.[4]

Eligible property

An ADR election applies only to eligible property. Generally, eligible property is new or used depreciable property for which an asset

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[4] 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 taxpaper 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.

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.[5]

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. 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). Under the ADR system, there are 14 asset classes for specific categories of depreciable assets. These categories apply to assets of specific types (e.g., automobiles) regardless of the type of business in which the assets are used. There are also approximately 118 classes (or subclasses) of depreciable assets grouped by the type of activity in which the assets are used. Table 1 illustrates the useful lives of a limited number of asset classes under ADR.

[5] Section 5 of Public Law 93–625.

TABLE 1.—ADR USEFUL LIVES OF VARIOUS ASSETS

Description of assets in guideline class	Asset depreciation range (in years) Lower limit	Asset guideline period	Upper limit
Certain short-lived assets:			
Manufacture of fabricated metal products—special tools	2.5	3	3.5
Manufacture of motor vehicles—special tools	2.5	3	3.5
Breeding hogs	2.5	3	3.5
Manufacture of electrical equipment—special tools	4.0	5	6.0
Certain intermediate-lived assets:			
Data handling equipment except computers	5.0	6	7.0
Assets used in drilling of oil and gas wells	5.0	6	7.0
Manufacture of electronic products	6.5	8	9.5
Certain long-lived assets:			
Railroad cars and locomotives, except those owned by railroad transportation companies	12.0	15	18.0
Vessels, barges, tugs and similar water transportation equipment, except those used in marine contract construction	14.5	18	21.5
Industrial steam and electric generation and/or distribution systems	17.5	22	26.5
Telephone central office equipment	16.0	20	24.0

Source: Revenue Procedure 77-10, 1977-1 C.B. 548, as modified by Rev. Proc. 79-26, 1979-18 I.R.B. 21.

"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 guidelines 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 of real property

Accelerated methods

Under present law, a depreciation deduction is allowed for the exhaustion, wear, and tear of buildings used in a trade or business or held for the production of income. New residential rental buildings may be depreciated under the declining balance method at a rate of up to 200 percent of the straight-line rate, the sum of the years-digits method, or any other method if the aggregate depreciation allowable during the first two-thirds of the property's useful life does not exceed the amount allowable under the 200-percent declining balance method. For this purpose, a building or structure is considered to be residential rental property for any taxable year only if 80 percent or more of the gross rental income is from the rental of dwelling units. New commercial buildings may be depreciated under the declining balance method at 150 percent of the straight-line rate. Used residential properties with an estimated useful life of 20 years or more can be depreciated under the declining balance method at a rate of up to 125 percent of the straight-line rate. All other used properties must be depreciated under the straight-line method.

Certain rehabilitation expenditures for low-income rental housing may be amortized on a straight-line basis over a period of 60 months. Qualified rehabilitation expenditures for certified historic structures also may be amortized over a 60-month period. Alternatively, in some cases, the cost of an historic structure, including the rehabilitation expenditures, may be depreciated as a new building, for example, under the 200-percent declining balance method for residential property or the 150-percent declining balance method for nonresidential property.

A 60-month amortization method is also available for certified pollution control facilities and certain expenditures for child care facilities.

Generally, in the case of all real estate other than certain low-income rental housing, depreciation in excess of straight-line depreciation is subject to recapture as ordinary income upon a sale or exchange of the property (rather than being considered long-term capital gain). All of the depreciation allowable, including straight-line depreciation, is recaptured as ordinary income if the property is not held for more than 12 months. Any gain in excess of the amount recaptured as ordinary income is treated as gain from the sale or exchange

of property used in a trade or business (sec. 1231). This portion of a gain is aggregated with gains and losses from other sales or exchanges of property used in a trade or business. After aggregation, a net gain is eligible for capital gains treatment and a net loss is treated as an ordinary loss.

In the case of 5-year amortization, gain is generally recaptured as ordinary income for the full amount of the amortization allowable in the same manner as recapture for depreciable personal property. However, in the case of low-income housing rehabilitation expenditures and qualified rehabilitation expenditures for certified historic structures, gain is recaptured as ordinary income only to the extent of the amortization allowable in excess of straight-line depreciation in essentially the same manner as for depreciable real property generally.

Accelerated depreciation on real property in excess of straight-line is treated as a tax preference for minimum tax purposes, reduces the amount of personal service income eligible for the 50-percent maximum tax on personal service income, and is not taken into account in determining the earnings and profits of a corporation.

Useful lives

Under present law, depreciation for real estate may be determined by estimating useful lives under a facts-and-circumstances test or under lives prescribed under Revenue Procedure 62-21, as in effect on December 31, 1970. Guideline lives under the class life asset depreciation range system (ADR) generally have not been prescribed for real property.

Under Revenue Procedure 62-21, useful lives are prescribed for certain types of buildings. The useful lives are based on a composite account for the structural shell and all integral parts, including air-conditioning, fire prevention, and power requirements, and equipment such as elevators and escalators. The lives exclude special-purpose structures which are an integral part of a production process and are normally replaced when the equipment housed is replaced. The lives are set forth in Table 2.

TABLE 2.—GUIDELINE LIVES FOR THE CERTAIN BUILDINGS UNDER REVENUE PROCEDURE 62-21

Type of Building	Useful life (years)
Apartments	40
Banks	50
Dwellings	45
Factories	45
Garages	45
Grain Elevators	60
Hotels	40
Loft Buildings	50
Machine Shops	45
Office Buildings	45
Stores	50
Theaters	40
Warehouses	60

Generally, as indicated in Table 3, taxpayers have claimed useful lives that are shorter than those listed in Rev. Proc. 62-21.

TABLE 3.—COMPARISON OF 1962 GUIDELINES AND LIVES CLAIMED FOR CERTAIN BUILDING TYPES

[In years]

Building type	Guideline lives under revenue procedure 62-21	Average lives claimed by taxpayers (new buildings only)	Percentage of taxpayers claiming lives shorter than guideline lives
Retail (including shopping centers)	50	36	93
Warehouses	60	37	99
Factories	45	37	77
Office buildings	45	41	91
Banks	50	43	79
Apartments	40	32	78

Source: Office of Industrial Economics. Department of the Treasury, *Business Building Statistics* (GPO, Washington, 1975).

Furthermore, by use of the component depreciation method, some taxpayers have claimed depreciation deductions which approximate the deductions which would be obtained by the use of composite lives of as short as 16-20 years on certain new commercial buildings.[6] However, there is no certainty that these deductions would be allowed by IRS or the courts.

Other rules relating to depreciation

Additional first-year depreciation

Under present law, the provision for additional first-year depreciation (sec. 179) permits an owner of tangible personal property with a useful life of six years or more 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).[7] Thus, the maximum additional first-year depreciation deduction is limited to $2,000 ($4,000 for individuals filing a joint return).

[6] Under this depreciation method, a taxpayer allocates the cost of a building to its basic component parts and then assigns separate useful lives to those components. These components would include the basic building shell, plumbing and heating system, roof, and other identifiable components. Each of the component parts is then depreciated as a separate item of property.

[7] 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.

Recapture

Under present law, with certain limited exceptions, gain from the disposition of depreciable personal property (and certain other property—generally property which is eligible for the investment credit) is "recaptured" as ordinary income to the extent of the depreciation taken (sec. 1245). Gain in excess of the depreciation taken may be treated as capital gain under section 1231 (unless the gain is aggregated with losses on sec. 1231 assets).

Generally, in the case of all real estate other than certain low-income rental housing, depreciation in excess of straight-line depreciation is subject to recapture as ordinary income upon a sale or exchange of the property (rather than being considered long-term capital gain). All of the depreciation allowable, including straight-line depreciation, is recaptured as ordinary income if the property is not held for more than 12 months. Any gain in excess of the amount recaptured as ordinary income is treated as gain from the sale or exchange of property used in a trade or business (sec. 1231). This portion of a gain is aggregated with gains and losses from other sales or exchanges of property used in a trade or business. After aggregation, a net gain is eligible for capital gains treatment and a net loss is treated as an ordinary loss.

Accelerated depreciation and the minimum tax

Under present law, a 15-percent minimum tax is imposed on the amount of a taxpayer's tax preferences in excess of the greater of (1) $10,000 ($5,000 in the case of married individuals filing separately), or (2) the amount of the regular income tax in the case of a corporation and one-half of the amount of the regular income tax in the case of an individual.[8]

One of the tax preferences in the minimum tax is accelerated depreciation on leased personal property.[9] The tax preference is the amount by which the income tax deduction for depreciation (or amortization) exceeds the depreciation deduction which would have been allowed if the property had been depreciated under the straight line method of depreciation for each year of its useful life for which the taxpayer owned the property. If the leased property is depreciated under the ADR system and the taxpayer chooses to use a shorter life than the ADR class life established for the asset, any increase in depreciation for the year on account of using a useful life shorter than the class life is included in the amount of the preference. Thus, additional ADR depreciation is a preference even if the straight line method is used rather than an "accelerated" method. This tax preference does not apply to corporations other than personal holding companies and subchapter S corporations.

With respect to real property (sec. 1250 property), accelerated depreciation, i.e., the excess of the deduction for depreciation (or amortization) over straight line depreciation, is a tax preference item.

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[8] The 15-percent minimum tax is separate and apart from the alternative minimum tax (under sec. 55).

[9] For this purpose, the term "personal property" means property which is subject to depreciation recapture under section 1245.

These tax preference items also reduce the amount of personal service taxable income eligible for the 50-percent maximum tax on personal service taxable income.

Earnings and profits

Generally, a corporate distribution with respect to the corporation's stock is a dividend only if it is made out of the corporation's current or accumulated "earnings and profits." Generally, earnings and profits are computed in a manner similar to the manner in which taxable income is computed. However, a number of adjustments and special rules apply.

Under one of these special rules, for taxable years beginning after straight-line depreciation) is not taken into account for purposes of determining earnings and profits (sec. 312(k)).

B. Investment tax credit

Present law provides a 10-percent regular investment credit and a 10-percent energy investment credit for investments in certain tangible property used in a trade or business or for the production of income. The amount of each credit is generally 10 percent of a taxpayer's eligible cost in acquiring qualifying property. The credits are used to offset the taxpayer's income tax liability.[10]

To be eligible for these credits, property must be depreciable or amortizable with a useful life of three years or more. However, reduced credits are allowed where property has a useful life of less than seven years. Under these rules, if the property has a useful life of three or four years, a credit is allowed on one-third of the cost of the property. Similarly, a credit is allowed on two-thirds of the cost where the property has a useful life of five or six years. This determination is generally made on the basis of the useful life which is used for purposes of depreciation or amortization. These useful life limitation rules are also applied where the credit has been claimed and the property is later disposed of by the taxpayer before the end of its useful life. In such situations, the credit is recomputed on the basis of its actual useful life in the hands of the taxpayer, which may result in a reduction in the allowable credit and a recapture of the excess credit from the taxpayer.

For purposes of the regular investment credit, qualifying property includes tangible personal property (such as motor vehicles, machinery and office equipment) and also other tangible property (such as blast furnaces, pipelines, railroad track and utility poles) used as an integral part of manufacturing, production, extraction or furnishing certain services, including electrical, gas and steam utility services. However, buildings and their structural components are not generally eligible for the regular investment credit. Qualifying property for purposes of the energy investment credit includes boilers, burners and

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[10] Under certain circumstances, a corporate taxpayer may elect an additional one percent investment tax credit if an amount equal to on percent of the qualified investmtent for the year is contributed to an employee stock ownership plan (ESOP). Further, an additional one-half of one percent investment tax credit is available if (a) an equivalent amount is contributed to the ESOP by the taxpayer and is matched by employee contributions and (b) certain other requirements concerning the operation of the ESOP are met.

related fuel handling and pollution control equipment to burn substances other than oil or natural gas or to convert these alternate substances into a fuel. In addition, energy property includes equipment which uses solar, wind, or geothermal energy, and equipment to produe either natural gas from geopressurized brine or oil from shale. Equipment used to recycle solid waste, as well as certain specially defined equipment (such as heat wheels) added to existing facilities to utilize otherwise wasted heat and gases, also qualifies as energy property. The energy credit is available for buildings and their structural components which otherwise qualify as energy property. However, the energy credit does not extend to energy property used to provide electrical, gas, steam and other public utility services.

Generally, the investment credits are claimed for the taxable year in which qualifying property was placed in service. However, in cases where property is constructed over a period of two or more years, an election is provided under which the credit may be claimed on the basis of progress expenditures made during the period of construction before the property is completed and placed in service.

The regular investment credit may be used to offset the first $25,000 of tax liability plus a percentage of tax liability in excess of $25,000. This percentage is 60 percent for 1979 and will increase by increments of 10 percentage points a year to 90 percent for 1982 and later years. The energy credit applies against all tax liability not offset by the regular credit, and energy credits for solar and wind energy property are fully refundable to the extent they exceed tax liability. Other excess regular and energy credits from a taxable year may be carried over to apply against tax liability for the three preceding and seven succeeding years.

DEPRECIATION AND OTHER INVESTMENT INCENTIVES IN SELECTED FOREIGN COUNTRIES

In general

It is argued that increases in productivity are less in the United States than in other industrialized nations in part because the United States provides lesser tax incentives for capital investment than other industrialized nations. Brief summaries of the depreciation rules (and other tax incentives for investment) of five industrialized nations are set forth below. In general, the nations selected are either major competitors or major trading partners of the United States. These rules are generally the rules in effect as of January 1, 1978.[11] Since these summaries are not exhaustive, in some cases definitive conclusions cannot be drawn as to whether the countries referred to below provide greater tax incentives for capital investment than the United States.

West Germany

Depreciation

In general

The beneficial owner of fixed tangible or intangible assets which have a determinable useful life in excess of one year may deduct a reasonable allowance for depreciation. In general, a taxpayer is required to deduct depreciation only in the year which it is allowable, and the deduction may not be deferred to a later year. However, it appears that depreciation allowances which have been inadvertently unclaimed when allowable may be deductible in later years.

The basis of an asset for purposes of depreciation is the cost of acquisition or manufacturing. Immovable assets can be depreciated only by using the straight-line method. On the other hand, in the case of movable fixed assets, straight-line, 2.5 times declining balance, and the production basis methods are permitted. If the declining balance method is used, the rate may not exceed 25 percent. Additional depreciation may be claimed when assets are subject to heavy use. In these situations, the straight line rates may be increased by 25 percent for two-shift use and by 50 percent for three-shift use.

A change from the declining balance method to the straight-line method is permissible, but not vice versa. Salvage value may be ignored at the taxpayer's election unless the salvage value is expected to be substantial. Because profits on disposal of fixed assets are taxable at the same rates as ordinary commercial profits, this factor has little significance and German companies seldom take it into account in determining their depreciation policy. At any time during the life of a movable asset, the going concern value, if lower than the adjusted cost basis, may be substituted for it. Also, it appears that a deduction for obsolescence resulting from technological or economic

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[11] Where depreciation rules are different for individuals and corporations, the rules applicable to corporations are set forth.

factors is allowable. However, on movable fixed assets which are being depreciated on the declining balance method, special depreciation for obsolescence cannot be deducted.

The depreciation taken in the commercial financial statements may exceed the depreciation shown on the tax statements, but not vice versa. This rule appears to require that depreciation claimed for tax purposes must be reflected in earnings statements.

The rates of depreciation permissible for fixed assets other than buildings are not fixed by statute, but the Federal Ministry of Finance publishes a table of recommendations. Since local finance offices can deviate from the tables in individual cases, the actual rates are a matter of negotiation. It appears that the following straight-line rates are generally accepted: machinery, 10–12 percent; automobiles and trucks, 20–25 percent; office equipment, 10–20 percent; computers, 20 percent; industrial buildings, such as factories and warehouses, 2–4 percent; office furniture, 10 percent.

Movable fixed assets can be depreciated under a 250-percent declining balance method at an annual rate not in excess of 25 percent.

In general, the depreciation rate for buildings is fixed by statute at a straight-line rate of 2 percent. However, buildings completed on or after December 1, 1977, can be depreciated under the declining balance method at the following rates:

(1) for the year of completion and each of the 11 subsequent years, 3.5 percent.

(2) for each of the following 20 years, 2 percent; and

(3) for each of the following 18 years, 1 percent.

Expenditures on movable fixed assets which cost DM 800 (about $460, as of October 1, 1979) or less may be written off in full during the year of acquisition.

Special depreciation and amortization for specific types of investment

Among the special rules for the recovery of costs of specific types of investment are the following:

(1) An initial allowance of 60 percent is permitted for depreciable personal and immovable assets serving the purposes of environmental protection (air pollution, water pollution, noise protection, etc.) if such assets are acquired or manufactured after December 31, 1974, but before January 1, 1979. In subsequent years, an annual depreciation rate of 10 percent is permissible until full amortization.

(2) In addition to normal depreciation, an initial allowance of 50 percent of the cost of movable fixed assets and 30 percent of the cost of immovable fixed assets is granted for investments in certain qualifying private hospitals, provided the assets are acquired or manufactured after December 31, 1976.

(3) Enterprises situated on the borders of the Iron Curtain Countries may be allowed a writeoff in the initial five years of 50 percent of the cost of movable fixed assets and 30 percent of the cost of buildings.

(4) An initial allowance of 40 percent is granted for new merchant ships and of 30 percent for aircraft registered in Germany.

This allowance may be spread over five years if (a) the ship or aircraft is acquired or manufactured before January 1, 1979, and (b) the ship is held for a period of not less than eight years (six years in the case of aircraft).

Under general rules for the application of special accelerated depreciation allowances, such allowances may not be used to create or increase a loss.

Other investment incentives

No investment tax credit is provided.

Japan

Depreciation

In general

Depreciation is allowed for all tangible fixed assets such as buildings, machinery, ships, etc. However, leasehold rights are not depreciable assets. The initial value of assets for purposes of depreciation is the acquisition cost of purchased assets, the total costs of manufacture or construction of assets produced internally, or the fair market value of assets acquired by gift, exchange or otherwise. Both the straight line and the declining balance (where allowable) calculations assume residual value of 10 percent of the acquisition cost of almost all tangible assets, but assets may be depreciated or amortized down to a residual value of 5 percent for tangible assets and 0 percent for intangibles. Certain manufacturing plants and the equipment therein are depreciated as a unit.

Depreciation may be deducted for tax purposes as entered on the books of the company and may be charged against profits, up to the limits established by law. Apparently this rule requires that all depreciation deducted for tax purposes be taken into account in computing earnings for financial purposes.[12]

The entire cost of depreciable assets may be deducted currently if the cost is less than 100,000 yen per unit or if the useful life is less than one year.

The Ministry of Finance has established standard useful lives for almost all depreciable assets. If shorter useful lives can be justified to the relevant regional tax bureau, the shorter lives may be used. If a shorter useful life is approved due to obsolescence, depreciation for previous years may be recomputed on the basis of the shorter useful life and the excess of depreciation (as computed over the depreciation actually deducted during such years) may be currently expenses.[13]

"Ordinary depreciation" is allowed for most assets, and the statutory limits on deductibility are calculated to reflect the average actual decline in economic value of the assets, as determined in accordance with generally accepted accounting principles. However, the Special Tax Measures Law allows special accelerated depreciation for certain types of assets.

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[12] If the depreciation deducted for financial purposes exceeds the statutory limits, the excess may be carried over and, taken together with subsequent book depreciation, deducted up to the statutory limits in subsequent years.

[13] A corporation may make its own reasonable estimate of the remaining useful life of used property.

Ordinary depreciation

Most assets eligible for ordinary depreciation may be depreciated using the straight-line method, the declining balance method, or another method specifically approved by the relevant regional tax bureau. The unit of production method may be used for assets used in the mining industry. A change in depreciation methods is subject to the prior approval of the relevant local tax office.

Special accelerated depreciation

A corporation meeting certain requirements may accelerate the depreciation of certain specified assets by either of two accelerated methods. In addition to ordinary depreciation, under the "special additional depreciation" method, a corporation may deduct during each year an additional percentage of the ordinary depreciation taken for such year. Examples of the amounts of special additional depreciation allowed for certain eligible assets are as follows:

(*a*) newly constructed rental housing, 100–150 percent of ordinary depreciation (depending on the useful life);

(*b*) qualified crude oil storage tanks, 50 percent of ordinary depreciation; and

(*c*) new machinery, plant, etc. of a small corporation installed as part of an approved modernization plan, 50 percent of ordinary depreciation.

Under the "special initial depreciation" method, a certain percentage of the acquisition costs of eligible assets may be deducted during the year when the assets are first placed in use. Examples of the amounts of special initial depreciation allowed for certain eligible assets are as follows:

(*a*) qualified manufacturing plants installed in the Okinawa free trade zone, 33⅓ percent of acquisition cost;

(*b*) qualified facilities to prevent pollution, 50 percent of acquisition cost;

(*c*) qualified plants equipped with special antipollution devices and qualified energy efficient plants, 25 percent of acquisition cost; and

(*d*) certain machinery using data processing equipment, 25 percent of acquisition cost.

Both the special additional depreciation and the special initial depreciation may be accounted for in the normal way by reducing the basis of the assets, thus reducing the amount of depreciation in future years. Alternatively, these amounts may be credited to a special depreciation reserve account, in which case basis is not reduced and ordinary depreciation may be taken on the remaining basis. If this latter approach is used, the amounts credited to the special depreciation reserve account must be taken back into income in equal installments over the immediately succeeding seven years. (Any allowable special depreciation which was not actually taken during the preceding three years may be credited to this special depreciation reserve account currently.)

Any tangible asset may not be depreciated, either through ordinary or special depreciation, to a residual value of less than 5 percent of original cost.

Investment credit, etc.

No general investment tax credit is provided. However, a special tax credit is allowed for any corporation which has increases in its research and experimental expenses and training costs of programmers and systems engineers for electric computers. This tax credit cannot exceed 10 percent of the corporation tax.

Certain special incentives are also available for overseas investment and reserves for designated percentages of export gross receipts.

France

Depreciation

In general, tangible assets are usually depreciated over the following useful lives—

Industrial buildings	20 years.
Commercial buildings	20 to 50 years.
Equipment and tools	4 to 10 years.
Office furniture	10 years.

Under French tax law, most depreciable assets must be depreciated on the straight-line method. However, new industrial and commercial equipment, plants to be used for conserving raw materials, and certain other assets may be depreciated under the declining balance method. Generally, the rates of depreciation under the declining balance method are obtained by multiplying the straight-line rates by a special co-efficient which is 1.5 for assets with a normal useful life of 3 to 4 years, 2 from 5 to 6 years and 2.5 from 6⅔ to 20 years.

The declining balance method is not allowed for:

(1) buildings (except for hotels and light buildings, the useful life of which does not exceed 15 years);

(2) passenger cars;

(3) pickup trucks;

(4) typewriters, telephone installations, and office furniture; and

(5) used property.

The cumulative depreciation on fixed assets recorded on a company's books as of each year must be at least equal to the normal cumulative straight line depreciation for each category of fixed assets. If any [illegible]

[illegible]

[illegible]

industrial water purification and pollution control, if they are acquired before December 31, 1980, and are parts of industrial installations existing on December 31, 1976.

An exceptional writeoff during the year of completion is permitted for 25 percent of the cost of buildings erected for industrial and commercial purposes, if the building has been started by December 31, 1977 (subject to Ministerial approval).

United Kingdom

Depreciation

In general, the full cost of all machinery and equipment (other than automobiles not used for public hire or the conveyance of goods or passengers) may be deducted in the year the expenditure is made. This rule applies to both new and used property. Also, it appears that the taxpayer may deduct all or any portion of the amount allowable and carry the rest over to succeeding years in such amounts as he desires.

An industrial building may be depreciated by taking a depreciation deduction of 50 percent in the first year and thereafter writing down the building at a rate of 4 percent per annum.

An alternative means of recovering expenditures for machinery and plant is to write down the undepreciated capital cost at a rate of 25 percent per year (on the declining balance method.) This declining balance method of depreciation at a rate of 25 percent per annum generally applies to automobiles which do not qualify for the full deduction in the year of the expenditure. Depreciation allowances are generally recaptured on the disposal of the assets.

Depreciation may be deducted only with respect to certain specified categories of assets. It appears that the main types of assets for which depreciation is not allowable are nonindustrial buildings (e.g., offices, hotels, showrooms, and retail shops), intangible assets other than patents, and, in certain circumstances, know-how.

Other investment incentives

It appears that development area grants of [illegible] percent to [illegible] percent of the capital expenditure on machinery and plant are available for certain expenditures. These grants do not reduce a taxpayer's basis for depreciation purposes. Other incentives may also be available in development areas for certain investments.

Canada

Depreciation

[illegible]

exceed the undepreciated capital cost of the entire class of property to which that item belongs.

In addition, a special 2-year writeoff is allowed for machinery and equipment for Canadian manufacturing and processing operations.

Unlike certain other systems described above, tax depreciation is not required to conform to book depreciation.

Other incentives

Certain regional development incentives are available under various Federal and provincial programs. These programs offer substantial incentives to encourage corporations to locate their manufacturing facilities in areas of slow economic growth.

Canada provides an investment tax credit of 5 percent (or 7½ percent or 10 percent, depending upon the region in Canada) of the cost of certain buildings, machinery and equipment if such assets are (1) acquired before July 1, 1980, and (2) are to be used in manufacturing, processing, or other specified activities. This credit reduces capital cost for tax depreciation purposes. The amount of this credit allowable may not exceed the sum of $15,000 plus one-half of the amount by which the Federal income tax otherwise payable exceeds $15,000. Any unused investment credit may be carried forward for up to 5 years.

ISSUES

The bill raises a number of issues. The most general issue is whether additional tax incentives are needed at this time to encourage capital formation or increase productivity. If so, a second issue is whether an approach which focuses mainly on accelerating depreciation allowances would be more appropriate than an approach which would be based primarily on rate reductions or an increased investment tax credit.

If it is appropriate to adopt an approach based on accelerating the deductions for the cost of depreciable property, the specific issues raised by this bill include the following:

(a) Whether the period over which assets are to be written off should be a specified period unrelated to the asset's economic useful life.

(b) Whether asset classes should be limited to a very few classes.

(c) Whether percentages of asset cost should be prescribed for each year of a recovery period (or useful life) in a manner which reflects accelerated methods of cost recovery.

(d) Whether used property should be entitled to the same type of depreciation or cost recovery system (including accelerated methods) as new property.

(e) [illegible]

[illegible]

[illegible]

[illegible]

(i) Whether a cost recovery system reflecting relatively short useful lives and accelerated depreciation should apply to depreciable real property.

(j) Whether the cost recovery system should apply to utility property (since utilities are required to normalize depreciation and the investment tax credit for rate-making purposes).

(k) Whether the investment tax credit should be revised to provide eligibility for the full credit for otherwise eligible assets using a 5-year cost recovery period and for a 60-percent credit for otherwise eligible assets using a 3-year recovery period.

(l) Whether investment tax credit recapture should be revised to provide for proportional recapture based on the number of years the asset is actually in service.

(m) Whether the depreciation recapture rules should apply to all depreciation on real property rather than only the accelerated portion of such depreciation.

(n) Whether the item of tax preference for accelerated depreciation on real property should apply to all real property or only to leased property.

Another issue is whether the expected capital formation and productivity gains to be expected from this measure are appropriate taking into account the revenue effects. A further issue is the extent to which budget constraints may limit or delay the implementation of tax revisions such as those suggested by the bill.

EXPLANATION OF THE BILL

A. In general

For most depreciable assets, the bill would replace existing depreciation rules with a system which provides an accelerated method of depreciation and useful lives which are generally substantially shorter than present useful lives for most eligible depreciable real and personal property (although the lives of some items of personal property would be lengthened, e.g., certain machine tools). The bill would generally permit a 10 year writeoff for plants and buildings (other than residential real estate), a 3 year writeoff for a limited amount of [illegible]

[illegible]

credit under existing law). The rules for the recapture of investment credit also would be liberalized.

Under the bill, the depreciation recapture rules for real estate covered by the new provisions would be revised to provide for a recapture of all depreciation (rather than only accelerated depreciation) upon sale or other disposition. The bill also revises the "add-on" minimum tax so that, in the case of real property subject to the new rules, the tax preference for accelerated depreciation on real property would apply only to leased property.

B. Capital cost recovery deduction

Eligibile property

Most property currently subject to an allowance for depreciation would be covered by the new capital cost recovery system. Eligible property, referred to as "recovery property," would generally include both new and used tangible property (other than land) that is used in a trade or business or held for the production of income. However, recovery property would not include: (1) property placed in service by the taxpayer before January 1, 1980; (2) residential rental property; (3) property which may be amortized (in lieu of depreciated) and for which the taxpayer elects such amortization; (4) property subject to a method of depreciation not expressed in a term of years (such as property depreciated under the units of production or machine-hour methods of depreciation); (5) leasehold improvements properly depreciated over the term of the leasehold, if the taxpayer elects to exclude such property or improvements from the rules of this new provision; and (6) property which is acquired from a person who had used the property before January 1, 1980, if either (a) the property is leased back to the person from whom it was acquired within one year after acquisition, or (b) the taxpayer and the person using the property before January 1, 1980, are related parties (within the meaning of sec. 267(b)).

Computation of recovery deduction

The recovery deduction would be determined by applying a statutory percentage to the capital cost of the recovery property. Recovery property would be separated into three classes, and the applicable percentage would be provided in the following capital cost recovery table.

Capital Cost Recovery Table

If the recovery year is:	The applicable percentage for the class of property is:		
	Class 1	Class 2	Class 3
[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	
[illegible]	[illegible]	[illegible]	
[illegible]	[illegible]		
[illegible]	[illegible]		
[illegible]	[illegible]		
[illegible]	[illegible]		
[illegible]	[illegible]		

In general, use of this table would result in a deduction which approximates the deduction which would result from using—(1) double declining balance depreciation for the earliest years of the recovery period, (2) sum-of-the-year's-digits depreciation for later years, (3) the half-year convention (under which all capital cost is treated as added to capital account on the first day of the second half of the taxable year), and (4) no salvage value.

Real property

Class 1 would include buildings and their structural components. When fully effective (in 1984), the capital cost of class 1 property would be recovered over a period of ten recovery years and the applicable percentages would range from 10 percent in the first recovery year and 18 percent in the second recovery year to 2 percent in the tenth recovery year.[14]

The bill contains a transitional rule which provides a phase-in for the recovery of costs of class 1 property. For capital costs added to capital account in 1980, 1981, 1982 or 1983, the recovery periods are 18 years, 16 years, 14 years and 12 years, respectively. These transitional rules apparently contemplate the same general type of accelerated recovery as would apply under the general rules.

Tangible personal property

Class 2 would generally include all tangible personal property not included in class 3 (relating to certain automobiles, etc.), and, when fully effective, the capital cost would be recovered over a period of five recovery years. The applicable percentages for class 2 property would range from 20 percent in the first recovery year and 32 percent in the second recovery year to 8 percent in the fifth recovery year. For recovery property included in class 2, transitional recovery periods and recovery percentages are to be provided for recovery property subject to the new recovery allowance rules if the capital cost of the recovery property is paid or incurred prior to 1984. Under these rules, the recovery period of assets for which the shortest permissible useful lives under ADR are more than [illegible] years but not less than [illegible] years [15] would be as follows:

For additions to capital account in—	The [illegible] recovery period is—
[illegible]	[illegible]
[illegible]	[illegible]
[illegible]	[illegible]
[illegible]	[illegible]

[illegible]

[14] [illegible]

[15] [illegible]

contemplate the same general type of accelerated recovery as would apply under the general rules.

Automobiles, taxis, and light-duty trucks

Class 3 property would include automobiles, taxis and light duty trucks, but the capital cost of such items to be taken into account could not exceed $100,000 for any taxable year. The capital cost of class 3 recovery property would be recovered over a term of 3 years, the applicable percentages amounting to 33 percent, 45 percent, and 22 percent in the first, second, and third recovery years, respectively.[16] The bill provides that any capital cost in excess of $100,000 for automobiles, taxis, and light duty trucks for any taxable year would be included in class 2. Special rules are also provided for (1) apportioning the $100,000 limit among the component members of a controlled group of corporations, (2) reducing the limit in the case of husband and wife filing separate returns, and (3) applying the limitation at both the partner and partnership levels.

Special rules for public utility property

The bill provides that public utility property is eligible to be treated as recovery property (i.e., eligible for the benefits of the bill) only if the taxpayer uses a normalization method of accounting. In general, a normalization method of accounting requires that, for ratemaking purposes, the tax benefits from accelerated depreciation, the investment credit, and other tax incentives are *not* immediately flowed through to customers but instead are prorated over the useful lives of the properties with respect to which the benefits are given. The rule in the bill (proposed sec. 168(g)(3)) is similar to rules in present law relating to the investment credit and accelerated depreciation (secs. 46(f) and 167(l)).

Commencement of cost recovery period

In general, the capital cost of recovery property is to be taken into account for purposes of computing the recovery allowance at the earlier of the year payment is made or the year property is placed in service. However, for self constructed assets, the cost of recovery property is to be taken into account in the earlier of the year the property is placed in service or the year for which the cost is properly added to capital account under the taxpayer's method of accounting.[17] The bill [illegible]

[illegible]

[illegible]

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 (sec. 167(f)). Thus, if salvage value is less than 10 percent, it may be ignored. A taxpayer must estimate the salvage value of each asset placed in service in a taxable year. The estimate is made on the basis of the facts and circumstances existing at the end of that taxable year.

The bill would result in the elimination of salvage value limitations on cost recovery deductions for both real property and personal property if the cost of such property is recovered under the new capital cost recovery provisions.

While these changes would not appear to have a significant effect for most depreciable personal property, the elimination of the salvage value restrictions may have a significant effect for depreciable real property (because the salvage value of such property tends to be significant and such property is not subject to the "10-percent of basis" reduction rule described above).

Election to deduct less than amount allowable

In any recovery year, the entire amount of the allowable recovery deduction may be taken into account, or, at the election of the taxpayer, only a portion thereof. The amount taken into account may be increased or decreased by the taxpayer before the expiration of the time for making a claim for refund. If only a portion of the recovery deduction is taken into account, the unused amount may be carried forward and taken into account in a subsequent taxable year. By contrast, under present law, depreciation must be deducted in the year in which it is allowable, and even if no depreciation deduction is claimed in such year, the basis of a depreciable asset must be reduced by the depreciation allowable.

Under the bill, if only a portion of the recovery deduction is taken [illegible]

[illegible]

[illegible]

nized, a recovery deduction with respect to the disposed recovery property is not allowed in the taxable year in which the disposition takes place.

C. Changes in the investment tax credit

Useful life requirement

Under present law, 100 percent of the cost of qualified property with a useful life for depreciation purposes of 7 years or more is eligible for the investment tax credit. If the useful life for depreciation purposes is 3 years or more but less than 5 years, only 33⅓ percent of the cost of the property qualifies for the investment credit, and if the useful life is 5 years or more but less than 7 years, 66⅔ percent of the cost of the property qualifies for the investment credit.

The bill would provide that, for class 1 or class 2 property (i.e., property for which the recovery period is at least 5 years), 100 percent of the capital cost is to be taken into account for purposes of the investment credit, and, for class 3 property, 60 percent of the capital cost is to be taken into account for such purposes. The investment tax credit would be allowable, subject to present law rules, in the first taxable year for which a recovery deduction is allowable with respect to the property if the property can reasonably be expected to qualify as investment tax credit property under present law rules.[19]

Recapture rules

The bill would also provide for new rules with respect to recapturing the investment tax credit on recovery property qualifying under this new provision. Qualified investment tax credit property which is classified as either class 1 or class 2 property would be subject to investment tax credit recapture if the property were to be disposed of within the first five years of it having been placed in service. One hundred percent of the investment tax credit claimed with respect to qualified investment tax credit property in classes 1 and 2 would be recaptured if a disposition of the property occurs in the first year in which the property is placed in service; the amount of investment tax credit recaptured thereafter would decrease at the rate of 20 percent per year. Thus, at the beginning of the fifth taxable year after the qualified property was placed in service, the investment tax credit claimed with respect to such property would not be recapturable. [illegible]

[19] [illegible]

able year following the taxable year in which such property is placed in service, any investment tax credit claimed with respect to such property would not be subject to investment tax credit recapture. (These rules contrast with the current recapture rules which generally recapture any investment credit which would not have been allowable if the useful life taken into account in computing the credit had been the period from the date the asset had been placed in service until the date of disposition.)

D. Other changes relating to depreciation

Additional first-year depreciation

Under present law, additional first-year depreciation amounting to 20 percent of the cost of tangible personal property with a useful life of six years or more (subject to certain dollar limitations) is allowed as a deduction. The bill would provide that property which is recovery property would not be entitled to additional first-year depreciation.

Recapture

Under present law, all depreciation allowable with respect to personal property is subject to depreciation recapture and treated as ordinary income upon disposition at a gain. Similarly, with certain exceptions, depreciation allowed on real estate in excess of straight-line depreciation (but not straight-line depreciation) is also subject to recapture. The bill would provide that all depreciation allowed with respect to recovery property, whether personal or real property, would be subject to depreciation recapture under the rules currently applicable to personal property. Thus, the allowable recovery amount deducted under the provisions of this bill would be subject to ordinary income treatment upon the disposition of the recovery property to the extent of gain.

Minimum tax

Under present law, the accelerated portion of depreciation on real property is an item of tax preference in the "add on" minimum tax. This item of tax preference applies to both corporate and noncorporate taxpayers. Also, for individual taxpayers, subchapter S corporations, and personal holding companies, accelerated depreciation on leased personal property is an item of tax preference. (This tax preference takes account of the acceleration due to use of the ADR system as well as acceleration due to the accelerated methods of recovery.)

[illegible]

[illegible]

subchapter S corporations and personal holding companies; also these provisions would not be applicable to property manufactured or produced by the taxpayer.

Earnings and profits

Under present law, earnings and profits of corporations are generally computed by taking into account only straight-line depreciation. Under the bill, earnings and profits would be computed by taking into account only straight-line capital recovery.

Carryover of corporate attributes

Under present law, many corporate attributes (such as net operating loss carryovers) of an acquired corporation may be utilized by another corporation which acquires the acquired corporation (or its assets) in any of certain types of tax-free reorganizations. The bill provides that the unused capital cost recovery deduction of a corporation is a tax attribute subject to these carryover rules. In general, the carryover of this unused deduction is subject to the same limitations as apply to the carryover of net operating losses.

EFFECTIVE DATE

The amendments made by this bill would be effective with respect to taxable years ending after December 31, 1979.

REVENUE EFFECT

The revenue estimate for this bill is not yet available.

4. S. 1467—Senators Dole and Bentsen

Method of Accounting for Railroad Track Assets

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, 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, to decay or decline from natural causes, to exhaustion and to obsolescence, the acquisition cost (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.

The railroad industry, however, generally uses for tax purposes what is called the "retirement-replacement-betterment" (RRB) method of accounting for railroad track (rail) and ties, and other items in the track accounts such as ballast, fasteners, other materials and labor costs. Although the RRB method is not specifically recognized as an allowable method of depreciation or accounting under the Internal Revenue Code, it has been allowed in court decisions and is recognized by the Internal Revenue Service in revenue rulings.[1] The Service's recognition of this method for tax purposes is based upon the requirement by the Interstate Commerce Commission (ICC) that this method be used for rate-making purposes. Although the ICC now requires use of the RRB method, it is presently considering a change to require the use of ratable depreciation.

For assets accounted for under the RRB method, when a new railroad line is laid, the costs (both materials and labor) of the line are capitalized. No depreciation is claimed on the original installation, but these original costs may be written off if this line is retired or abandoned. If the original installation is replaced with components (track, ties, etc.) of a like kind or quality, the costs of the replacements (both materials and labor) are deducted as current expense. When the replacement is of an improved quality, it generally is treated as a betterment, under which the betterment portion of the replacement is capitalized and the remainder is expensed.[2] Where rail and other track assets are retired, the salvage value [illegible]

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[1] [illegible]

[2] [illegible]

value) of the recovered materials is reflected as ordinary income.[3]

The operation of the RRB method can be illustrated by the following examples. If the original installation of a new rail line included a railroad tie which cost $3, this cost is capitalized and no ratable depreciation is allowed. When this tie is replaced with a tie which currently costs $20, the $3 original cost remains frozen and the $20 replacement cost is deducted currently. Where a betterment is involved, for example, where 100-pound rail is replaced with 150-pound rail which costs $120, under the RRB method the betterment portion ($40) [4] is capitalized and the replacement portion ($80) is deducted currently.

Issue

The issue is whether the retirement-replacement-betterment method of accounting for railroad track assets should be codified as an acceptable method of depreciation for Federal income tax purposes.

Explanation of the bill

The bill would codify the retirement-replacement-betterment method of accounting for railroad track assets as an acceptable method of depreciation for Federal income tax purposes.[5]

Effective date

The provisions of the bill would be effective for taxable years ending after December 31, 1953 (the general effective date of the Internal Revenue Code of 1954).

Revenue effect

It is estimated that this bill will have no effect on budget receipts. The estimate is based on the assumption that the Internal Revenue Service would not, without this legislation, require a change in the method of accounting for tax purposes to a ratable depreciation method from the presently accepted retirement-replacement-betterment method.

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[3] See, e.g., Seaboard Coast Line Railroad Company, Successor by Merger to Atlantic Coast Line Railroad Company v. Commissioner, [illegible] T.C. [illegible], No. [illegible] (August [illegible], [illegible]).

[4] The $40 betterment portion is computed as follows:

[illegible]

[5] [illegible]

Senator BYRD. Each of these measures deserves careful consideration. However, S. 1435, to provide more rapid depreciation of business investment and machinery equipment and buildings is of special importance.

In the industrial sector, spiraling inflation has a self-generating momentum as rising inflation drags down capital spending, cutting the growth in productivity, raising labor costs and bringing on more inflation.

The high rate of inflation demonstrates that tax policies directed at encouraging greater consumer spending and demand will only create more inflation. What is needed is fiscal discipline in restraining Government spending, and tax policies which encourage greater productivity and real economic growth.

Growth in capital investment which raises productivity and reduces unit labor costs can have a positive effect on lowering inflation.

The proposal S. 1435, which replaces current depreciation methods with the capital cost recovery method has great merit. The proposal will require careful consideration. I do, however, have some reservations about a 10-year writeoff for structures.

The revenue loss for this measure will have to be studied closely. In this regard, the phasein period is important. However, while short-term revenue losses may occur, in my mind, accelerated depreciation methods are attractive as a means of encouraging greater investment.

In the long run, potential revenue losses will diminish as depreciation reductions are used up on an accelerated basis and tax revenues will be recovered on the sale of the asset.

Now, this legislation was introduced by Senator Nelson and Senator Bentsen. Senator Nelson is to be the first witness.

Senator Nelson is not here at the moment. Senator Bentsen, would you like to proceed?

Senator BENTSEN. Thank you very much, Mr Chairman

As one of the original sponsors of S. 1435, the Capital Cost Recovery Act, I am very pleased, Mr. Chairman, that you have called this meeting at such an early date so that we can start the discussion and debate on this issue

This legislation would substantially boost the depreciation schedule and is critical if we want to find some long-term solutions to fighting inflation

I think that this proposal is of particular importance to small businesses across the country. What we are trying to avoid is the [illegible]

[illegible]

[illegible]

measure. Ever since World War II, the major focus of our economic policy have been to stimulate demand in this country. We have, in effect, become a nation of demand junkies.

The Joint Economic Committee, for the first time in 20 years, had every member of that committee sign the same report. Mr. Chairman, I think it is unusual when you get 20 Members of Congress to agree to anything, but in this situation it is more remarkable because they agreed to something which is a major change in economic philosophy, saying that we should emphasize the supply side of the economy.

The 10-5-3 bill is not going to set-aside all of the problems that inflation has created. But it will be a major step forward, as it is a substantial simplification of present law.

One portion of this proposal provides for a 10-year depreciation on investments in nonresidential structures. Frankly, I have some concern about that, Mr. Chairman.

I would guess that we will have to make some modifications in this provision in order that it is not taken advantage of for speculative purposes.

The 5-year depreciation with the full 10-percent investment tax credit would be provided for investments in equipment and machinery. That compares to a 10-year depreciation schedule under existing law.

The first $100,000 of annual investments in certain automobiles and light-duty trucks would be depreciated over 3 years, allowing a 6-percent investment tax credit.

It has several important objectives:

First, larger depreciation tax deductions will help fight inflation by encouraging firms to invest in new plants and equipment that will result in enhanced productivity and help avoid inflationary capacity shortages.

Second, one of the best things that can be done to reverse the staggering trade deficit is to encourage the modernization of American business so that U.S. firms can compete effectively in world markets.

Take the industrial base of Japan. It turns over once every 10 years. The industrial base of America turns over once in about 30 years.

You do not have to look forward long to understand that Japanese workers and German workers are going to have more modern tools in their hands than will their American counterparts. If this trend persists, we will be exporting all of the high-paying jobs in this country.

I think that this bill will particularly help small business through its dramatic simplification of the depreciation schedules. In Great Britain, the full cost of nearly all machinery and equipment may be deducted in the year that the expenditure is made. That is quite a change for Britain.

The industrial base in this country, and the annual increase in productivity, are the lowest of any major industrial nation in the world. Great Britain, with the second lowest rate of productivity increases, is dramatically trying to turn this around through changes in their tax policies.

Canada provides a special 2-year writeoff for machinery and equipment used for manufacturing and processing operations. We ought to be moving in that direction.

Mr. Chairman, at this point in the hearings, I would like to insert a more lengthy presentation supporting this bill.

Senator BYRD. The lengthy presentation will be inserted as a part of the record.

[The material referred to follows:]

STATEMENT OF SENATOR LLOYD BENTSEN, CAPITAL COST RECOVERY ACT, S. 1435, SENATE FINANCE COMMITTEE, OCTOBER 22, 1979

Mr. Chairman, as one of the sponsors of S. 1435, the Capital Cost Recovery Act, I am very pleased that you so promptly scheduled hearings on this important legislative proposal.

The Capital Cost Recovery Act will substantially boost depreciation tax deductions as part of the long-range war against inflation. This proposal is of particular importance to small businesses across the country.

This legislation is a major bipartisan effort by members of the congressional tax writing committees to address the very serious problem of built-in, continuing inflation through an innovative change in our tax laws. There are 36 sponsors and cosponsors in the Senate already.

Ever since World War II, the major focus of economic policy has been to maintain an adequate level of demand. The Joint Economic Committee's 1979 Annual Report, which for the first time in 20 years was endorsed by all committee Members, suggests that the supply side of the economy should now become a major area of concern.

It makes more sense to fight inflation by putting more goods on the shelf than to fight it by discouraging consumers from buying those goods.

There is a solution to inflation that our allies in Japan and Germany have used with great skill over the past 25 years. They fight it, without creating recessions, through productivity growth, through substantial and continuing increases in output per manhour. Our own productivity rate in the meantime has declined from three percent a year in the '50's and early '60's to only .8 percent last year. In 1950, for example, it took seven Japanese to produce what one American produced. By 1977 it took less than two Japanese to match one American.

One of the primary reasons for our lagging productivity rate is a lack of investment capital for new plants and equipment, and this major tax bill will go a long way in our efforts to spur investment.

There are clearly no simple solutions to the problem of inflation but adoption of the Capital Cost Recovery Act would be one constructive step.

Five-year depreciation with a full 10-percent investment tax credit would be provided for investments in equipment and machinery. This compares to depreciation of about 10 years under existing law.

The first $100,000 of annual investments in certain automobiles and light duty trucks would be depreciated over 3 years and allowed a 6-percent investment tax credit.

The bill has several important objectives:

First, larger depreciation tax deductions will help fight inflation by encouraging firms to invest in new plants and equipment that will boost productivity and help avoid inflationary capacity shortages.

Second, one of the best things that can be done to reverse the staggering trade deficit is to encourage the modernization of American business so that U.S. firms can compete more effectively in world markets. The staggering trade deficit which reached $34 billion last year contributed to domestic inflation.

Third, the bill will help simplify the computation of depreciation deductions for taxpayers throughout the Nation. One of the major goals of the Senate Finance Committee during the 96th Congress is to simplify our tax laws.

Fourth, simpler and faster depreciation will be particularly helpful to small businesses. A healthy small business sector is indispensable to a competitive economy.

In Great Britain the full cost of most all machinery and equipment may be deducted in the year the expenditure is made. Canada provides a special 2-year writeoff for machinery and equipment for manufacturing and processing operations. The United States should move in that direction.

Senator BYRD. Before calling on Senator Nelson, the chief sponsor of this legislation, let me say I like that expression that Senator Bentsen used over the years. Governmental policy has been to prime the pump and pump the prime.

Senator BENTSEN. I would like to say that was not original. Somebody else came up with it.

I have just taken the Texas rights to it, Mr. Chairman.

Senator BYRD. You can have the Virginia rights, also.

I want to commend Senator Bentsen, too. He mentioned the unanimous vote of the Joint Economic Committee. I think that is a tribute to his leadership. That is a reversal on the part of both that committee and the Congress. I think it is a healthy trend.

Senator Nelson, you are the chief sponsor of this legislation.

Senator NELSON. Well, Mr. Chairman, I would ask that my statement be printed in full in the record. Senator Bentsen has covered the subject matter quite well and some of the material I have is repetitious of what he has already stated.

[The prepared statement of Senator Nelson follows:]

TESTIMONY OF U.S. SENATOR GAYLORD NELSON BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

Mr. Chairman, I appreciate the opportunity to discuss with this subcommittee S. 1435, a bill I introduced earlier this year along with Senators Bentsen, Packwood and Chafee. This measure would allow businesses to write off investments in structures over 10 years, equipment in five years, and vehicles in three years. It is cosponsored by 36 Senators, including a majority of this Committee.

One of the most pressing problems besetting American industry today is the matter of capital formation, the process of raising cash to maintain and expand the productive capacity of the U.S. economy, its machinery, tooling, plant and transport equipment.

We need to take a whole new look at how to increase the productivity and efficiency of American industry and the depreciation system is the right place to start.

The need for investment capital—to promote productivity growth and enhance job opportunities, to combat inflation and protect U.S. competitiveness in the international market—is staggering. Leading economists have estimated that the U.S. private sector will require $4 to $5 trillion over the next ten years for new equipment and machinery to generate new jobs and increase productivity. Almost half of these funds will be needed simply to replace and maintain the capital already invested. The question is where to get the money.

Traditionally, there are four methods by which industry raises essential investment capital: depreciation deductions, re-investment of profits, borrowing and new equity capital. Depreciation deductions are by far the largest source of money available to businesses for modernization, accounting for over $112 billion per year.

In recent years businesses have had great difficulty raising equity capital at reasonable costs. The prime interest rate is currently a record 14.5 percent. And, that means interest rates on borrowed funds are becoming more and more prohibitive.

What can American industry do to raise new capital for new plant construction, new jobs and increased productivity? Treasury Secretary Bill Miller has said repeatedly that accelerating depreciation deductions would be the most cost-effective way to rebuild America's industrial efficiency and competitiveness.

The Capital Cost Recovery Act would be the biggest change in the U.S. business tax system in the past 25 years. The potential tax cuts and revenue loss to the Treasury could exceed the recent reductions in corporate income taxes, capital gains taxes and estate taxes put together.

At the same time, the bill contains an entirely new concept which the Congress has never dealt with before—a ten year write-off for investments in buildings. We are familiar with proposals for more rapid depreciation deductions involving equipment and machinery. For example, last year I introduced legislation which would

have permitted business to write-off up to $100,000 of machinery and equipment purchased each year, using a 3-year straight-line depreciation method. But the proposal involving buildings is a unique idea which requires careful consideration. As I stated when I introduced the bill:

"However, I have one major reservation concerning this proposal. And that involves the 10-year writeoff for commercial buildings. I shall reserve final judgment on this provision until additional statistics are available.

"The purpose of introducing this measure today is to place the concept before the Congress. We urgently need an indepth re-evaluation of our whole capital recovery system. Hearings must be held on this proposal as well as other depreciation reform bills that have been introduced earlier this year in order to examine the views of business groups, and economists and to get the revenue costs in precise terms."

Today's hearing will give us the opportunity to examine the experts.

Also to be examined is the distributive effect on various sizes of businesses and availability of capital, particularly to the nation's smaller businesses.

There is no question that our current depreciation system must be changed. Indeed, there are several compelling reasons for significant alternations to it.

First, the system is unbelievably complex, particularly for small businesses. This is the main reason why small businesses use a straight-line 10-year depreciation method for their assets, even if they are entitled to more rapid recovery methods. These businesses must contend with the tax code's complicated asset depreciation range (ADR) system, 132 different asset classes and 107 pages of regulations to determine the useful life of equipment. As a result, less than 1 percent of the nation's businesses use the ADR system.

Second, inflation during the last few years has compounded the problem. With spiraling inflation, businesses are being squeezed two ways. First, the money they are getting back in deductions is worth less each year. And second, by the time a business has recovered the cost of its investment, the replacement equipment it must buy invariably costs far more. The result of this squeeze is that capital which should be recovered, renewed, and expanded is instead being swallowed up. The greatest deterrent to inflation is improved productivity.

Third, there simply is not enough investment money available to meet industry's needs. Equity capital is expensive to raise. Interest rates on borrowed funds are prohibitive. And industry simply cannot generate enough cash internally because of our outdated depreciation system. Industry is unable to modernize plant facilities and replace worn out machinery. This causes rising production costs, declining productivity, loss of jobs and a lowering of our standard of living. The situation threatens a lasting capital crisis that will have a severe impact on the U.S. economy.

Yet, the period of capital recovery in the United States is one of the longest among all Western industrial nations.

For example, Great Britain allows businesses to recover 100 percent of their investments in machinery and equipment in 1 year while Canada allows a full cost recovery over 2 years.

The ability to recover capital over a realistic period has a direct bearing on the ability of the nation's businesses to furnish goods and services to their communities, to provide new jobs, and to keep prices down through vigorous competition.

The Capital Cost Recovery Act is a step in the right direction which deserves serious consideration. It will help to increase our productivity and offset wage increases, thereby restraining price increases. It will infuse billions of dollars into the economy by allowing all businesses to recover their investments in depreciable assets twice as fast as under current law.

Senator NELSON. In any event, let me say that I think that there is a fairly general agreement among those who have given it thought and this agreement crosses party lines and philosophical lines, I think.

That is the agreement that there is a very pressing need to do something about the question of capital formation and it seems to me we need to take a whole new look at how to increase the productivity and efficiency of American industry and the depreciation system is an important place to start.

The need for investment capital to promote productivity growth and enhance job opportunities, to combat inflation and protect U.S. competitiveness in the international market is staggering. Leading

economists have estimated that the U.S. private sector will require $4 to $5 trillion over the next decade for new equipment and machinery to generate new jobs and increase productivity.

Almost half of these will be needed simply to replace and maintain the capital already invested. The question is, where does industry and business get the money?

Well, obviously there are four traditional methods by which industry raises capital: depreciation deductions, reinvestment of profits, borrowing, and new equity capital.

Depreciation deductions are by far the largest source of money available to businesses for modernization, accounting for about $112 billion per year.

In recent years, businesses have had great difficulty raising equity capital at reasonable costs. This has been particularly so for small businesses. The Small Business Committee has conducted a series of hearings over the past 2 or 3 years on this precise question. The problem of small businesses is critical. Many of them are unable, even if they are successful and profitable, to raise capital for purposes of expansion.

The Capital Costs Recovery Act would be far and away the largest business tax change in the past quarter century, or probably in the last half century. However, the bill contains a provision for a 10-year writeoff for investments in buildings.

At the time I introduced the legislation along with Senators Bentsen, Packwood, and Chafee, I made note of the fact that the building writeoff period was, as far as I was concerned, a new concept. In the years that I have been on finance, we have not seriously addressed the question of the depreciation period for buildings.

Everything that I have noted, at least in the hearings, has concerned capital investments in machinery. So when I introduced S. 1435 I made the point that I had reservations about the 10-year writeoff on buildings simply because I do not know enough about it to come to a conclusion myself.

There is no doubt in my mind about the importance of shortening the depreciation period for a capital investment in machinery and equipment and the argument may be just as compelling for buildings.

I made the point because I think it may be important, that this is a new issue as far as I am concerned insofar as serious consideration in tax reform is concerned. It is a new issue and I think the committee needs to look at it very carefully from the standpoint of attempting to determine what it does for increased productivity.

There is not any question but what it would do a good deal in terms of capital recovery.

There are a number of reasons in addition to the necessity of raising capital, that I need not go into in any detail, why we need to change the current depreciation system.

First, the system is unbelievably complex, particularly for small businesses, even for medium sized businesses. This is the main reason why small businesses use the straight line 10-year depreciation method for their assets, even if they are entitled to more rapid recovery.

These businesses must contend with the Tax Code's complicated asset depreciation rate system, 132 different asset classes and 107 pages of regulations, to determine the useful life of equipment.

Less than 1 percent—I think it is 0.7 if my memory is right, 0.7 of 1 percent of the Nation's businesses use the ADR system.

Second, inflation during the last few years has dramatically compounded the system and made the periods for depreciation simply obsolete.

In a 10-year period, by the time the capital is recovered, the machinery that is to be replaced will cost three and four times as much so, in fact, business does not recover its investment so that it can reinvest in new equipment.

Third, there is not enough investment money available to meet industry's needs. I need not get into that Senator Bentsen has made reference to it.

I think, Mr. Chairman, that these hearings are very important, that we need a significant change in our approach to the depreciation of capital equipment.

Senator Bentsen made reference to the fact that England has gone to a 1-year system of depreciation; Canada, about 5 or 6 years ago, went to 2 years.

Obviously, in the long pull, for a profitable company, at least, it just comes out as a wash. If it is a nonprofitable company, it does not cost the Treasury anything anyway. They do not have anything to write off.

So the old argument that it would be expensive to the Treasury, really in the long pull, does not stand up. I understand Treasury's position that, as of next year, 3 or 4 years down the line, it may cost the Treasury a fair amount of money but, at least the figures that I have looked at, they are usually looking at a static assumption, making no assumptions that there is an additional return as a consequence of the increased productivity.

In any event, I think it is time to begin a reform of this system. I want to commend the Chairman for initiating the hearings on a very important, though very complicated, subject.

Thank you, Mr. Chairman.

I have another appointment in a few minutes. I will not be able to sit through the hearings with you, but I appreciate the chance to appear.

Senator BYRD. Thank you, Senator Nelson. I think you make a very strong point.

Over a period of time, it really is not costly to the Treasury. Treasury comes out about even over a period of time because the faster the equipment is written off, the faster the corporation comes to the point where it must pay the full tax without getting the benefit of depreciation.

I think that the legislation that you and Senator Bentsen, Senator Packwood, and Senator Chafee have introduced is a very significant piece of legislation.

Secretary Miller will be here at 10 and immediately following Secretary Miller there will be a panel with Representative Barber B. Conable of the State of New York and Representative James R. Jones of the State of Oklahoma. They will be followed by the

Honorable Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy.

The next witnesses will be a panel of two: Dr. Charls E. Walker, chairman, American Council for Capital Formation; and Mr. Mike McKevitt, Washington counsel, National Federation of Independent Businessmen. He will be accompanied by Mr. Ed Pendergast, an accountant. We are very glad that the committee is to have each of you here this morning, gentlemen.

Dr. Walker, you may proceed and Mr. McKevitt.

STATEMENT OF CHARLS E. WALKER, CHAIRMAN, AMERICAN COUNCIL FOR CAPITAL FORMATION

Mr. WALKER. Thank you, Mr. Chairman.

I am Charls E. Walker of the American Council for Capital Formation, a group that strongly supports enactment of the Capital Costs Recovery Act of 1979, S. 1435.

This legislation, known as 10-5-3, is the most innovative and constructive business tax legislation since the introduction of the investment tax credit in 1962.

I wrote that last Tuesday night and, hearing Senator Nelson's remarks this morning, I am going back to my original idea, which is to say that it is the most innovative and constructive in the history of the Internal Revenue Code.

Only a few years ago many argued that there was no capital formation problem, but now both the public and Congress have become convinced that the capital formation problem is not only significant but its solution is critical to the Nation's well-being.

I must say a big part of that progress is a result of the work of this Senate Finance Committee in general, particularly the hearings that Senator Bentsen launched several years ago in his Subcommittee on Capital and Financial Markets.

The highly constructive Revenue Act of 1978 marked a major turning point in economic policy in general and in tax policy in particular. It signaled a turn from Keynesian-prescribed policies which affect overall demand, to the supply-side considerations that deal with incentives to work, save and invest. Attention shifted from the question of how income should be distributed to how best it could be produced.

S. 1435 has broad and deep support in the business community including both small and large businesses. The legislation is supported by highly capital intensive industries and by individual companies and groups that are not capital intensive, such as retailers, banks, and other service institutions, as the most cost-effective approach to meeting the capital formation problem.

S. 1435 has many advantages: [a] when fully phased in, business will be able to recoup most capital investment even under high rates of inflation; [b] the Internal Revenue Code is simplified because the so-called useful life is separated from the depreciation of capital assets; [c] 10-5-3 will virtually eliminate the present tax bias against investment in very long-lived equipment; and [d] it will have a relatively modest negative impact on Federal revenue initially under the proposed phasein of the system.

Criticism of 10-5-3 because it eliminates the useful life concept fails to distinguish between the goal of tax policy, which is to raise

revenue with the least damage to the economy, and the goal of traditional accounting practices, which is to provide management with the best possible understanding of the operation of the firm.

Arguments that the proposal is a giveaway to business fail to recognize that it is not business that pays taxes, people do. Also, with the inflation of the past decade, many business concerns have been paying taxes on capital and not on real income. The real issue is the positive impact of the proposal on economic growth, inflation, and jobs.

Mr. Chairman, the case for the Capital Cost Recovery Act—which, I repeat, is landmark legislation—is very strong. The crucial nature of our capital formation problem, the need to shape the tax system so as to encourage saving and productive investment, demands that this legislation be enacted at the earliest possible date.

These hearings are therefore timely, indeed, and it is to be hoped that they will pave the way for favorable action on 10-5-3 in the 96th Congress.

I have a longer statement I would like to submit for the record.

Senator BYRD. Yes, that will be published in the record.

Mr. McKevitt?

STATEMENT OF MIKE McKEVITT, WASHINGTON COUNSEL, NATIONAL FEDERATION OF INDEPENDENT BUSINESS, ACCOMPANIED BY ED PENDERGAST, ACCOUNTANT

Mr. McKEVITT. Mr. Chairman, I am Mike McKevitt. I am here as Washington counsel for the National Federation of Independent Business which now has 585,000 members.

Mr. Chairman, I would like to commend your comments as well as those of Senator Bentsen and Senator Nelson for your concern for small business.

The present depreciation system is inequitable for our needs and Mr. Pendergast will comment on that in a minute. I think it is a milestone that we are considering legislation that is progressive of this nature and also the fact that the business community, be it large, medium, or small, has been for a number of months trying to work out something that would be beneficial to all segments of business.

At this point, I would like to introduce Mr. Pendergast, who is a businessman himself, practicing CPA in Boston, and one who is very knowledgeable in the problems of small business in the field of depreciation.

Mr. PENDERGAST. Thank you, Mike.

The Capital Cost Recovery Act, S. 1435, is supported strongly by the National Federation of Independent Business. We have reviewed some of the problems raised by Senator Nelson. He has been our leader over the last 4 or 5 years in helping us try to develop an approach to depreciation. It started out with a 3-year life and we come along to recognize that small business and the whole commercial independent sector needs to get together in one bill that will be acceptable to all, one simple system.

I was very happy to hear Senator Nelson speak about the fact that many small businesses take a 10-year straight line depreciation even though they could get access to accelerated depreciation if they knew about it.

If we look at that company and compare the benefit that company gets under a mandated 5-year accelerated depreciation, compare this to almost any other company, large or small, that company is the one who is going to benefit the most by S. 1345.

I am sure other witnesses will emphasize the advantages in productivity exports and increased employment that will be created by simplified depreciation, although I am not going to concentrate on that.

I am going to point out that the present system has had only one major reform in the last 6 years. That was the introduction of the asset depreciation range system of depreciation which has not been beneficial to small business but, in fact, has put small business at a competitive disadvantage.

I would like to have my formal statement put into the record and in that there is an indication of the benefit that has been given to large businesses under asset depreciation range—92 percent of that benefit is for the companies with $100 million or more in assets. Very little of that benefit has come to the small business.

The present system is complex. If you read the tax guide for small business that the Internal Revenue Service puts out, you will see that the choices facing the small businessman who is trying to prepare his own return are so myriad that he could not possibly come up with any other conclusion but taking the simplest way out, albeit not the most beneficial to him.

In fact, in the whole series of instructions issued by the IRS, there are no useful life suggestions. There is one paragraph making reference to the fact that class life as a depreciation range would be available to a small businessman except that it is probably too complex, so there are no guidelines where every small business has to resort to facts and circumstances in determining the lives of their assets.

So we see the advantages of the bills being simplified or celebrated. Depreciation will be available to all small businesses.

A significant reduction of the complexity of the options that are now available to companies down to one simple, and at the same time flexible system, and a substantial elimination of any two-tiered system.

I think we have come to the conclusion that one of the problems in most of the bills we have come across in the last 2 years is the complexity of the issue, which has made it more difficult for small business.

We do ask that an immediate inclusion of the first $100,000 of depreciation in the 5-year categories, so there would be no phasein for that very complex aspect of the bill so that 90 percent of the small businesses will not have to worry about the phasein provision.

Senator BYRD. Thank you.

Your statement will be published in full in the record.

Senator Bentsen.

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

First, let me say, Mr. Walker, that I appreciate your comments on what we are trying to do in the area of capital formation. I think that this will be a significant breakthrough, more, frankly, that what we did on capital gains.

The lowering of the capital gains tax has made a dramatic change in capital formation and risk capital available in this country. The number of new issues offered have increased substantially since the time we passed the bill.

Let me say to Mr. McKevitt and Mr. Pendergast, that I am particularly impressed with the idea of simplification in the interest of small business. When I look at the 25 definitions at the beginning of the income tax regulation on ADR and what they talk about—asset guideline period, modified half-year conventions, half-year conventions, gross salvage value, salvage value * * * on it goes.

Finally, the small businessman throws up his hands. He cannot afford the battery of accountants and lawyers to really get into the definition of these things so he is unable to take sufficient advantage of accelerated depreciation.

You made the point that many small businesses have such an extremely difficult time in acquiring capital and borrowing money that most of their capital has to be self-generated. The 10-5-3 proposal would give small businesses the cash flow that they need and would lead to a very substantial modernization of their equipment. Let me note that a very high percentage of jobs in this country come through small business and the innovative ideas they have developed.

I believe that small businesses would take advantage of this simplified depreciation schedule far and away above the complicated accelerated depreciation schedules that we presently have.

Mr. PENDERGAST. They certainly will. If someone is ingenious enough at Treasury to set up a simple worksheet as a part of the depreciation schedule that could be included in your form 1120 or schedule C of your 1040, on one page, the small business person could put in and calculate the right depreciation very simply. That, in and of itself, would be an astounding advance.

I like the term "advantage." That has always been my favorite of the 25 definitions in ADR.

Mr. MCKEVITT. On page 6 of Mr. Pendergast's testimony he sets forth some simple language which I think would be very beneficial for small business.

As you well know, Senator, small business is labor intensive—that means jobs.

To have this kind of language would be extremely beneficial. In talking with small business groups as I have about this bill around the country in the last several months, it has been met with a great deal of enthusiasm.

Senator BENTSEN. Mr. McKevitt, on the Joint Economic Committee we have been dealing with the question of productivity. Let's look at the situation in Japan. Productivity has increased four times faster in Japan than in the United States for the period 1950 to 1977. Their rate of productivity has accelerated in recent years.

Last year their productivity increased at 8 percent while ours was around three-tenths to four-tenths of 1 percent. This year, productivity increases were actually negative.

I really believe what we are doing here will substantially help turn that around. During the hearings I called in the chairman of the Productivity Center of Japan to testify before us and talk about

some of the ideas that the Japanese have taken from this country and improved upon.

Under the Marshall plan we sent over so-called experts. They were not going to spend Marshall plan money unless certain productivity goals were adopted.

Well, the Japanese did it, but we did not follow our own advice. That is one of the reasons I think we find ourselves in our present situation. We need to make this kind of turnaround.

Thank you very much.

Senator BYRD. Senator Nelson?

Senator NELSON. I mentioned in my statement that I had some concern about the question on buildings simply because I did not know enough about the issue to have an opinion. As to investments in machinery and equipment, I believe you should be allowed to write it off in 1 or 2 years.

I do not know enough about the building issue. It may have a significant capital formation impact and a significant productivity impact sufficient to justify its costs which, on the static figures I have looked at, are pretty high.

Does anybody want to comment on that?

Mr. PENDERGAST. One of my clients had an old three-story building and they converted it to a brandnew building which is one story and the depreciation—I am sorry. The debt service cost has been met just by the increased savings in insurance.

Their productivity is somewhere near 50 percent better than it was prior to this building because they are able to lay out their production better.

I do not know that that is true generally, Senator, and I think that the 10-year life should be examined most closely. In any part of this bill, we should look to see what the revenue estimates are and then judge what benefit there is. It is an area that we agree with you, I think, is the most questionable area of the bill.

Mr. WALKER. As you pointed out, Senator, this is an area which has been the forgotten man of productive tax reform and capital formation. Most of the direct measures since the investment credit has been confined to equipment.

And, to add to what Mr. Pendergast said, one of the great advantages of the early start in hearings on this legislation is that the legislative process can very thoroughly air these sorts of things.

Senator NELSON. I have seen revenue loss estimates prepared by Data Resources in which the revenue loss for the building aspect was very large. This concerns me very much. We are trying to control Federal spending. We are trying to reduce the Federal budget deficit. We must set priorities. The question is—Can we afford this provision in terms of the Federal budget?

It may be that the 10-year writeoff for buildings will have to be extended. I just raise the question.

The other question I have concerns equipment leasing. I discussed this question with one of the representatives of the new government in Great Britain who favors a 1-year writeoff for equipment.

He said there is a fairly strong feeling in England that leasing arrangements have developed as significant tax shelters because of the 1-year depreciation for equipment. Do you have a view on that?

Mr. WALKER. I do not have any specific view.

Senator NELSON. Do you see the problem of a 1-year depreciation?

Mr. WALKER. Yes, I see how it could be a problem. This is one of the difficult areas you have to work through, going back again to the experience of the investment tax credit and looking at both sides of this.

The leasing function is very important in respect to industries and companies which themselves are somewhat capital short, or cash short.

Obviously if the lessor, or the fellow who builds and leases the equipment can also get some of the tax advantages, if that can be carried over to the banks and others who buy the airplane and lease it to the airlines, as it is in the case of the investment credit, you get the effect that you want to get.

You are rightly concerned about whether there is too much of a windfall or too much of a suggestion of a windfall to this question. Congress in very recent years has taken steps to subject that aspect of the invesment credit to the minimum tax.

Senator NELSON. Thank you, Mr. Chairman.

Senator BYRD. May I ask this question before yielding to Senator Chafee?

Do I understand from your reply to Senator Nelson that it is the investment tax credit rather than the 1-year depreciation that creates the tax shelter?

Mr. WALKER. No, sir.

What I meant to say was Congress became concerned about individuals in particular buying equipment and leasing it. Senator Byrd, if you recall in the 1971 legislation, when we restored the investment tax credit the way Treasury asked, proscription was put into the legislation which prevented individuals from taking that sort of advantage. I was simply making a comparison; I was not saying that this is where the problem is.

Senator BYRD. Thank you.

Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman.

I apologize for being a little late.

I am a cosponsor of S. 1435 along with Senators Nelson, Bentsen, and Packwood. To me, it is an important piece of legislation.

It is a method for making our country more competitive by producing goods at lower costs through having more modern machinery and if everything came to fruition, it would help balance the trade deficits, help reduce budget deficits, and help fight inflation.

It is a very optimistic prediction and I do not think all of them will happen at once. But this bill, with its emphasis on capital cost recovery would help accomplish those goals.

It seems to me there are other possible approaches to doing this, such as elimination of double taxation on dividends or increasing the investment tax credit or cutting the corporate rate, but I think that the fastest way and the most direct way of getting more investment in modern equipment is accelerated depreciation.

I have a couple of questions that I would like to direct to the panel here.

It is my understanding that this measure has the support of small business and large business. I do, however, share Senator Nelson's concern over more rapid depreciation of buildings.

Buildings are of importance but it seems to me the lack in our economy has not been the failure to construct new buildings.

Nevertheless, I support the total package. To deviate from the 10-5-3 formula, at this early stage would upset the applecart before it even gets started.

But I would like a little more discussion, if I might, from Mr. Pendergast and Mr. Walker, on how important they feel that the 10th provision is.

Would you address that, Mr. Pendergast?

Mr. PENDERGAST. Yes, I will.

I said that there are, certainly, to some manufacturing companies, a significant benefit in being able to depreciate their buildings in a shorter period of time. I see the contribution to productivity as being quite strong in the manufacturing and distribution areas, particularly in the manufacturing area.

If you look at the plant layouts of 50 years ago when these buildings were still being used, you will see that they tend to be four- and five-story buildings, the concept of productivity being that you brought your materials to the fourth floor and you processed them by dropping them to the first floor, kind of like gravity.

The technology has changed considerably since then. Now the most efficient production is, let us talk about the horizontal motion of a product from the front door to the rear door, going on a level productivity basis.

As I indicated, one of my clients had an increase of productivity of 50 percent because of their ability to get a new building that gave them a more modern approach to manufacturing efficiency.

Senator CHAFEE. In your capacity—you and Mr. McKevitt are representing the smaller business side of the independent businessmen, do you feel if something had to give here—I am not saying that something should give, but if you look at the formula of the 10-5-3 would you pull out your support if the 10 were changed in some manner?

Mr. PENDERGAST. In the last part of our testimony on page 8 it is our statement if the revenue impact of the act is too costly, we suggest that any adjustments might be in the 10-year provisions relating to real property. This could be in the form of limitations in the amount of 10-year depreciation or extension of the 10-year life over the longer period.

I think the answer to that is "Yes."

Senator CHAFEE. I am not setting this up that we are going to back away from the 10. I suppose the revenue estimates, when they come in, will be about $30 billion for the whole package. If we had to make any adjustments, I would just want to know the feeling of the witnesses.

Mr. Walker, do you want to address that?

Mr. WALKER. Yes; I would like to, Senator.

I am concerned, especially at this stage of the legislative process, that we not go too far with adjustments. The question ought to be explored, certainly.

The point I want to make is this. You can make a very strong case for completely junking the useful life concept. It is complex and difficult to administer. You could make a strong case for going as far as complete expensing, as they have in the United Kingdom.

What 10-5-3 does, however, is move you in the direction of expensing and offsets somewhat the ravages of inflation. Inflation has caused corporate taxes to be much too high and we are taxing capital in addition to taxing income.

Martin Feldstein, the prominent economist, estimated in 1977—I will quote that—"The effect of inflation with existing tax laws was to raise the 1977 tax burden on corporate sector capital income by more than $32 billion."

I understand that updating these estimates for 1979 will bring that to a $40 billion figure.

So looking at this in toto, when you are talking about something with static revenue costs of $30 billion, $28 billion, $35 billion, $40 billion, or whatever it is, you are not doing much more than just offsetting the effect of inflation on the tax bill that business is paying.

I think the building sector, partly because, as Senator Nelson noted, we overlooked that sector in the past, deserves a full, fair hearing before we decide to back away from the 10-year approach, if we have a problem on how much revenue is involved. There is also the other side of the equation that you gentlemen in Congress, of course, consider; that is, whether or not spending restraint could help on the revenue side of the picture.

Senator CHAFEE. I am not for junking the 10, but the purpose of the hearings is to get the views of you gentlemen who are here, and I do not want the word to go abroad I am backing away from the 10. I just want to get the feelings of those involved, small business and large, as we wrestle with these problems.

Thank you very much, Mr. Chairman.

Senator NELSON. I have one question on that.

Senator BYRD. Yes.

Senator NELSON. I agree with Senator Chafee. The only reason I do not have a positive opinion, as I said twice previously, is because we do not have enough information.

If, however, on the question raised by Senator Chafee, it were necessary to make some modification, I would like to pose this question. I would agree with you. I would not mind if you write off all investments in equipment in a brief period of time.

Is there a way of phasing in the building aspect over a long enough period of time so that it would not have an immediate impact or an impact over the next few years on the revenues, but at the same time would not discourage investment in construction?

It seems to me you run into a problem. If you are going to provide a benefit, you do not want to cause people to hesitate to do the construction because they are looking for the benefit.

I think some of you experts ought to address that question.

Mr. PENDERGAST. There may be a way to do it, you do start running into the problem. You stretch out the time period of the phasein where you have that counterproductive effect on investment decisions. Five years seems to be a pretty good horizon to work from.

Senator BYRD. Senator Bentsen.

Senator BENTSEN. I would like to ask another question, particularly when I have this group of experts in front of me.

Let's look at the 10-year writeoff and apply it to a 20-year life building, a building that cost $100,000 and was sold for $150,000.

Under the 10-5-3 proposal, you would have ordinary income rates against the $100,000 that would have been written off on the original cost. You would have capital gains on the extra $50,000 however, if you took the present law and you used straightline depreciation on this 20-year building, and after 10 years half of it would be written off. In this instance, you actually have a better tax situation under present law than you would under the Capital Cost Recovery Act.

This law would actually penalize speculation in buildings.

Now, the other side of the argument, of course, is that inflation generally works to the benefit of building owners, where it has worked to the detriment of equipment owners as regards to replacement costs.

So I agree with you gentlemen; we do not want to throw out the 10. The theory that this is going to be a great boon to speculation and building does not exactly add up.

Mr. MCKEVITT. I want to make one comment to Senator Chafee's question and if I could reiterate another position.

The fact that the business community, big, medium, and small, has spent so much time together on this, I hope the opportunity would be given to us to come back with expertise as far as the full range on 10-5-3 rather than allow any fragmentation to develop in the business input.

Senator BENTSEN. Oh, I agree Mr. McKevitt. I also agree when the point was made by Senator Chafee that there are many approaches, other than just depreciation. However, as Secretary Miller testified, you still get a lot more bang for the buck as regards to productivity under the depreciation schedule.

That is when you almost force them to spend it there. If you give a corporate tax cut, that money can be spent on paying off on debt, buying another company, increasing your dividends, what have you.

If we are really trying to turn this country around and get it moving again, I think 10-5-3 is the way to do it.

Senator CHAFEE. I want to reassure Mr. McKevitt, I am not falling off the wagon here. It is just that I believe that the whole purpose of these hearings is to have a chance to explore with you gentlemen where we are going with this.

To me, this is the most significant piece of domestic legislation before the Congress and I just want to make sure we know exactly what we are doing.

Senator BYRD. I think that it is important to explore the 10 in the 10-5-3 formula. I have no problem with the other two. I am just not sure about the 10-year writeoff for the simple reason I do not know how it would work.

I take it from what you have replied to various of my colleagues that you would prefer at the moment, at least, that no change be made in the formula.

Mr. WALKER. That is correct.

Senator BYRD. If a change had to be made, I assume that the place to make the change would be in the 10 part of the 10-5-3.

Mr. WALKER. I would like to reserve on that, Senator. I would like to hear a lot of the testimony and discussion.

As you know, there may be major tax legislation introduced in the House today with hearings in the Ways and Means Committee getting underway next month. There is going to be a lot of exploration.

I would like to reserve as to where adjustments might be made.

Senator BYRD. That is certainly reasonable. Let me ask you this, Mr. Walker.

In 1978 you were a strong advocate of a reduction in the capital gains tax. Have you been able to determine any precise impact of this reduction on the economy?

Mr. WALKER. Yes, sir, and I would like to put into the record a kit that the American Council for Capital Formation prepared for our annual meeting last week that goes into some detail as to that impact.

[The material referred to follows:]

THE CAPITAL GAINS TAX CUT DID WORK

Last year the maximum capital gains tax rate was reduced from 49.125 percent to 28 percent as a part of the Revenue Act of 1978. Hailed by many as a "first step" toward encouraging needed new capital formation, the positive impact of the cut in capital gains taxation is just beginning to be felt.

This kit contains supporting evidence that the reduction in capital gains taxes is producing the desired results despite the uncertain economic climate, escalating rates of inflation, and widespread recession forecasts. Summarized below are some of the significant developments attributed to the capital gains tax cut.

A dramatic increase in funds entering the venture capital market has taken place. Industry sources indicate that in 1977 total commitments of new capital raised by professionally managed independent venture capital companies totaled only $20.2 million. During 1978, and particularly in the second half of the year when the capital gains tax rate cut was imminent, new capital committed rose to $215.8 million, nearly an eleven-fold increase over the previous year. Funds committed through mid-May of this year totaled $69.3 million, and industry spokesmen have indicated the 1979 goal is $250-$300 million in additional investment funds.

Stock issues for firms going public for the first time are on the rise. In 1974, only nine firms tapped the new issues market for a total of $16 million. During 1978, 46 public offerings raised $250 million, an increase of 63 percent over the previous year. Figures for the first half of 1979 show an even better year with 37 firms raising $227 million.

The capital gains tax reduction has been a shot in the arm for existing stocks, too. The index of the American Stock Exchange, home of many small and medium-sized public companies, increased 48 percent in the first nine months of 1979. The National Association of Securities Dealers' index of over-the-counter stocks rose 27 percent over the same time period. These increases have come at a time of considerable economic uncertainty and high and rising rates of inflation, traditional stock market depressants.

Planned business outlays for 1979 plant and equipment spending have shown suprising strength despite recession fears. The August survey by the Department of Commerce shows that business expects to spend approximately 4 percent more this year than last year for new plant and equipment, after adjustment for inflation.

Knowledgeable observers have studied the economic climate since the capital gains tax rate was cut from 49 percent to 28 percent and have noted these effects:

Forbes recently suggested that "The change in the climate can be traced directly to Congress, which last November cut the capital gains tax from 49 percent to 28 percent." (6/25/79)

The Wall Street Journal stated in a recent editorial that "There is evidence that lowering the capital gains tax rate had wider ripple effects. The Dow Jones Industrial average rose 130 points from March to August last year as it became evident that there were enough votes in Congress to cut the capital gains rate." (7/30/79)

Newsweek noted that "The new boom in venture capital was touched off last year when Congress reduced the maximum tax on capital gains from 49 percent to 28 percent." (6/4/79)

Walter Heller, former chairman of the Council of Economic Advisers under Presidents Kennedy and Johnson, stated recently in an article for the Wall Street Journal "Last year, Congress enacted a major cut in the capital gains tax, thereby, improving the general atmosphere for investment." (8/2/79)

All the results are not yet in from the crucial reversal in the trend toward the overtaxation of capital gains. But, as former Senator Clifford P. Hansen predicted when he introduced the Senate version of the "Steiger-Hansen Bill" which led to the reduction in the capital gains tax rate, "We are calling for a new policy that will stimulate risk capital investment. We recognize that out past successes in this country were based on risk, hard work, and reward. By means of this legislation, we affirm our belief in that system, and out intention to revitalize it."

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"The Outlook for Ventures Suddenly Seems Brighter," Venture, May, 1979.

"Plans By Business for Outlays in '79 Seen Unchanged," Wall Street Journal, September 6, 1979.

"A Special Background Report on Trends in Industry and Finance," Wall Street Journal, August 16, 1979.

[Reprinted from the Wall Street Journal, July 30, 1979]

Review and Outlook—Snapping Back

Anyone who might be wondering about the effects of last year's reduction in capital gains tax rates would do well to look at the venture capital revival that has since occurred. We particularly urge a look by those who argued then—and still do in some cases—that you can't improve capital formation by lightening the tax burden on it.

Venture capital is money raised by entrepreneurs whose only assets are their new ideas. Even if they turn out to be successful, investors must expect their capital to be locked up for 5 or 6 years. A decade ago venture capital was thriving. But along came the Tax Reform Act of 1969 which together with its subsequent revisions raised the maximum tax on capital gains from 25 percent to 49 percent, reduced the write-off of capital losses by 50 percent, and sharply curtailed the deduction of interest expense on borrowed funds used to make an investment. All in all, the rewards for success were cut in half, and the penalties for failure were doubled.

The effect on venture capital was devastating. The ability of small companies to raise equity capital by public stock issues declined drastically, and by 1973 small company issues had practically ceased. In 1977 when the maximum tax on capital gains hit 49 percent, equity capital from all sources dried up.

The tax reformers who sold this bad bill of goods to the Congress said the purpose of it was "to make the righ pay taxes." Congress expected to score some easy political points, not to dry up important wellsprings of economic progress. New small companies account for a disproportionate amount of new products and technologies, and they contribute substantially to the growth of the economy as a result of their own rapid growth and the productivity gains that they introduce into the economy.

By 1978 Congress realized what it had done, and Rep. Bill Steiger found majority support in both houses for his proposal to reduce the capital gains tax. In November the rate was reduced to 28 percent.

The response from venture capital was instantaneous and began in May before the law was passed when Senator Hansen rounded up 60 Senate cosponsors of the Steiger bill. By the end of the year venture capital raised by firms specializing in the activity rose eleven-fold over the previous year. In 1979 venture capital stock is back where it was 10 years ago.

The snapback is easy to understand. In 1969 Congress began adding to the costs of failure on risky new ventures, while reducing the rewards of success. With risk taxed at the same rate as corporate salaries, fewer people left comfortable employment to go off on their own with the ideas they couldn't sell to their employers.

Those still willing could find few financial backers. In 1978 Congress restored incentives for assuming risk, and people began assuming risk once more.

There is evidence that lowering the capital gains tax rate had wider ripple effects. The Dow Jones Industrial average rose 130 points from March to August last year as it became evident that there were enough votes in Congress to cut the capital gains rate. The market has since lost some of that exuberance but still is well above March 1978 despite rampant inflation and a recession threat.

Equally impressive, in light of recession fears, is the fact that corporate expenditures for new plant and equipment and for research and development are once again showing signs of life after a long period of stagnation. Shareholders can once again look with favor on managers plowing back earnings rather than paying them out in dividends.

These signs that the economy would like to get back on its growth track are encouraging challenges to the gloomy predictions that the growth era is over. They indicate that the economy responds to incentives, and is not in the clutches of some inexorable process of decline. More encouragement of its inclinations to grow would no doubt produce further benefits.

We have in mind cutting tax rates on personal income in order to lower the high marginal rates on real income that a decade of inflation has brought about, altering taxes on interest and dividend income in ways to lessen the tax bias against saving and passing something like the Jones-Conable Capital Cost Recovery Act so that businesses can recover their investment capital before inflation eats up their depreciation allowances. A little good tax law and the economy as a whole will snap back as rapidly as venture capital.

[Reprinted from the Wall Street Journal, June 15, 1979]

VENTURE CAPITAL IS PLENTIFUL ONCE MORE, PARTLY DUE TO CHANGE IN CAPITAL-GAINS TAX

(By William M. Bulkeley and Lindley B. Richert, staff reporters of the Wall Street Journal)

RETURN OF THE RISK-TAKERS

Bernard J. O'Keefe is well-acquainted with risk. As a young scientist engaged in weapons research in the mid-1940s, he once climbed a 300-foot tower in the Nevada desert to disarm a nuclear device that had failed to detonate.

Today, at age 59, he is still taking chances. Mr. O'Keefe is chairman and chief executive of EG&G Inc., a scientific instrumentation and testing concern based in Wellesley, Mass. Recently he put $1 million of his company's money into a limited-partnership fund. He could lose it all in risky investments in new high-technology companies. But Mr. O'Keefe is betting that his money will finance firms that will return as much on capital as the 52% that EG&G returns before taxes. If he wins his bet, he believes, he will get "a better window on new-product developments" and be performing a social service by aiding entrepreneurs as well.

Decisions like Mr. O'Keefe's are increasingly common because venture capital is suddenly fashionable again. After languishing for years, the venture-capital market is booming. Among the reasons: recent spectacular successes by some companies financed by venture capital, increasing corporate acquisitions, and changes in the capital-gains tax and in some securities laws. Some new companies are even turning away funds, and observers ar beginning to worry that there is more money chasing deals than there are good deals to be had.

MORE ACTIVE AND VIGOROUS

"The industry is more active and more vigorous than at any time since 1969," says Reid W. Dennis, a West Coast venture capitalist. He is also chairman of the National Venture Capital Association, a trade group.

He says managers of venture-capital funds raised $215 million last year and have already raised $69 million this year on the way to a goal of as much as $300 million. Those figures don't include money available from many big banks and such industrial concerns as General Electric Co. and Textron Inc., which have their own venture-capital arms. In all 1977, he says, only $20 million was raised.

The current boom reverses a five-year trend that begain in the second half of 1973 when the depressed stock market and subsequent recession caused a drought in venture capital. Investors refused to buy new stock issues, making it hard to take

private companies public. That made venture-capital investments undesirable because it meant it would be difficult for investors to realize profits by selling stock to a wider group.

The resurgence of venture capital is important because it is a key to the development and survival of new companies and because new companies are vital to the economy. Some of these firms develop new technologies, compete successfully with older, stodgier firms and even spawn new industries.

New small companies, rather than established large ones, have been responsible for such technological wonders as the light bulb, instant photography, the minicomputer and the plain-paper copier. "The lifeblood of this economy has been in backing new ideas, and a lot of the best have come from individuals who couldn't sell them within their own organizations," says William Donaldson, dean of the Yale Graduate School of Organization and Management.

When these firms are starting, many don't have the money to get off the ground. Entrepreneurs without any assets other than their ideas can't hope to repay investors for five or even 10 years. "In a start-up situation, you're investing in a payroll. And when you invest in payroll, you're investing in losses," says E. F. Heizer, chairman of Chicago-based Heizer Corp., one of the nations' biggest and most successful venture-capital firms.

PORTFOLIO APPROACH

In the past, venture capital has generally come from private investors who were willing to back an inventor or innovator. But in the past 30 years, such financing has come increasingly from firms set up specifically to help a number of entrepreneurs in return for equity in thr fledgling businesses. That's good from the viewpoint of investors in the venture-capital firms; the investors don't have to keep as close an eye on their investments. "This new portfolio approach permits us to better leverage our time as well as our money," says Mr. O'Keefe, who put EG&G's $1 million in a new fund that was organized by two former executives of Citicorp's venture unit and is known as Welsh, Carson, Anderson & Co.

Despite the nature of their investments, venture-capital firms have increasingly found ways to limit their overall risk. More and more big investments are handled by several firms, one or two of which will monitor the new company's progress. In the past, it was common to have one venture-capital firm supply all the money for a small venture.

"Generally now we're part of a syndication rather than a sole investor," says Larry J. Lawrence, president of Citicorp Venture Capital. "We're seeing a lot more chances to participate from the private funds" than five years ago, he adds.

Venture-capital firms also are increasingly involved with less risky small companies that already have established products but need an injection of capital for rapid expansion.

REASONS FOR RESURGENCE

Observers trace the resurgence of venture capital to a number of factors, the most important of which is the track record established by many venture firms over the past five years.

Several young companies backed by venture capital have recently emerged as spectacular successes. For instance, there is Amdahl Corp., a West Coast computer maker that successfully challenged International Business Machines Corp. in the large-computer field. Heizer, the venture-capital firm that backed Amdahl from the time its founder was still working for IBM, now holds four million shares, or 23% of the company's stock, valued at $160 million.

Although Heizer has been unusually successful, other firms, can also cite impressive results. It is that kind of success that may hold the seeds of trouble, venture capitalists concede. "There haven't been any real disasters. In recent years, the business was highly selective because so little money was available," says the trade-group president, Mr. Dennis, who is himself a managing partner of Institutional Venture Associates of Menlo Park, Calif. With more money looking for good deals, there is more danger that some venture capitalists will get burned making investments that a year ago might have been dismissed as too risky. But that, he notes, is the way venture capital is supposed to work. "The business really became more selective than was good for the country," he says.

GOVERNMENT MOVES

The growing penchant for corporate acquisitions has strengthened the venture-capital business because it gives investors a chance to sell their interest in a

company. "You can't look at the (stock) market as a prime way out of an investment anymore," says Jeffrey W. Wilson, an investment officer with First Venture Capital Corp., an arm of First National Bank of Boston. "You ask, 'Would this fit in as a product line for a major company?'"

In the past few years, the government has taken a hand as well. The most important action, according to many venture-capital firms, was the passage last fall of a reduction to 28% from 49% in the maximum capital-gains tax for investments held over a year.

The Securities and Exchange Commission also helped when it eased its regulations on selling restricted securities that were first purchased without the filing of a full prospectus. Under the change, Business Development Services Inc., GE's venture-capital unit, calculates that it now can sell all its stock in one investment while under the old rule it couldn't have sold out for 14 years.

Even the Labor Department has increased the availability of capital for venture firms. It recently issued a proposal clarifying its position on the fiduciary responsibilities of pension-fund trustees. The proposed regulation makes it clear that "investments other than stocks and bonds would be reasonable," says Stewart Greenfield, a managing partner of Oak Investment Partners, a new fund that just raised $25 million, including $3 million from pension funds.

For the entrepreneur, the swelling venture-capital market can be good news indeed. Take Magnuson Systems Corp., a firm founded three years ago to make IBM-type big computers. Last year, Fairchild Camera & Instrument Corp. invested $4 million to expand development and marketing at the audacious little Santa Clara, Calif. company. Early this year, Magnuson began to raise money from venture capitalists for building manufacturing and sales operations. Joseph L. Hitt, president and chief executive, says Magnuson planned to raise $5 million. But it was offered more than $10 million, Mr. Hitt says, and it decided to take $10 million, fulfilling its capital needs for the foreseeable future. "We had an awful lot of interest," he notes.

"There's a lot of money out there, and there's a willingness to invest it," he concludes.

[Reprinted from the Wall Street Journal, Aug. 2, 1979]

An Anti-Inflationary Tax Cut

(By Walter W. Heller[1])

BOARD OF CONTRIBUTORS

A tax cut to neutralize the $25 billion to $30 billion OPEC oil drag can be so structured that every dollar of tax relief will ease cost and price pressures and/or boost productive incentives.

With an eye cocked on the dollar, the Federal Reserve recently tightened credit and President Carter appointed the internationally respected Paul Volcker to head the Federal Reserve System. These moves confirm the historic November 1 commitment to defend the dollar, even at some expense to the domestic economy. They confirm further that actions to keep the OPEC "oil tax" from dragging us into too deep and too long a recession will have to come primarily from the fiscal rather than the monetary side. And with the country, the Congress and Mr. Carter firmly determined to hold federal spending in check, it becomes ever clearer that tax cuts are the way to go.

But not any old tax cuts. They have to be carefully contoured to fit the shape of today's economy. The purchasing power lost to OPEC must be restored in ways that will reduce the cost and price bulges in today's economy and provide incentives to boost productivity in tomorrow's. Can it be done? Yes.

A tax cut to neutralize the $25 billion to $30 billion OPEC oil drag can be so structured that every dollar of tax relief will ease cost and price pressures and/or boost productive incentives. The centerpiece would be a $15 billion to $20 billion cut in Social Security payroll taxes on employers and employes.

Consider the advantages:

Every dollar lopped off the employers' net payroll tax would be a dollar cut in business costs. Given the prevalence of mark-up pricing, this should quickly pass

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[1] Mr. Heller is Regents' Professor of Economics at the University of Minnesota, former chairman of the Council of Economic Advisers under Presidents Kennedy and Johnson and a member of the Journal's Board of Contributors.

through to consumer prices. It is widely agreed that through this process most of the employer-paid payroll tax eventually ends up on the backs of employes. The same process should work in reverse.

Every dollar lopped off the employes' payroll tax is an increase in take-home pay that government can offer workers as part of the price for accepting more restrained wage increases. In the face of what will be predominately a cost-push inflation in the period ahead, this potential easing of wage-push pressure has particular relevance.

Payroll tax cuts are an especially fitting response to OPEC price increases that have been pummeling lower income groups with skyrocketing gasoline and heating oil prices. The payroll tax, like the "OPEC tax," makes no concessions for small incomes or big families, a bane when the tax rises, but a boon when it drops.

INTEGRITY OF SOCIAL SECURITY

So payroll tax cuts are tailor-made to fit the needs of an economy badgered by both inflation and recession. But what of the integrity of the Social Security system? That integrity can be readily protected by shifting Medicare health insurance from payroll tax to general revenue financing. Unlike old age and survivors insurance and unemployment compensation, there is no particular link between wages and health benefits. The shift to general revenue financing would be good short-run fiscal policy, good long-run social policy, and good for the consumer price index.

What would it cost? A payroll tax cut of $21.5 billion (the projected 1980 tax revenues for the hospital insurance program) could be enacted at a net revenue cost of $17.7 billion to the overall federal budget. Because payroll taxes are a deductible business expense, the $10 billion-plus of employers' payroll tax savings would boost business income-tax liabilities by $3.7 billion.

If the health insurance transfer proves too controversial, there is an easy alternative: Simply grant a refundable credit against income taxes for a specified percentage of payroll taxes paid. Congressman Gephardt, for example, has introduced a bill pegging the cut at 20% for both employers and employes. This would do the trick, but since it operates through the income tax in a more roundabout way, it might blur the favorable impact of the tax cut on costs and prices.

A second, closely related component of the anti-inflationary tax cut would be a revised form of real wage insurance. This year's proposal wilted under the heat of price run-ups in oil, food and home building. In contrast, 1980 should be a year of receding inflation, a much more reassuring context in which to consider wage insurance.

Changes in the plan would have to be geared to any changes in the base line of the White House wage-price standards. Instead of calling for income-tax credits for complying wage earners if the consumer price index rises by more than 7 percent, as in this year's proposal, the benchmark might be raised to 8 percent.

At an inflation rate half a percent above the norm, the 1979 proposal would have cost $2.5 billion. If legislation for 1980 were to allow $5 billion for the wage-insurance plan, it would cover reasonable contingencies. To assure that it would not bust the budget in case of a new inflationary breakout, one could apply the co-insurance principle and also put a cap on tax credits at three percentage points above the inflation base line. But such limits would correspondingly dilute the inducement to comply with the wage restraints.

Some observers consider wage insurance a first step towards income-tax indexing, a view that attracts some and repels others. But both sides are missing the point. Unlike indexing, which would try to accommodate inflation by indexing taxpayers against it, wage insurance would serve as an incentive to unions and workers to comply with the wage guidelines and thereby join the battle against inflation. The point is to fight inflation, not adjust to it.

One should note that most of the revenue impact of any wage insurance plan would be delayed until 1981. But with a scheduled payroll tax increase of $15 billion coming up in 1981, the White House and Congress need to take a two-year perspective on tax cuts in any event.

A third major piece of the anti-inflationary tax cut would be a significant easing of depreciation allowances. It is clear that the time has come for such action partly as a response to high inflation rates and partly as an incentive for the increases in business investment and productivity that can help curb inflation in the longer run.

Last year, Congress enacted a major cut in the capital gains tax, thereby improving the general atmosphere for investment. Next year, it should focus more directly on decisions to invest in plant, machinery and equipment by allowing more rapid write-offs that would cut the effective cost of every capital outlay by business. This measure could also add clout to the wage-price restraint program if, as Arthur

Okun has suggested, companies would have to certify compliance with the wage-price guidelines in order to qualify for accelerated depreciation.

A first-year cut of about $5 billion in business tax liabilities would be an appropriate target for the easing of depreciation allowances. A careful appraisal of revenue impacts in future years will be essential.

Even as modest a tax cut as the one here proposed—only slightly more than 1 percent of next year's $2.5 trillion GNP—has to be tested for its impact not just on the cost and supply side of inflation but also on the demand side. In this connection, one should take into account that we are at a curious dual turning point on inflation, downward in the overall rate but upward in the underlying rate:

The overall rate should drop from its torrid 13.3 percent in the first six months of this year to less than 10 percent by year-end as the economy softens, beef and other food prices ease, the fuel price explosion slows down and mortgage interest rates taper off. In other words, there's a downturn in "demand-pull" and "external shock" inflation just ahead.

But at the same time, we are on the verge of an upturn in the underlying "cost-push" of "wage-push" inflation rate.

There is no reason to believe that the proposed tax cuts would reverse the easing of demand inflation. The tax cut is designed not to pump up the economy but to control the damage done by OPEC's rapacious price increases. True, tax cuts cannot restore the real income that the 1979 price explosion is leeching out of the consumers' pockets. But without tax cuts to offset the OPEC drag on purchasing power, recession will lengthen and deepen. To the insult of lost output, jobs, investment and productivity would be added the injury of lost real income. On inflation's demand side, then, an OPEC-offsetting tax cut poses no threat.

What of the cost and supply side? Thus far, thanks in large part to the much-maligned but not ineffective wage-price guidelines, zooming food, fuel and home building costs have not been built into wage increases. Contrary to widespread impressions, the rise in the average hourly earnings index actually tapered down during the 12 months ending in May and average pay increases from June 1978 to June 1979 were lower than in the preceding 12 months.

THE HONEYMOON IS OVER

But the honeymoon seems to be just about over. The game of wage catch-up is about to begin—catch-up with soaring food and fuel prices and non-union catch-up with unions. With little or no productivity gains to absorb the wage increases, the great bulk of wage boosts will pass through to price boosts. The present bedrock or basic inflation rate of around 7 percent could well be boosted to 8 percent or more, thus making the winding down of inflation vastly more difficult.

To forestall or at least minimize the imbedding of the food-fuel-home price bulge into the wage-price structure and into the hardcore inflation rate requires that the wage-price guidelines be revised, reaffirmed and revitalized. A carefully crafted tax cut could go a long way in putting new life and starch into the guidelines and slowing down the price-wage-price merry-go-round.

If the government could strike a wage-moderating bargain with labor of offering a meaningful menu of tax actions to boost take-home pay and provide real wage insurance, prospects for curbing cost-push inflation would brighten overnight. Even if a formal endorsement is out of reach, such tax actions will strengthen the appeal of the wage-price restraint program to millions of workers and to the public in general.

While it is too early to push the panic button on a tax cut, it is none too early to push the planning button. Given the realities of the political process and in particular the budget process, Jan. 1, 1980, is probably the earliest practical effective date for a tax cut. Even that date will require prompt planning, firm proposals by fall and hearings late in the year as a prelude to rapid action after Congress convenes next January. But the earlier the tax cut is announced, the more support it can provide for the wage-price restraint program.

Recently, Vice President Mondale aptly noted that most of the tough economic problems we face involve "solutions that inevitably *front-load* pain and *back-load* pleasure." Surely, that is true of the energy problem and the use of economic slack and slowdown to cope with the inflation problem. But a tax cut, properly structured, can be *both* front-loaded and back-loaded with pleasure.

[Reprinted from Forbes, June 25, 1979]

Comeback for the Dream Merchants

(By Nick Galluccio)

Not many venture capital deals pay off, but what the hell! It's better than dying a slow death with Treasury notes.

Dust off that dream. After a near-dormant decade, the venture capital business is booming again. This year alone an estimated $1 billion in *new* money will be put into financing "the next Xerox," more than ten times the amount available only two years ago. A lot of the money is chasing after high-technology computer and electronics companies, many of which are nestled among the electronic giants operating out of northern California's Silicon Valley. But money is also pouring into such diverse fields as medical research and heavy manufacturing. Other beneficiaries of all this largesse include established dealmakers such as New York's Partick Welsh and Russell Carson, the San Francisco firm of Hambercht & Quist as well as scores of new dream merchants who are sprouting up around the country to assist in channeling the new money.

They are backing some real long shots these days. Here's Magnuson Systems Corp., a capital-starved upstart that hopes to take on IBM. Magnuson was started in 1977 by three California entrepreneurs. Although the firm has only recently built its first medium-size mainframe computers, it was able to raise $10 million in the last three months by giving an investor group a scant 26 percent of its equity. Is $10 million, equal to $7 a share, too much to pay for little more than a dream? Says Bill Hambrecht, senior partner in Hambrecht & Quist, "The risks are horrendous," and if the company actually gets off the ground "they will be even greater" when it tries to take on IBM. Yet Hambrecht's firm has put $1.5 million into Magnuson.

Why? Sutter HIll Ventures' William Draper, who invested $300,000 in Magnuson, says: "The worst feeling is when you turn down something that becomes a real great winner and then you ask yourself, 'Why was I so picky?' Nobody will probably make very much on that company, but they all felt they needed to be in it."

Magnuson's recent experience contrasts sharply with that of Amdahl Corp., another computer maker which, only six years ago, had to go outside the U.S. to get much of the money it needed to finance a high-stakes gamble against IBM's top-end computers. Amdahl was able to tap Chicago's Heizer Corp. for $6 million, but "no one else in the States wanted to touch us," says Clifford Madden, Amdahl's vice president—finance.

The change in the climate can be traced directly to Congress, which last November cut the capital gains tax from 49 percent to 28 percent. While is isn't yet clear whether that cut has made much of a difference to the stock market, it certainly helped open the floodgates for venture capital. Wealthy individuals and families like New York attorney Frederick Adler, Raychem founder Paul Cook, the Hillmans of Pittsburgh and the Rockefellers. Big corporations like Ford Motor, Continental Group, EG&G, Fairchild Camera and American Express, to name a few. Insurance companies and banks like Aetna, Life & Casualty, and Connecticut General, Bank of America, Citibank and Security Pacific National. Even Harvard University, through its endowment fund. They're all getting into the act. Predictably, venture capitalists are themselves becoming entrepreneurs. Citibank lost six of its nine venture group members in the last year, all of whom have started their own funds; BofA's number-two man, Kirk Bowman, recently defected to San Francisco's VestVen. "A period like this tends to make investors say 'Yes' more often than 'No,' " says Sutter Hill's Draper.

The dreamers, of course, have always been there. The American air seems to breed them. But the potential backers had gone elsewhere. By reducing the capital gains tax, Congress improved the odds for the backer. Instead of getting to keep 51 cents on the dollar of their winnings, the backers now get to keep 72 cents. The result is that the odds have improved by almost 50 percent. Without a chance at big winnings, venture capital is a losers' game, as there are inevitably more losses than gains. Los Angeles' Brentwood Associates, for example, estimates that over the next five years the after tax gain on its present $8 million fund will be $3 milion more than it would have been under the old law.

Other factors are behind the boom besides more favorable tax treatment. The Labor Department has told pension fund managers they can invest in new ventures without violating their fiduciary responsibilities. In the last six months over $50 million of pension money has flowed into venture funds, compared with under $5 million for the previous three years, according to Venture Capital Journal.

The venture capitalists are happiest when there is a flourishing new-issue market. That way they have someone to sell their winners to, so they can turn around and back additional ventures. Without the new-issue market, the venture capitalists tend to become stockholders, even with relatively successful ventures. The new-issue market may be meager in comparison with the bull market of 1969 when 698 initial public offerings were made, but it is showing signs of revival. Last year there were 46 public offerings in which $250 million was raised, up 63 percent form 1977. Compare this with only 9 offerings at $16 million in 1974. This year is even better; in the first quarter alone, 15 new companies bank-rolled at $68 million—1,000 percent more money than at the same time in 1978.

Finally, investors are obviously impressed by the heady performance of these few successful venture capital deals, such as Amdahl, Federal Express and Intel, which did get started during the past decade or so. Many venture funds have shown 30 percent to 40 percent annual compound rates of return for that period. Take the case of venture capitalist Arthur Rock. His $300,000 investment in Intel, made back in 1969, is worth over $20 million in today's market. Citibank and First Capital Corp. of Chicago each put $1.6 million into Federal Express in 1973 and each has returned about $11 million. Investors have made millions on smaller deals as well. A $1 million investment in Tandem Computers made in 1974 by the San Francisco venture firm now know as Kleiner Perkins Caufield & Byers in worth $32 million.

The bulk of the money is flowing into the hands of venture capitalists who, like Draper, set up limited partnerships for their investors and decide where to put the money. Each fund is diversified among a number of investments to minimize the risk. Magnuson, for example, was financed by a group of investors including the Rockefellers, Bessemer Securities, Time Inc., Brentwood Associates and Fairchild Camera.

With so much money chasing him, the entrepreneur today can call the shots and demand a bigger piece of the equity in the new company. Case in point: Chicago-based GST laboratories, Inc., a company started three years ago that is developing an instrument to detect breast cancer. Desperately needing financing, inventor David Phillips and three founders, Richard Reilly, James Kelly and James Ryan, recently sought out San Francisco's Montgomery Securities. Montgomery offered to raise $3 million in return for 51 percent of GST's equity. The offer was turned down by the entrepreneurs, who have since found a sweeter offer. The Chicago investment banking firm of John H. Altorfer & Co. has promised to raise $2.5 million (in tax-shelter money), demanding in return a mere 20 percent of GST's equity.

Says Gib Myers, a partner in Menlo Park's Mayfield Fund: "It used to be that you would spend a month and a half doing homework on a prospective deal. No more. Today decisions are made in a week because investors can't wait to get in." In less than a week, for example, Kleiner Perkins Caufield & Byers closed their deal with Keith Swanson, who left Measurex last year to start Econics, a maker of computerized control systems for boilers. The firm bankrolled Swanson to the tune of $1.5 million for 55 percent of Econics' equity. The management team got 45 percent without putting up a dime.

With so much money available for these deals, many of the excesses that caused the venture market to collapse in the late Sixties are already beginning to reappear—high valuations, hasty decisions, entry into furiously competitive markets with second-rate products and novices putting deals together. "There are going to be some absolute horror stories down the road," says Timothy Hay, president of Security Pacific National Bank's venture capital group.

Another factor that is pushing money into venture capital is the dearth of good alternatives. At a time of double-digit inflation, even high-yielding fixed-income investments show negative yields. The stock market as a whole is not going anywhere. Gold is for the constipated. And real estate is getting almost ridiculously overpriced (Forbes, June 11). What's left? Venture capital.

Noel Atkinson, 62, is a California real estate consultant who has for 20 years been putting together limited real estate partnerships as tax shelters for doctors, lawyers and other wealthy individuals. Says Atkinson: "Real estate prices are getting bid so high that people are buying break-even properties. To hell with it, I'm gong to get into venture capital; I just have to call my investors and they will write me out a check."

For his first foray into the venture market Atkinson is raising $1 million to bankroll an electronic graphic-plotting machine developed by a man who has been unable to get backers for five years.

Many newcomers to the field are mesmerized by the Amdahls, Federal expresses and Tandem Computers. They forget that these fat successes were spawned when money was scarce and very choosy. With money less choosy, the failure rate is

inevitably higher. Moreover, if the recession proves a bad one, many of these fledgling ventures are going to die for lack of fresh capital; today's eager backer can easily become tomorrow's hardhearted no-sayer.

Says Morton Collins of Princeton's DSV Associates, a 12-year veteran of the business: "I don't think this is a particularly attractive time to invest. I would rather be countercyclical. Two years from now many of these deals will look disappointing ot their investors—I look forward to refinancing them at bargain prices." He may be right. Yet nobody seems to care. It's kind of like going to the races. You don't really expect to win, but look at the fun you can have if even one of your nags turns out to be a longshot winner.

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VENTURE CAPITAL COMES BACK

Just four or five years ago, stagflation, high capital-gains taxes and a bearish stock market sent venture capitalists scurrying for cover, and promising young companies could barely raise a dime. But suddenly, venture capital seems to be blossoming again. In the last year, entrepreneurs have raised an estimated $750 million for investment in fledging companies—an amount roughly equal to all the venture capital raised between 1969 and 1977. "There's probably more venture capital available today than there's been in ten years," says president Robert Faris of Alan Patricof Associates, Inc., a New York venture-capital firm.

But venture capital is no longer what it used to be. Back in the go-go 1960s, investors backed solid propositions and pipe dreams alike and, predictably, many deals turned into financial disasters. Today, venture capitalists tend to be more conservative, concentrating their investments in companies with at least a few years of experience and some solid indication of ultimate success. "It's a lot more sophisticated game now," says Fred Warren, a general partner in Brentwood Associates in Los Angeles. "People are more selective and more professional, and the quality of deals is much higher."

TAX CUT

The new boom in venture capital was touched off last year when Congress reduced the maximum tax on capital gains from 49 per cent to 28 per cent. The cut did two things: it made venture-capital investments more attractive and it encouraged innovative executives to leave the security of big companies to strike out on their own—with the promise of a killing if they were able to take their new firms public. The government also helped attract venture capital with a Labor Department guideline suggesting that pension-fund managers could invest in a certain number of new ventures and still live us to their fiduciary responsibilities.

At the same time, the stock market was becoming increasingly receptive to new issues, giving the venture capitalists a greater opportunity to cash in their winnings. Last year, for instance, 37 small companies were able to raise $205 million in public offerings; in 1975, by contrast, only four small new firms went to the market, raising just $16 million.

The backbone of the current venture-capital community is a string of about 200 smallish partnerships that typically raise $10 million to $30 million at a time for investment. But giant companies are becoming interested as well. Citicorp, for instance, has invested $55 million in venture-deals since 1967 and has allocated another $100 million for the next few years. Exxon Corp. has an estimated $10 million invested in about 30 ventures. Both big companies take limited partnerships in deals set up by traditional venture-capital firms, as well as seeking investments on their own.

Big company or small, most of the money goes into high-technology industries, such as computers, telecommunications and medical equipment. Because of the great risks involved, the venture capitalists like to spread their money widely. Patricof Associates, for instance, has about $20 million invested in no fewer than seventeen ventures. The theory is simple: venture-capital firms bet that a few big winners will make the game worthwhile and produce an overall compounded annual return of 15 to 25 per cent for their own investors.

WINNERS

In recent years, some impressive success stories have been written with venture capital. Seymour Cray, former senior vice president of Control Data Corp, was able to raise $8.6 million from venture-capital firms in 1972 and take his small company

public in 1976—just after he sold his first computer. Cray Research, Inc., earned $3.5 million last year and many investors have doubled their money.

Similarly, in 1970, venture capitalists poured $46 million into the Amdahl Corp.—formed by Gene Amdahl, who had left IBM after helping design its 360-series computers. Last year, Amdahl earned that much and more on the sale of his own computers. In another big payoff, Qume Corp., which makes printers for data processors, was founded with venture funds in 1973; last year, it was sold to International Telephone and Telegraph Co. for $147.5 millon in ITT stock.

HIGH STAKES

One of the biggest venture-capital successes in recent years was Federal Express, the innovative service airline that delivers small packages. A $5.4 million investment in Federal by New Court Securities Corp. in 973-74 is now worth $24 million. But New Court has some frightening moments along the way. Twice, it had to raise its stake in the company as other investors dropped out.

Still, venture capital isn't flowing freely to everyone with a bright idea, as it seemed to do a decade ago. "It's still quite hard for the beginner to get start-up funds," says Faris of Patricof Associates.

But for entrepreneurs who can operate on a shoestring until the big money comes along, the future looks brighter than it has in years. Venture capitalists now tend to give owner-managers a bigger share of the pie. And tax experts expect Congress to give a further boost to venture capital in its next major tax package. Among the possibilities: a simplified, faster depreciation schedule for buildings and equipment, a "roll-over" provision that would defer capital-gains taxes for investors if they immediately reinvest their profits in a new venture, and more favorable treatment for the now all-but-forgotten executive stock options. The venture-capital firms themselves apparently sense a better future: right now, twenty firms alone are raising another $275 million for investment in promising small enterprises.

[Reprinted from Venture, May 1979]

THE OUTLOOK FOR VENTURES SUDDENLY SEEMS BRIGHTER—LOWER CAPITAL GAINS TAXES MAKE INVESTORS RECEPTIVE; A TOP-BRACKET INVESTOR CAN HOPE TO POCKET $72 INSTEAD OF $50

(By William G. Shepherd, Jr.)

As tax cuts go these days, U.S. Public Law 95-600 didn't receive much fanfare—hardly a rustle compared to, say, California's Proposition 13. But when President Carter signed it into law last November, the Revenue Act of 1978, as it is called, became a watershed for U.S. venture capital.

Most prominently, the act reduced the tax on long-term capital gains, whacking the maximum rate down to 28 percent from 49½ percent. That means that out of every $100 in capital gains, a top-bracket investor can look forward to pocketing, or reinvesting, $72 instead of $50.50—itself a gain of nearly 43 percent.

There is nothing like the allure of capital gains to provoke a healthy itch in investors, entrepreneurs, and the managers both of venture funds and of fledgling enterprises. And in the business of nurturing new business, everybody is beginning to scratch. Big sums of money are flowing into venture partnerships. Investors are starting to take profits they were unwilling to take in the past, thus freeing money for new commitments.

"There've been millions sprung in the past few months," says an exuberant Burt McMurtry of Institutional Ventures Associates (IVA) in Menlo Park, Calif., one of the top venture fund operations. "People are selling things that they wouldn't have sold a year ago. And what's exciting to me is they're putting a lot of it into startups."

San Francisco's Kleiner, Perkins, Caulfield & Byers last summer raised $15 million from individuals for a new venture capital partnership. At the start of 1978, Tom Perkins reports, those investors were very gloomy—but they changed their minds when the tax cut began to appear likely. After the legislation passed, "I personally sold stock that I'd held for five years," Perkins says. "With a 50 percent tax on it, I figured I'd just as soon hold onto it and let it grow."

In Los Angeles, Brentwood Associates raised $20 million in December to start its second fund after a long dry spell. (Its first began in 1972.) "We know that some of that money was roll-over capital from our partners in Brentwood One," says Brentwood's Fred Warren. His first deals include investments in an existing young

company, computer-maker Magnuson Systems in California's Silicon Valley, and a start-up, discount air service operator Midway Airlines out of Chicago's Midway Airport.

On the other side of the fence, the itch is beginning to goad prospective entrepreneurs into leaving safe jobs in big companies. "The entrepreneurs are beginning to stick their heads up," says Perkins. New York venture capitalist Fred Adler agrees. "The biggest impact has been to attract good guys, both the guys who start companies and the guys who run them. We just got a new guy, Bob Morrison, to become president of Telxon," Adler adds by way of example, "and capital gains was a big consideration." And as more high-quality managers are attracted into ventures, notes Ed Glassmeyer of Charter Oak Enterprises in Westport, Conn., "it will make the ventures higher quality."

Under the new act, investors must now add only 40 percent, instead of 50 percent, of net capital gains to gross income on their tax returns. And the untaxed portion, now 60 percent, is free and clear—no longer considered a preference item subject to the add-on minimum tax. Other provisions that help encourage new ventures:

Subchapter S corporations may now have 15 shareholders instead of 10. Actually, they can have more than 15, because under the new rules a husband and wife can be counted as only one shareholder. Subchapter S companies—a structure popular with new companies in the early stages of product development and often abandoned once a product begins to be marketed—are not taxed at the corporate level but, like partnerhips, at the shareholder level.

Companies with up to $1 million of stock can now qualify as "1244 companies" (for Section 1244 of the Internal Revenue Code), double the old limit. And 1244 stockholders who sell shares at a loss can now report up to $50,000 of that loss on individual returns, and $100,000 on joint returns, as an ordinary rather than a capital loss. The previous limits were $25,000 and $50,000.

The investment tax credit, due to drop to 7 percent, was frozen permanently at 10 percent. It was also extended to include some forms of real estate.

The venture capital industry's lobbyists also prevailed upon the Securities & Exchange Commission to alter another rule that has inhibited the reinvestment cycle. Under the SEC's Rule 144, a holder of restricted, or unregistered, stock could sell off shares without registering them provided he sold no more than 1 percent of a company's capitalization every six months. At that rate it would take a holder of 20 percent of a company a decade to cash in.

Under the new Rule 144, he can sell 1 percent of the capitalization every three months. And after five years there is no restriction at all; the shareholder is then free to sell as much as he wants.

As sensitive as the business is to tax angles, the renaissance in venture capital is not due solely to the 1978 Revenue Act. It was a dismal stockmarket that put the kibosh on deals in the mid-1970s. "There was one 12-month period, between mid-1974 and mid-1975," marvels Kleiner, Perkins' Tom Perkins, "when only two companies started up with capitalizations of over $1 million—Tandem Computers and Telenet Corp. Only two!"

Venture deals began to perk up a year or so back when publicly traded shares of small companies began outperforming the market averages. The key to the revival was the mouth-watering successes of such companies as Amdahl, Cray Computer, Storage Technology, and Federal Express.

But the tax cut for capital grains has produced a climate of renewed enthusiasm. "Back in the mid-1970s people would say, 'Capital gains, who needs them? What we need is to find a way to increase earned income,'" explains Milt Pappas of New York's Euclid Partners. But with Proposition 13, the capital gains tax cut, and pressures for a constitutional amendment to halt deficit spending, "we have signs from our lawmakers that we're not going the route to British-type socialism."

Says IVA's Reed Dennis, who as president of the National Venture Capital Association headed the industry's lobbying efforts, "If there hadn't been this kind of change, you'd have seen money drifting out of venture capital and into the income-producing real estate field."

The tax cut has produced tremendous psychological uplift, but it hasn't prompted specific deals directly—at least not among the pros who evaluate deals on their economic merits. "You're not going to go into deal X or deal Y because of the tax cut," says Peter Crisp, who heads Venrock, the Rockefeller family's venture arm. "But on balance, over several years, you'll do more in venture capital generally."

Boston's Peter Brooke, in fact, gives the tax cut no credit at all. Brooke, who runs TA Associates and Brooke & Co., raised $15 million last fall for his third Advent fund. (His first deals for Advent III include two startups, a genetic engineering

company called BioGen, in Switzerland, and a company in the main frame computer field, Functional Automation Corp., in Nashua, N.H.)

But, he says, "I don't think the capital gains tax had anything to do with it"—meaning the money he raised. "It was the success of Federal Express last year more than anything." The stock promptly doubled after the company went public last year.

"That opened up a lot of portfolios to venture capital," he says. But then, more than half of Brooke's clients are either foreign investors who pay no U.S. taxes on tax-exempt college endowment funds.

Something in the neighborhood of $300 million has nevertheless swung to venture partnerships in the past six months. And one major result is that it is permitting managers of such partnerships to become entrepreneurs themselves.

Russell Carson and Patrick Welsh, for example, used to run Citicorp's hugely successful venture fund. They left last year to form a firm of their own with Bruce Anderson—Welsh, Carson & Anderson in New York—and have just succeeded in raising $30 million from institutional investors to do deals.

Charter Oak Enterprises is another case in point. Ed Glassmayer and Stu Greenfield ran Donaldson, Lufkin & Jenrette's Sprout Fund and had been looking for money for several years to start a fund of their own. Last November, less than a month after the tax bill was signed, they raised $25 million and Charter Oak was off and running.

Interestingly in the light of the tax cut, Charter Oak's first deals were not startups but what are called "secondary stock" deals—arrangments to buy into existing small companies that are not yet public. In such instances the company typically has enough cash that it has no reason to sell more stock, but its shareholders are interested in cashing some chips through a private tender.

In one case, the existing shareholders hadn't done too well; they were what Glassmeyer calls "tired investors. They'd been at it 10 years and we were able to buy from them at their original cost." In another case, the company "was doing so well it put too high a value on itself," Glassmeyer says. "But engineers no longer active in the company were willing to sell."

Yet a third deal involved Triad Systems Corp., a fast-growing, five-year-old company in Menlo Park, Calif., that makes inventory control systems for auto parts dealers and that expects to gross between $20 million and $30 million this year. Once again, the company didn't need cash, but management and shareholders relished the idea of taking profits on some of their holdings.

Triad Systems is one of IVA's companies, and IVA's Burt McMurtry structured the deal at roughly 10 times trailing earnings, and 20 times the stock's original price. That way, McMurtry explains, existing shareholders could sell 10 percent of their shares, recover their original investment, take a 100 percent profit—and still have 90 percent of their holdings left. The whole deal amounted to $2.5 million. IVA took $1.5 million of that, and McMurtry invited Charter Oak and San Francisco's Hambrecht & Quist in for $500,000 apiece.

The management people "were by no means selling out," McMurtry hastens to add. One seller was Triad's president, Bill Stevens, who sold 10 percent of his shares. Did the tax cut influence his decision to sell? "For sure," he says.

Private secondary deals like Triad's used to be rare. "There was never much liquidity in venture capital," notes Glassmayer. But they are such a godsend to investors who've been locked into situations that they're likely to proliferate in the months to come. "I think more companies should look at secondaries as a liquidity mechanism," McMurtry says.

The venture capital lobby isn't sitting on its duffs now that the tax cut has gone through.The industry would like to see a further cut in the future, naturally. Also, venture capitalists are pushing for an investment credit for research and development. The credit would be a carry-forward item, explains Brentwood's Warren. And it might stimulate more Subchapter S startups—so initial investors could take the R&D credit themselves.

How to get more deductions for startup investors is a wide-spread topic. New York's Alan Patricoff, in fact, would like to see a mechanism that would permit a first year writeoff for startup investors, something like the 10 percent investment tax credit for companies. "As an incentive, capital gains is not that significant. What investors want is nonrecourse leverage and tax savings up front," Patricoff says. "There's no limit to how much money I could raise if I could offer people startup deductions.

"You'd destroy tax shelters just like that—you'd have tax shelters for different things, corporate instead of real estate or oil and gas. You'd have to limit it, of course," Patricoff explains. "I'd leave it to the government to come up with a

formula that suits their social and economic objectives. You could do electronic companies one year, or companies in the Northeast. You could change it depending on what you wanted to stimulate."

Still another tax issue involves management stock options. Nobody uses options as a management incentive much anymore, because the 1976 Tax Reform Act made the difference between an option's exercise price and the stock's market price taxable as ordinary income rather than as capital gains. The reasoning was that a person who exercises an option has not put his money at risk; theoretically, at least, he can exercise his option by buying his company's shares at $2 each, for instance, and immediately resell in the open market at $10 each, say, for an instant $8 gain.

In fact, though, the SEC's insider rules prevent him from selling very many shares right away. And not only must he pay ordinary income tax rates, he's liable for the tax as soon as he exercises the option.

That has thrown a monkey wrench into the traditional way of letting management share in a company's equity. "What you can do now is establish a low-cost stock ownership program," says Charter Oak's Glassmayer.

But the prospective manager doesn't always have a lot of cash to tie up that way. And of course, the best way to lure a good manager from a safe job is to reduce the risks as much as possible. "I try to get them to gamble and buy stock with company-guaranteed loans," says Fred Adler. "And in some cases I've guaranteed the loans myself—I wanted the buys that bad."

All in all, the prospects and perils of venture capital, like many other segments of the economy, have become inextricably enmeshed in the intricacies of tax law. Whether they like it or not, entrepreneurs have to steep themselves in the angles. And by and large, Adler notes, "I've found them to be very sophisticated about taxes. Sometimes over sophisticated," he adds, "to the point that you wonder if they've involved to start a new company or just to make a quick dollar." Adler shudders. "And we all learned about the quick-dollar guys in the 1960s."

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PLANS BY BUSINESS FOR OUTLAYS IN 1979 SEEN UNCHANGED

U.S. SURVEY SAYS COMPANIES EXPECT 4 PERCENT SPENDING RISE FOR PLANT AND EQUIPMENT

(By a Wall Street Journal Staff Reporter)

WASHINGTON.—Business hasn't significantly altered its plans for 1979 plant and equipment spending, despite the prospect of recession.

The Commerce Department's latest survey of business-spending plans, taken in August, shows that business expects to spend about 4 percent more this year than last for new plant and equipment, after adjustment for inflation. An earlier survey, taken in April and May, showed that business planned to increase spending about 4.5 percent this year following last year's 5 percent rise.

But the latest survey, in adjusting for inflation, assumed a 9 percent increase for capital-goods prices, whereas the earlier survey used 8 percent. As a result, the spending figures "are probably close to being unchanged," a government analyst said.

The Carter administration, which has been saying that any recession this year will be a mild one, is counting on a strong business investment performance to help pick up the expected slack in consumer spending. The government analyst said the expected 4 percent rise in business outlays "appears to be consistent with a relatively mild slowdown."

He warned, however, that "these plans could change again if consumption were to turn sour." Indeed, the latest survey does show some signs consistent with slower economic growth. A Commerce Department economist said that in the earlier survey spending plans accelerated at a 12.9 percent annual rate from this year's second quarter to the final quarter. The latest survey shows that this acceleration slowed to a 7.1 percent rate for the same period.

KREPS SEES REASSURANCE IN SURVEY

Commerce Secretary Juanita Kreps acknowledged in a statement that there would be hardly and "real," or inflation-adjusted, increase in business spending during 1979's second half. But she said "despite the small increase in business capital formation projected for the second half, the survey provides reassurance that

business" haven't altered their investment plans substantially even though overall economic growth declined in the second quarter.

The latest report shows that spending, before adjustment for inflation, was at a $165.94 billion annual rate in this year's first quarter and rose 4.6 percent to a $173,48 billion clip in the second period. Business spending is expected to be at a $175.29 billion annual rate in the third quarter and at a $179.56 billion rate in the final quarter.

The Commerce Department economist also said that the latest report shows a slight reduction from the earlier survey in manufacturers' spending plans. He said, "You expect production to slow down somewhat" during an economic downturn. Still, most government analysts remain convinced that businesses are looking beyond the valley of recession. Unless the economy experiences unexpected shocks, they believe, business spending should remain on a steady course for the remainder of the year.

UNADJUSTED RISE AT 13.2 PERCENT

Before inflation adjustment, the department said, businesses plan to increase spending 13.2 percent this year to $174.1 billion, following an increase of 13.3 percent last year to $153.82 billion. Last June, the department said that business planned to spend an unadjusted $173.3 billion this year, up 12.7 percent from 1978.

The slight boost, before adjustment for inflation, from the June report reflected an increase in 1979 spending plans in the non-manufacturing sector that offset a small lowering of spending plans by manufacturers.

Overall, manufacturers currently expect a 14.6 percent spending rise this year, down slightly from June's estimate of 14.8 percent but up from last year's 12.4 percent increase from 1977. The latest survey shows that durable-goods makers expect an 18.5 percent rise in capital outlays, compared with a 14 percent increase last year. Nondurable-goods industries plan an 11.2 percent increase this year, following a rise of 11 percent in 1978.

Nonmanufacturing concerns expect to spend 12 percent more this year than last, up from an 11.1 percent rise expected in June, but down from last year's 13.9 percent boost.

Here is the breakdown by major industries of capital spending results for past periods and estimates for current and future periods. For comparability with annual totals, the quarterly figures are at seasonally adjusted annual rates, in billions of dollars:

	Actual total 1978	Anticipated total 1979	1979 Apr.-June	1979 July-Sept.	1979 Oct.-Dec.
All industries	153.81	174.11	173.46	175.29	179.56
Manufacturing	67.62	77.53	76.42	78.30	81.95
Durable	31.66	37.53	36.86	38.08	40.38
Nondurable	35.96	40.00	39.56	40.27	41.58
Mining	4.78	5.41	5.31	5.30	5.50
Railroad	3.32	3.90	3.66	4.13	3.92
Air transportation	2.30	3.14	3.26	2.92	3.15
Other transportation	2.43	2.96	2.79	3.24	3.08
Public utilities	29.48	32.89	33.24	33.26	32.79
Communications, commercial and other	43.87	48.27	48.80	48.13	49.08

[Reprinted from the Wall Street Journal, Aug. 16, 1979]

BUSINESS BULLETIN—A SPECIAL BACKGROUND REPORT ON TRENDS IN INDUSTRY AND FINANCE

Venture Capital market, continuing its resurgence, attracts top-drawer funds.

More big companies invest larger portions of their pension and development funds in venture-capital situations. Some top-rated companies set up special funds solely to invest in new high-technology firms. Barry A. Bloomfield, venture-captial specialist at Ladenburg, Thalmann & Co., says, "The risk-to-reward ratio in this area is more favorable to the investor than it has been in some time," due mainly to recent changes in rules on capital-gains taxes and sales of unregistered stock.

Time Inc. has set up a $10 million fund for investment in firms just getting started in a variety of fields. "This allows us to participate in new growth industries

without changing our own structure," says a spokesman. Two winners Time had money on: Atari Inc., a small firm that made it big in electronic TV games, and Telenet Inc., recently acquired by GTE for $55 million.

Venture-capital underwritings, usually initial public offerings of stock, raised $33.9 million in the second quarter, a five-year high, says one industry report.

Mr. WALKER. The most vivid area, the most constructive area—in fact, the area that really piqued the interest and attention of the late William Steiger in introducing the legislation in the House, is the field of venture capital. There has been a dramatic increase in the availability of venture capital documented by many sources.

As Senator Bentsen said, he had to get somebody from Japan to testify on productivity. One of the points that impressed Mr. Steiger so much in the introduction of the legislation, was that the venture capitalists on the west coast said they had to go to Japan to get venture capital to put into businesses over here.

Critics of the cut in capital gains will argue that the econometric studies, some of which were sponsored by the American Council, indicated at the time that there would be a significant increase in the price of corporate stocks. They look at the stock market and say, aha, the legislation is a complete failure.

That overlooks a number of factors.

The most important factor is that the first impact of a reduction in the top capital gains rate from 49 percent to 28 percent will be the unlocking effect on individuals and other taxable holders of the stocks who want to get out and take their capital gains. This means the initial impact in the market tends to be a selling impact.

The second aspect, and I think many of us could make a very strong case for this, is that given all of the tremendous pressures on the stock market in an age of double-digit inflation, the capital gains reduction, by increasing the after-tax return on holding stocks has helped significantly to mitigate the drop in the market.

We do not yet know much, although perhaps the Treasury people do, about the final point which has to do with what happened to revenues. If there was a significant unlocking effect, we would expect the revenues received from the realization of capital gains to start to just do the opposite of what they did after the tax rates were raised in 1969. Then realizations went down and tax receipts went down.

We would expect the opposite impact this time. I will submit that material for the record.[1]

Senator BYRD. Thank you.

Senator BENTSEN. Mr. Chairman, on this very point about venture capital, because in our capital formation hearings that we started some 4 years ago, we were expressing our concern about what had happened in new issues. But in 1977, professionally managed venture capital firms raised approximately $20 million.

That was in 1977.

In 1978, particularly in the last half, you had approximately $215 million raised by such professionally managed venture capital companies.

Through mid-May of this year, you had almost $70 million raised.

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[1] See p. 107.

Stock issues for firms going public for the first time are on the rise. In 1974, only nine firms tapped the new issues market for a total of $60 million.

During 1978, 46 public issues raising $250 million. That is an increase of 63 percent over the previous years. Figures for the first half of 1979 show even better figures, with 37 firms raising $227 million.

There is a substantial change in what has happened to venture capital.

Senator BYRD. Are there any further questions of this panel? Thank you, gentlemen.

[The prepared statement of the preceding panel follows:]

STATEMENT OF DR. CHARLS E. WALKER, CHAIRMAN, AMERICAN COUNCIL FOR CAPITAL FORMATION

Mr. Chairman and Members of the Committee, my name if Charls E. Walker, chairman of the American Council for Capital Formation. I am grateful for this opprtunity to present to the Committee the views of the Council on S. 1435, the Capital Cost Recovery Act of 1979.

The American Council for Capital Formation is a rapidly growing association of individuals and businesses dedicated to promoting the productive investment that fosters stable growth, limits inflation, and creates jobs for our expanding labor force. Established in the early 1970's, the Council has actively supported legislation to eliminate the bias in our tax system that favors consumption but works against the saving and productive investment that increases productivity. Among the most important of these measures have been the reductions in the corporate income tax rate, liberalization of the investment tax credit, and last year's sharp cut in the tax rate on capital gains.

Today we are especially pleased to voice our strong support for the Capital Cost Recovery Act of 1979. This legislation, known as 10-5-3, would both simplify and liberalize business recovery of capital costs. It would, over a five-year period, abolish the useful-life concept and classify depreciable business assets into three groups, each with a different cost recovery period. Class I assests, generally buildings and structural components, would be eligible for a 10-year cost recovery period. The costs of assets in Class II, limited essentially to machinery and equipment, would be recovered over a five-year period. Class III assests would include certain short-lived assets such as cars and light duty trucks whose costs would be recovered over a three-year period. An annual limitation of $100,000 on the amount of investment qualifying under this class would also be in force. The new capital cost recovery system would not be applicable to investment in intangible assets, residential rental property or land.

In addition, the full 10-percent investment tax credit would be allowed for investment in both Class I and Class II assests to the extent that such investment qualifies for the investment tax credit under current law. Investment in Class III assets would be eligible for a 6-percent investment credit. Credit recapature rules would also be established.

It is no overstatement to suggest that 10-5-3 is the most innovative and constructive business tax legislation since introduction of the investment tax credit in 1962. However, before turning specifically to this proposal, let's evaluate the capital formation movement.

CAPITAL FORMATION: WHERE WE ARE AND WHERE WE'VE COME FROM

Memories being short, we are likely to forget that only a few years ago, when the debate on the capital formation issue really got under way, there were many in Congress and outside who argued strongly that there was no capital formation problem, that stimulation of consumer demand was all that was needed to foster such formation, and that in any event the type of tax cuts advocated by capital formation supporters were politically unrealistic. Thus the case for tax changes to promote capital formation became entwined in the ongoing debate over "tax reform." Capital formation measures tended to be smothered by charges that the Federal tax system was shot through with loopholes, that the rich get away with murder when it came to paying taxes, that corporations could be taxed with no ultimate impact on people, and that the impact of capital formation tax measures

on the Federal budget were far too large to contemplate. As recently as 1971, when Treasury officials wer arguing strongly for reinstatement of the investment tax credit and liberalization of depreciation schedules, a prominent liberal economist characterized the proposals as "red meat" for business and "bare bones" for consumers.

The issue, although debated widely, was not solidly joined until mid-1975, when the House Ways and Means Committee began hearings on what became the Tax Reform Act of 1976. In addition, Senator Bentsen launched highly constructive capital formation hearings in his Subcommittee on Financial Markets.

Slowly but surely, both the public and Congress became convinced that the developing capital formation problem was not only significant but its solution could indeed be crucial to the nation's well-being. Moreover, tax reform pressures of the traditional "loophole-closing" variety crested in 1976, and subsequently consideration of measures to promote widely esteemed but longneglected goals of increased saving and investment moved center stage. The urgency of the problem was brought home even more forcefully by poor productivity performance in this country relative to our competitors in world markets, with the resulting negative impact on our balance of trade and the value of the dollar abroad.

Viewed in this perspective, the highly constructive Revenue Act of 1978, which your Committee helped shape in significant ways, marked a major turning point in economic policy in general and tax policy in particular. As to general policy, we began to turn at long last from Keynesian prescribed policies which affect overall demand, to the supply-side considerations that deal with incentives to work, save, and invest. As to tax policy, attention shifted in the country and in the Congress from the question of how income should be distributed to how best it could be produced.

In the process, the barriers to truly productive tax reform for capital formation, if not destroyed, were in effect overrun. The Carter Administration's last fling at closing the alleged loopholes in 1978 was almost totally rejected by the Congress. Attention moved from a few millionaires able to take advantage of a shrinking array of tax shelters to the American Middle Class, which was bearing on overwhelming portion of the rapidly rising Federal tax burden. Members of Congress come to realize what typical Americans had really believed all along—that taxes leved on business are ultimately paid by people; that is, that business does not pay taxes people do, with the burden either passed backwards to those who take the risk and provide the badly needed saving and investment, or forward to consumers.

And, surely not least in importance, Congressional tax leaders—especially on this Committee—finally rebelled against long-standing Treasury and staff approaches to estimating the budget costs of tax measures. The secondary or "feedback" effects of tax changes to promote economic growth and, therefore, taxable income, were actively considered and, in the case of the capital gains tax reduction, plugged into the estimates. Moreover, this Committee recognizing the inadequacy of existing Keynesian demand-oriented economic models, commissioned the development of a modern supply-side model, which I understand is to be ready by next march. In addition, the American Council for Capital Formation: Center for Policy Research has sponsored work in this important area. Our model—the "Prototype Wedge Model ™" developed under the leadership of Professor Arthur Laffer—has been made available to this Committee and staff and we hope that it will prove useful as tax measures are debated.

Mr. Chairman, nothing demonstrates more vividly just how far the country and Congress have come in the capital formation movement than to cast our minds back to the early 1970's and ask: How would the proposal for 10-5-3 have been received at that time? In all probability, it would have been subjected to extreme criticism and even ridicule. Tax purists would have attacked the scuttling of the useful-life concept with respect to capital cost recovery as heresay. The static revenue cost would have brought forth forecasts of huge increases in the Federal deficit. And the whole exercise would have been castigated as a "Fat Cat" plot to provide a "bonanza" for business by further "stacking" the Federal tax system in favor of the rich and against the poor. The fact that only a few voices are now raised in objection to 10-5-3 testifies to the great progress that has been made. And the fact that such progress has been made where it really counts, in Congress, is emphasized by the number of co-sponsors of 10-5-3 legislation—a clear majority of Members in both Houses.

Before turning to the case for 10-5-3, one other aspect of the current situation is noteworthy. I refer to the broad and deep support in the business community for the proposal. It is neither a big business nor a small business measure; the capital formation benefits are spread equitably across the board, and the legislation is

supported by large and small businesses alike. And even though the first-order impact of the legislation will tilt strongly toward capital intensive industries (after all, that's where capital formation is most important), the legislation is supported by individual companies and groups that are not capital intensive, such as retailers, banks and other service institutions.

THE CASE FOR 10-5-3

This Committee will hear from other witnesses who will address the finer points of the Capital Cost Recovery Act. Let me take my few minutes to speak to its overall merit, and also to answer some of the broader criticisms of the measure.

Given the urgency of our capital formation problem—and few dispute that urgency today, 10-5-3 is surely the most cost-effective approach to meeting that problem. Liberalized capital cost recovery provides a bigger and more certain "bang for the buck" with respect to business direct investment than perhaps any other tax measure (the investment credit may be an exception, but Congress at this stage does not appear disposed to increasing the level of the ITC above 10 percent). For a business to receive the depreciation tax cut, the investment must be made. Although highly desirable on their own, cuts in the tax rates on such things as corporate profits and capital gains do not involve the direct, expansive relationship to business investment in plant or equipment.

The proposed capital recovery system possesses other highly desirable qualities. First, when the system is fully phased in, businesses will be able to recoup most of their capital investment even under high rates of inflation—today's drastic underdepreciation of business capital will be largely offset.

Second, the proposal simplifies the Internal Revenue Code because its separates the so-called useful-life concept from the depreciation of capital assets. this is particularly important to small business men, most of whom find the present asset depreciation range too complex and too costly to comply with.

Third, the system will virtually eliminate the present tax bias against investment in very long-lived equipment, which is much more prone to be burdened with the change in the rate of inflation and unforeseen technological obsolescence.

Fourth, 10-5-3 will have a relatively modest negative impact on Federal revenue initially under the proposed phase-in of the system. This is particularly true when the very considerable feedback effects are considered, as they correctly ought to be.

Opponents of the proposal have centered their criticisms on two points—elimination of the useful life-concept and the belief that 10-5-3 is a "giveaway" to business. Some tax and accounting purists argue that abolition of the useful-life concept will violate accepted accounting practices. This argument fails to distinguish between the goal of tax policy, which is to raise revenue with the least damage to the economy, and the goal of traditional accounting practices, which is to provide management and owners with the best possible understanding of the operation of the firm. Tax policy should not serve to allocate resources contrary to the public interest, nor should it unduly distort management decisions. The present useful-life system can only be justified under conditions of zero inflation and a known rate of technological obsolescence, neither of which describes the real world.

Others argue that 10-5-3 is a "giveaway" of tax revenues to business. These critics fail to recognize that, as noted earlier, it is not the business concerns which pay taxs; people do—the owners, creditors and customers. Second, with the inflation of the past decade, many business concerns have been paying taxes on their capital and not on real income, since nominal business profits have been greatly overstated. Third, the real question relates not to any projected reduction (calculated in static terms) in business tax payments as a result of 10-5-3, but the impact of that reduction on growth, inflation and jobs. We submit that that impact will be both positive and large.

CONCLUSION

The case for the Capital Cost Recovery Act—which, I repeat, is landmark legislation—is very strong. The crucial nature of our capital formation problem—the need to shape the tax system so as to encourage saving and productive investment—demands action at the earliest possible date.

These hearings are therefore timely indeed, and it is to be hoped that they will pave the way for favorable action on 10-5-3 in the 96th Congress.

Statement of Edward H. Pendergast, Representing the National Federation of Independent Business

Mr. Chairman and members of the committee: Thank you for this opportunity for the National Federation of Independent Business (NFIB) to share its views with you on these important ten subjects. As you undoubtedly know, NFIB represents over 585,000 small business member firms. Our membership represents all segments of the small business community. One of the most serious problems facing our members is that of capital formation. Outside sources of capital are scarce, so growth must be financed internally to a large extent. One way to facilitate this type of activity is by creating a satisfactory cost recovery system. To be satisfactory, it must be fair, simple and competitive with large businesses and with our international competitors. The present system is not equitable. The need for an effective capital cost recovery extends well beyond the small business community. Our productivity rates as a nation are becoming less competitive. Our exports are being hurt due to our inability to produce products at the same price as other countries. In order to continue to expand employment we must have a modernized plant capacity equal to other Western nations. Our testimony will not address itself to the issue of imports to the country as a whole but, rather to the small business community.

Historically small business has not been able to amortize the purchase price of capital assets as rapidly as larger businesses. While there may not have been a conscious attempt to cause this situation, the effect has been the same. The prime culprits have been the complexities of the Internal Revenue Code, the rules and regulations of the Internal Revenue Service and their attendence paperwork requirements.

The only relief afforded business in the capital recovery area recently is a very complex alternative called Asset Depreciation Range (ADR.) As the enclosed list shows, all assets owned by companies under $100,000 in assets are not covered by ADR, but 86 percent of all assets owned by companies over 100,000 are covered by ADR! Little wonder, since the second paragraph of the regulations refer to 25 definitions necessary to understand terms used in ADR! (Reg. 1.167 (2)(a)). Since 95 percent of depreciable assets of ADR electors are those with companies with assets in access of $100 million, this amounts to a benefit almost solely available to giants. The amount of this benefit alone was estimated at $9 billion in 1974. The Capital Cost Recovery Act repeals ADR and more. For small business, the two most important aspects of the bill relate to the distributive benefits and to the simplicity.

The Distributive Effect of the Capitol Cost Recovery Act

Much has been said of the benefits of the Capital Cost Recovery Act. There has also been much discussion as to who will receive this benefit. It is very difficult to determine what size companies will receive the maximum benefit. Some people have claimed that 75 percent of the benefit would go to the largest corporations in this country, representing 1/10th of 1 percent of the total number of corporations, and that 25 percent of the benefit would go to the smaller businesses. This is based on the assumption that 75 percent of the assets are held by those corporations and that the benefits of the Capital Cost Recovery Act will insure equally to every company.

This is clearly not true since the three-year provisions in the Bill are much more advantageous for small companies since the limitation of the three-year life is for the first $100,000 of assets and the investment tax credit will increase from 3⅓ percent to 6 percent, and companies taking straightline life, due to the lack of either knowledge or some other reason, will now receive a larger benefit because of the automatic acceleration of the rate of depreciation.

Another clear differential is that the benefits of the asset depreciation range bracket (ADR) system of capital cost recovery will be repealed upon passage of the Capital Cost Recovery Act.

To give some perspective to the import of this, when the class life asset depreciation range system (ADR) was put into effect in 1971, the then Undersecretary of the Treasury for Tax Policy told me that this would be a $9 billion benefit. The attached part that shows the use of ADR will show that 97 percent of that benefit went to companies with assets in excess of $50 million and only 3 percent of that went to the benefit of companies with assets of $50 million and under.

This means that the disparity created by ADR will be eliminated under this new Capital Cost Recovery Act which treats everyone roughly the same and eliminates the current prejudice against the small company created by ADR. We say roughly equal because there are instances where the three-year life will be more beneficial to a smaller company because the larger companies will have to use a five-year life for automobiles and light delivery trucks once they reach $100,000.

Putting aside for the moment the subject of what the benefits of the ten-year life for non-residential real property would accomplish, we would like to concentrate for a moment on the benefits of the five- and three-year life sections of the Bill.

We attach a number of examples of how much benefits would be received by some typical types of companies. We understand there are other companies that will receive more benefit and there are some that will receive less benefit, but these examples, albeit arbitrary, will show some of the advantage relatively depending upon the size of the company. It can be seen that the benefits in dollars clearly are in favor of a large company. This is true of any system that is relatively non-discriminatory, since if you have 10 times the number of assets, and you have enough taxable income, and your taxable bracket is higher; then you'll get more benefit than the company that does not have the same size assets and the same tax bracket, due primarily to the fact that the smaller company pays less tax. If we analyze, however, the percentage benefits, it looks somewhat different. See Table A.

TABLE A—USE OF ADR DEPRECIATION BY ASSETS SIZE OF BUSINESS

Asset size	Depreciable assets		Percent of assets under ADR	Percent of total assets in size group
	All businesses	ADR electors		
$0 to $500,000	$87,125,449	$552,528	1	7.4
To $1,000,000	38,796,041	497,657	1	3.3
Subtotal	125,921,490	1,050,185	1	10.7
To $10,000,000	107,151,343	6,147,522	6	9.2
Subtotal	233,073,833	7,197,707	3	19.9
To $100,000,000	108,261,700	29,751,392	27	9.2
Subtotal	341,335,533	36,949,099	11	29.1
To $1 billion	227,099,521	161,479,321	71	19.4
Over $1 billion	604,079,152	556,322,277	92	51.5
Total	1,172,514,206	754,750,697	64	100.0

Source: Office of Industrial Economics, Treasury Department, July 14, 1977; based on 1974 ADR data.

THE SIMPLIFICATION ASPECTS OF THE CAPITAL COST RECOVERY ACT

One of the major aspects of the Capital Cost Recovery Act is the element of simplification. The present system of depreciation is extremely complex. I refer you to our exhibit which is a copy of the seven pages used to describe depreciation in IRS Publication No. 334, "Tax Guide for Small Business—1979 Edition." (Exhibit B)

Starting with page no. 44, the amount of description used here could be reduced significantly by eliminating major portions of the verbiage due to the simplification of the Capital Cost Recovery Act. The section entitled "Useful Life" could be eliminated; the section entitled "Salvage Value" could be eliminated; the subject entitled "Additional First Year Depreciation" can be eliminated; the "Methods of Computing Depreciation" can be eliminated, since there will only be one method. In lieu of this, there could be a reasonably short section saying: "Method of Computing Depreciation", which might read as follows:

There are three types of assets generally used in computing depreciation:

1. Automobiles and Light Delivery Trucks—the first $100,000 is deductible over three years as outlined in the attached schedule.

2. All other tangible personal property is depreciated over 5 years using the attached schedule.

The investment tax credit is 6 percent for the first $100,000 of automobiles and light delivery trucks and the balance of tangible personal property receives a 10 percent investment tax credit.

3. Real property that is non-residential which has a useful life now of 10 years, depreciated over the attached schedule.

This eliminates the explanation for straight line method, declining balance method, salvage value and sum-of-the-years digits. Under the section that is called "Real Estate Depreciation", they give a brief description of the methods for calculating depreciation on real property which primarily are for non-residential real property, the 10-year life method and the old rules apply for other types of real property.

The brief explanation of class life asset depreciation range system which is used by over 90% of the major corporations can be eliminated.

It should be pointed out that the explanation under "Class Life Asset Depreciation Range System" is so vague and general as to preclude the utilization by the normal small business. It is obvious why the description is not broader in the brochure since the first regulation under ADR requires a knowledge of some 25 different terms which may explain why the advantages of ADR have been enjoyed by major corporations and not by the average small business.

There are a number of other simplifications that are helpful to small business that aren't emphasized in this previous comparison. Once fully implemented, the system will allow the average small businessman to go to the "Tax Guide for Small Business" and figure his own depreciation assuming that IRS is clever enough to add a worksheet for these purposes!

All choices have basically been reduced down to a very few. The system automatically qualifies the small business for the benefit of accelerated depreciation. If the small business decides that there is too much depreciation in this year, they may carry it over to a future year which serves as a method of income averaging for the companies with less than $100,000 of taxable income.

The major complexity of the Bill is in the transition rules. To facilitate this complexity for small business, we recommend that in the Class 2 Category, $100,000 of additions be allowed or allowable for the new lifes at once. This removes any problem of transition from over 90% of the corporations.

NFIB strongly supports the Capital Cost Recovery Act. We urge that implementation for five years life assets be immediate for the first $100,000 of depreciation to eliminate the complexities of transition for 90 percent of companies. We further suggest that excess depreciation be allowable to specific assets for simplicity sakes. The essence of the bill is in the 5 and 3 year life provisions for tangible personal property. If the revenue impact of the Act is too costly, we suggest that any adjustments might be in the 10 year provisions relating to real property. This could be in the form of limitations in amount of 10 year depreciation or extension of the 10 year life to a longer period.

We would be pleased to answer any questions you might have.

13. Depreciation

The basis of a building or other tangible and intangible property is recovered by deductions for depreciation. If income-producing property or property used in a trade or business has a limited useful life that can be determined or reasonably estimated, you may deduct its cost or other basis over its useful life. See Chapter 6 for a discussion of basis. The cost of property with a useful life of more than one year, such as buildings, furniture, machinery, copyrights, patents, and oil wells, may not be deducted entirely in one year.

Ordinarily, you cannot depreciate an asset that does not have a limited useful life, such as land or goodwill.

Each year you may deduct, as depreciation, a reasonable allowance for the exhaustion, wear and tear, and obsolescence of *depreciable property* used in your trade or business or held for the production of income. This enables you to recover your cost or other basis of depreciable property during its estimated useful life. There are several methods of computing depreciation. No asset may be depreciated below a reasonable salvage value (defined later) under any method.

Generally, if your depreciable property is sold, exchanged, or involuntarily converted and if a gain is realized, all or a portion of the gain may be treated as ordinary income. See Chapter 24.

Tax preference items for the minimum tax include: a portion of accelerated depreciation on real property, a portion of accelerated depreciation on leased personal property, depletion in excess of property's cost or other basis, and excess amortization of pollution control facilities. For information see Chapter 32.

Various parts of the following discussion may not apply to taxpayers who elect the Class Life Asset Depreciation Range (CLADR) System or the Class Life (CL) System. These systems are discussed briefly at the end of this chapter.

Depreciable Property

The kind of property on which you ordinarily may claim the depreciation deduction is property with a useful life of more than one year. Examples are buildings, machinery, equipment, and trucks.

Must be for business. The depreciation deduction is allowed only for property you use in a trade or business or hold for the production of income. You may not deduct depreciation on property that you and your family use as your personal residence, on your automobile used solely for pleasure or for commuting, or other items used in a similar manner.

If property is used for both business and personal purposes, depreciation is deductible only to the extent that the property is used in your business. See *Property used partly for business,* in Chapter 8.

Property held primarily for sale to customers or property, that is, property includible in your inventory is not depreciable property used in your business. If you look to the sale of property for the recovery of most, or substantially all, of your investment and not to its consumption through use in your business operations, it is not depreciable property used in your business. See Chapter 25 for information on the sale of such property.

Containers generally are includible in inventory. However, large durable containers, used to ship your products, may be depreciable if they have a life in excess of one year, if they qualify as property used in your business, and if title to them does not pass to the buyer. Factors to be considered are your retention of title as indicated by the sales contract, sales invoice, or acknowledgement of order; and their treatment as separate items on the invoice; and their proper recording of basis in your records.

If deposits on containers are required, your gain or loss because customers fail to return them is ordinary income or loss. These items may not be included in the grouping discussed under *How to Report Gains and Losses* in Chapter 25.

Professional libraries are depreciable if their value will diminish. The cost of technical books, journals, and services that have a usefulness of one year or less is deducted as business expense.

Depreciation on equipment used to construct your own capital improvements is not deductible as an expense. The depreciation allowable for the period of construction must be added to the cost basis of the improvements.

Repairs and replacements. You may deduct, as an expense, the cost of incidental repairs that maintain the property in efficient operating condition, if they do not materially add to the value of the property or appreciably prolong its life. Any expenditures for replacements that arrest deterioration or appreciably prolong the life of the property should either be capitalized and depreciated or charged against the depreciation reserve.

Expenses for the removal of architectural and transportation barriers for the handicapped and elderly. For tax years beginning after 1976 and before 1980, you may elect to currently deduct the cost of the removal of architectural and transportation barriers for the handicapped and elderly. If you do not make this election the cost must be capitalized and depreciated over the useful life of the property. For information concerning the election to currently deduct these expenses and the expenses that qualify, see Chapter 20.

Tangible property. You may deduct depreciation on tangible property only to the extent that it is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence. Buildings may be depreciated; land may not.

Intangible property. If an intangible asset used in your business has a limited period of usefulness, it may be depreciated. Your unsupported opinion is not sufficient to establish that fact, but your experience and other factors may be used in the determination. All supporting information should be shown on your tax return.

Straight-line method of depreciation must be used for intangible property.

The additional first-year depreciation deduction, discussed later, may not be claimed on intangible property.

Patents and copyrights are examples of intangible property subject to depreciation. The period of usefulness is ordinarily the life granted by the Government for the patent or copyright. If a patent or copyright becomes valueless in any year before it expires, your unrecovered cost or other basis may be deducted in that tax year. No accounting for salvage value is required for a patent or copyright.

Covenants not to compete are discussed in Chapter 8.

Franchises, designs, drawings, and patterns are intangible assets, and, in some instances, you may deduct a pro rata part of their cost or other basis over their life. But see *Amortization* in Chapter 20.

Assets, such as customer and subscription lists, location contracts, and insurance expirations may be depreciable, if they are recognizable and distinguishable from goodwill. A factual determination must be made that these types of assets have an ascertainable value, separate and distinct from goodwill, and have a limited useful life of which the duration can be ascertained with reasonable accuracy. If both of these facts exist and are determined properly, the value may be depreciated. No deduction, however, is allowable merely because a basis for the asset and a limited useful life have been estimated in the unsupported view of the taxpayer.

Nondepreciable Property

Inventories and stock in trade, automobiles used solely for pleasure purposes or for commuting, and a building used only as a residence are never subject to an allowance for depreciation.

Land is never subject to an allowance for depreciation. Also, the costs of clearing land, grading, planting, and landscaping generally are not depreciable since they are part of the cost of land.

The cost of streets, curbs, sidewalks, sewers, and water mains turned over to a local government and dedicated to public use is not depreciable.

Goodwill is an intangible asset that is not subject to depreciation.

Trademarks and trade names usually have an indefinite life, and the purchase price of such intangible property is not deductible, depreciable, or amortizable. But see *Amortization* in Chapter 20.

Leased Property

Property that is leased is never subject to an allowance for depreciation by the lessee (ten-

ent). Payments under the lease may be deducted as expenses, as explained in Chapter 11.

Improvements by the lessee, ordinarily are subject to an allowance for depreciation or amortization by the lessee. See Chapter 11.

Improvements by lessor. Capital expenditures made by a lessor (landlord) for the erection of buildings or other improvements subject to depreciation allowance must be recovered as depreciation deductions over the useful life of the improvements without regard to the period of the lease.

Cost of acquiring lease. See *Amortization* in Chapter 20.

Option to renew. See Chapter 11.

Basis for Determining Depreciation

The basis for determining depreciation is the same as the basis that you would use to determine your gain if you sold the property. Usually, the cost of property is its basis. If you materially improve the property, the additional costs are added to the basis; whereas, casualty losses reduce the basis. Chapter 6 discusses the basis and adjusted basis of property.

The basis for nonbusiness property converted to business use is the lesser of its fair market value on the date you began using it in your business, or the adjusted basis of the property at that time.

Apportionment of basis. If you acquire property for a lump sum which includes both depreciable and nondepreciable property, you must allocate your total basis between the depreciable and nondepreciable property. The basis for depreciation cannot exceed an amount which bears the same proportion to the lump sum as the value of the depreciable property bears to the value of the entire property at the time you acquired it.

Example. You purchased a building and the land on which it stands for $30,000. If the value of the building is two-thirds of the total value of the land and building, your basis for depreciating the building, before considering salvage, is $20,000 (⅔ × $30,000). See Chapter 6 for determining basis.

Amount of Depreciation Deduction

You should take the proper depreciation in each tax year. If you failed to deduct allowable depreciation in past years, you may not deduct the unclaimed depreciation in the current or a later tax year.

If you acquire or dispose of property during the year, and do not use an averaging convention, regular depreciation is allowable for only part of the year. Depreciation begins when the asset is placed in service and ends when the asset is retired from service. An asset is considered first placed in service when it is first available for service.

Example. You order a new frame straightening machine for use in your auto body shop. The machine is installed in your shop and available for use on May 1. The machine is not used until July, because you did not have any frame straightening jobs until then. Depreciation begins as of May 1, when the machine was first available for service.

You are not required to allocate the *Additional First-Year Depreciation*, discussed later.

In the case of a multiple asset account, the amount of depreciation may be determined by using an *averaging convention*, that is, by using an assumed timing of additions and retirements. For example, it might be assumed that all additions and retirements to the asset account occur uniformly throughout the tax year in which case depreciation is computed on the average beginning and ending balances of the asset account for the tax year. An averaging convention, if used, must be consistently followed for the account or accounts for which it is adopted. The averaging convention method may not be used in computing depreciation for large and unusual acquisitions that substantially distort the depreciation deduction for the year. Instead, such assets must be depreciated separately from the multiple asset accounts according to their useful lives.

Cannot exceed basis. The total of all your annual depreciation deductions cannot exceed your cost or other basis (less salvage value) of a property. For this purpose, the depreciation deduction amounts must include any depreciation you were allowed to claim, even if you failed to claim the deduction. *Salvage value* is discussed later.

If you acquire a combination of depreciable and amortizable property, depreciation is allowable only for the portion of the property that is not subject to the allowance for amortization. See Chapter 20 for a discussion of amortization.

Useful Life

The first step in computing depreciation is to determine the estimated useful life of the asset. No average useful life for an item is applicable in all businesses. The useful life of any item depends upon such things as the frequency with which you use it; its age when you acquired it; your policy as to repairs, renewals, and replacements; the climate in which it is used; the normal progress of the art, economic changes, inventions, and other developments within the industry and your trade or business.

You should determine the useful life of the depreciable property on the basis of your particular operating conditions and experience. If your experience is inadequate, you may use the general experience in the industry until your own experience forms an adequate basis for making the determination.

Can be changed. The estimated useful life may be modified because of conditions you know exist at the end of any tax year. This change may be made when necessary regardless of your method of computing depreciation. However, the estimated remaining useful life of any asset should be redetermined only when the change in useful life is significant and there is a clear and convincing basis for a redetermination.

Boilers fueled by oil or gas. If you expect to retire or replace a boiler that is fueled by oil or gas before the end of its orginally determined useful life, then for tax years ending after November 9, 1978, you may file a special application with the Internal Revenue Service to depreciate the remaining basis of the equipment over a shortened useful life. For more information, see Publication 534.

Agreement as to life. You may enter into a written agreement with the Internal Revenue Service as to the estimated useful life, method and rate of depreciation, and salvage value of any property. You must apply for this agreement, in quadruplicate, to your District Director of Internal Revenue. For further information on this type of agreement, see Publication 534.

Obsolescence. In computing depreciation, you may consider the extent to which the expected useful life of the property will be shortened by technological improvements, progress in the arts, reasonably foreseeable economic changes, shifting of business centers, prohibitory laws, and other causes, apart from physical wear and tear that actually diminish the value of the property or shorten its useful life.

Salvage Value

Salvage value is the amount (determined at the time of acquisition) that you estimate will be realized upon sale or other disposition of an asset when it is no longer useful in your business or in the production of your income and is to be retired from service. Salvage value is not subsequently adjusted merely because of a price level change. If you customarily use an asset for its full inherent useful life, salvage value may be no more than junk value. But, if it is your policy to retire assets that are still in good operating condition, salvage value may represent a relatively large portion of the original cost or basis of the asset.

Salvage, when reduced by the cost of removal, is called *net salvage*. You may use either salvage or net salvage in determining depreciation but one practice must be consistently followed. However, negative net salvage is not allowable, and the net salvage is zero when the estimated charges for removal exceed estimated salvage value. Your treatment of the costs of removal must be consistent with the practice you adopt. If you redetermine the useful life of an asset, you should at the same time redetermine the salvage value.

If you acquire new or used personal property (other than livestock) with a useful life of 3 years or more, you may reduce the salvage value by any amount up to 10% of the full adjusted basis of the property when acquired.

Example 1. You purchased a new lathe, having a useful life of 10 years for $1,000, for use in

your business. Assume the salvage value to you of this lathe at the end of its useful life would be $80. If you wish, you may disregard salvage value and compute your depreciation based on the entire $1,000 cost.

Example 2. Assume the same facts as in Example 1, except that salvage value is $120. You may disregard up to $100 of salvage value and compute your depreciation deduction on $980. The remaining $20 is your salvage value for this asset.

Additional First-Year Depreciation

You may elect to deduct 20% of the cost of qualifying property (subject to a dollar limitation discussed later) as additional first-year depreciation in addition to your regular depreciation. You do not use salvage value in computing this deduction.

Trusts may not claim the additional first-year depreciation. All other taxpayers may, if they acquire qualifying property.

When allowable. You may take this deduction only in the first tax year that a depreciation deduction is allowable on the property. Ordinarily this is the year in which the property is acquired. However, if it has been your consistent practice to treat property acquired during the last half of a month as property acquired on the first of the following month, then additional first-year depreciation on property acquired during the last few days of your tax year would be deducted in the following year.

Qualifying property. New or used tangible personal property having a useful life of at least 6 years (determined at date of acquisition) is qualifying property. It must be purchased for use in your business or for the production of income.

Tangible personal property includes assets that are accessories to the operation of a business, such as machinery, printing presses, transportation equipment, office equipment, refrigerators, individual air-conditioning units, and grocery counters (even though such assets may be termed fixtures under local law). The adjusted basis of property traded in for like property will not be taken into account in determining the cost of the newly acquired property for purposes of the additional depreciation allowance.

Example. You are allowed $500 on an old truck that you traded for a new $3,000 truck. You paid $2,500 either in cash or notes. Only the $2,500 would be the cost of the qualifying property.

Nonqualifying property. Land and improvements, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings or structures), and intangible property, such as patents or trademarks, do not qualify for the additional first-year depreciation deduction. Also, property must be *purchased* in order to be eligible for this deduction (gifts and bequests do not qualify). If property is purchased for personal purposes and later converted to use in a trade or business or to property held for the production of income, it does not qualify for the additional allowance. Moreover, the additional allowance is not allowed on purchase transactions between related taxpayers, related partners and partnerships, and certain members of the same affiliated group of corporations.

Related taxpayer transactions, as defined in Chapter 4 (except that for this purpose, brothers and sisters—whether by the whole or halfblood—are not considered members of the immediate family), will not qualify for the additional allowance. For example, a purchase of property from your husband or your wife does not qualify, but property purchased from your brother or sister will qualify for the deduction.

Transactions between either a partnership and a partner owning directly or indirectly an interest of more than 50% of the capital or profits of the partnership, or two partnerships in which the same persons own directly or indirectly more than 50% of the capital or profits of both partnerships, will not qualify for the additional allowance.

The rules contained in Chapter 28 for constructive ownership apply in determining the 50% ownership in partnership capital or profits.

If property is acquired by one component member of a controlled group from another member of the same controlled group, the additional allowance is not allowed.

Limitation. The cost of property on which you may take this additional allowance is limited to $10,000 on a separate return and $20,000 on a joint return. For example, if during your tax year you bought $30,000 worth of qualifying property, you may deduct 20% of only $10,000 on a separate return or 20% of only $20,000 on a joint return. If a corporation had purchased the property, its deduction would be 20% of only $10,000.

You may select the items, and the portion of their costs upon which you wish to claim the additional allowance.

Any additional allowance claimed by an estate and allocated to a beneficiary does not affect the additional allowance that a beneficiary may otherwise claim on property not held by the estate.

Computation of deduction. The additional first-year depreciation deduction is determined without adjustment to basis for salvage value and is allowed in full, even though the property is acquired during the year. Ordinary depreciation is then computed on the cost or other basis of the property, less the additional first-year depreciation deduction and salvage value.

Example. You are a calendar-year taxpayer. On July 1, you bought a used piledriver for $14,800. It had an estimated useful life of 10 years and a salvage value of $800 (over and above the 10% of basis that may be disregarded). Your depreciation deduction is computed as follows:

SEPARATE RETURN	
Additional first-year depreciation: 20% of $10,000 ($14,800 limited to $10,000)	$2,000
Regular depreciation: 10% of $12,000 ($14,800 less the $2,000 and less $800 salvage) × 1/2 year	600
Total depreciation for the year	$2,600
JOINT RETURN	
Additional first-year depreciation: 20% of $14,800 (limitation is $20,000)	$2,960
Regular depreciation: 10% of $11,040 ($14,800 less the $2,960 and less $800 salvage) × 1/2 year	552
Total depreciation for the year	$3,512

The election must be made separately for each tax year for which you claim additional first-year depreciation. You make the election on your income tax return for the year to which the election applies. This tax return must be filed within the time (including extensions) prescribed for filing your return for the first year for which a deduction for depreciation is allowable on the qualifying property.

To make the election you must show the additional first-year depreciation separately on the depreciation schedule, which should be attached to your return. However, you combine your regular depreciation and the additional first-year depreciation amounts to compute your total depreciation deduction for the year.

The items of property selected, as well as the election itself are binding and cannot be changed without the consent of the Internal Revenue Service.

Records. You must keep records that permit specific identification of each piece of property for which the additional first-year depreciation is claimed and that show how, when, and from whom the property was acquired.

Partnerships. The election to claim additional first-year depreciation on partnership property is made by the partnership. However, the amount of the additional allowance is determined separately for each partner. Each partner's additional allowable depreciation is determined by allocating to each partner a portion of the cost of the qualifying property selected by the partnership in the same ratio as is used for determining each partner's distributive share of ordinary depreciation. An allocation of the amount of the qualifying property among the partners may not be modified after the due date of the partnership return (without regard to extensions of time) for the year of the election.

For partnership tax years beginning *after 1975,* the partnership is limited to $10,000 of cost upon which the partnership is allowed to compute the additional allowance.

Each partner's total allowance for additional first-year depreciation is limited to $2,000 ($4,000 if married and filing a joint return), including the amount allocated by the partnership and any additional first-year depreciation to which the partner may be entitled from a separate trade or business.

The basis of the partnership's qualifying property must be adjusted to reflect this additional allowance. This adjustment to the part-

nership's basis is required, even though a partner may not be entitled to deduct all or any of the amount attributable to the partner from the partnership because the total additional first-year depreciation allowances available to the partner from this and other partnerships or sole proprietorships exceed the limitation of $2,000 or $4,000. Of course, if the partnership elected to claim the additional allowance for a smaller portion of the cost of the qualifying property, the basis would be adjusted only for the smaller additional allowance.

Example. Assume that the partnership of Jones, Smith, and Brown purchased $100,000 of qualifying property on February 10, 1978. The tax year of the partnership began on January 1, 1978. Under the partnership agreement, the allocation of each partner's distributive share of ordinary depreciation is 45% to Jones, 5% to Smith, and 50% to Brown. Jones is married and files a joint income tax return. Smith and Brown are both single. The partnership elects to claim the additional first-year depreciation allowance on the qualifying property. The partnership is entitled to deduct, in the year of purchase only, $2,000 (20% of $10,000) of additional first-year depreciation because a partnership with a tax year beginning after 1975 is limited to $10,000 of cost upon which the additional allowance may be computed. The allocation of the $10,000 and the additional allowance to each partner is computed as follows:

Partners	Jones	Smith	Brown
Shares of ordinary depreciation	45%	5%	50%
Maximum amount subject to election ($10,000)	$4,500	$500	$5,000
Additional first-year depreciation allowance ($2,000)	$ 900	$100	$1,000

If any of the partners was a member of another partnership or had an individual business that elected to claim additional first-year depreciation on its qualifying property, and the sum of the additional allowances from the partnership in the Example and any other businesses exceeded the limitation of $2,000 or $4,000, that partner could not deduct the full amount of the additional allowance as computed in these examples. However, the basis of the partnership property still would be adjusted for the full allowance.

Trust as partner. If one of the partners is a trust, the partnership may only use the cost of qualifying property attributable to the non-trust partners. No additional first-year depreciation is allowed to the trust, and no adjustment to the basis of the qualifying property is required for the share of the property allocable to the trust. If in the previous example Brown was a trust, only the qualifying property attributable to Jones' 45% and Smith's 5% could be selected by the partnership for the additional first-year depreciation allowance. The entries in the Example would then appear as follows:

Partners	Jones	Smith	Brown Trust
Share of ordinary depreciation	45%	5%	50%
Maximum amount subject to election ($5,000)	$4,500	$500	[illegible]
Additional first-year depreciation allowance ($1,000)	$ 900	$100	[illegible]

Methods of Computing Depreciation

Any reasonable method that is consistently applied may be used in computing depreciation. The three methods most generally used are:

1) Straight-line;
2) Declining-balance; and
3) Sum-of the years-digits.

Certain depreciable property, such as used property, may be eligible for the additional first-year depreciation, but not for use of the sum of the years-digits method or the declining-balance method using twice the straight-line rate.

Likewise, the sum of the years-digits method or the declining-balance method using twice the straight-line rate may apply to certain depreciable property that is not eligible for the additional first-year depreciation.

Depreciable real property that you acquire new after July 24, 1969, may not be eligible for use of the sum of the years-digits method or the declining-balance method using twice the straight-line rate. (See the sections describing the declining-balance and sum of the years-digits methods.)

The depreciation allowance illustrated in the examples in the following paragraphs does not include additional first-year depreciation, since the depreciable property is not eligible for this additional depreciation in all cases.

Straight-line method. This method is the simplest for computing depreciation. Under this method, the cost or other basis of the property less its salvage value is deducted in equal annual amounts over the period of its estimated useful life.

The depreciation for each year is determined by dividing the adjusted basis of the property, less salvage value, by the remaining useful life. This method must be used for any depreciable property for which you have not adopted a different acceptable method. The straight-line method must also be used for certain boilers that use oil or gas and that are placed in service after September 1978. For more information, see Publication 534.

Declining-balance method. Under this method, the depreciation, which you take each year, is subtracted from the cost or other basis of the property before computing the next year's depreciation. The same depreciation rate applies to a smaller or declining balance each year. Thus, a larger depreciation deduction is taken for the first year and a gradually smaller deduction in succeeding years.

Within limits, the depreciation rate used is greater than the rate that would be used under the straight-line method. Under some circumstances you may use a rate twice as great as would be proper under the straight-line method. Under other circumstances you are limited to a rate 1½ or 1¼ times as great as the rate you would use under the straight-line method.

Salvage value is not deducted from the cost or other basis of your property in determining the annual depreciation allowance under the declining-balance method. However, you must not depreciate your property below its reasonable salvage value. But see *Salvage Value.*

Twice the straight-line rate may be used to compute depreciation under this method only on the following tangible property:

1) Property having a useful life of 3 years or more that you acquire new after 1953, and, if real property, before July 25, 1969.
2) Property having a useful life of 3 years or more that is constructed, reconstructed, or erected by you after 1953, and, if real property, before July 25, 1969;
3) Real property, any part of which was constructed or financed under a written contract entered into by you before July 25, 1969, and binding on you on and after that date; or
4) Real property that is new residential rental property. (See *Real Estate Depreciation* discussed later.)

Example. Assume you purchased a new machine in January of this year for $2,000, and its estimated life is 10 years. Under the straight-line method of computing depreciation, the rate is 10%. Since this machine meets all the conditions already stated, it may be depreciated under the declining-balance method at a rate twice the straight-line rate or 20%. Your depreciation allowance on this machine for this year is $400, which is 20% of $2,000. Your depreciation allowance the following year is $320, or 20% of $1,600 ($2,000 minus $400).

One and one-half times straight-line rate. The maximum rate you may use under the declining-balance method on *used tangible personal property* (or new property acquired before 1954) having a useful life of 3 years or more, is 1½ times the straight-line rate. The same maximum rate applies to *used depreciable real property* acquired before July 25, 1969, and to *new real property* (other than new residential rental property) acquired after July 24, 1969.

Example. If in the preceding example you had purchased a used machine, the maximum declining-balance rate would be 15% (1½ times the straight-line rate of 10%). Thus, your depreciation for the first year would have been $300, which is 15% of $2,000, and for the 2nd year $255, which is 15% of $1,700 ($2,000 minus $300).

One and one-fourth times straight-line rate. The maximum rate that you can use under the declining-balance method on *used residential rental property* acquired after July 24, 1969, and having a useful life of 20 years or more is 1¼ times the straight-line rate.

You may change from the declining-balance method to the straight-line method without the consent of the Internal Revenue Service. This change may be made at any time during the useful life of the property, unless the change is prohibited by a written agreement. When this change is made, the unrecovered cost or other basis less the estimated salvage value must be spread over the estimated remaining useful life determined at the time of change.

A change from the declining-balance method to the straight-line method may be made only on the original return for the tax year in which the change is made. The change may not be made on an amended return filed after the due date, including extensions, for filing your return.

You must attach a statement to your return for the tax year in which the change is made showing the date of acquisition of the property, the cost or other basis, the amounts recovered through depreciation and other allowances, the salvage value, the character of the property, its remaining useful life, and other information as may be required.

After you change to the straight-line method for any property, you generally may not change to the declining-balance or to another method of depreciation for a period of 10 years without written permission from the Internal Revenue Service.

You cannot combine assets in an account on which depreciation was formerly computed by the declining-balance method with assets in an account previously depreciated by the straight-line method. They must be maintained in separate accounts.

If you used an erroneous method of depreciation for used property and the Internal Revenue Service disallows such improper method, you may adopt the straight-line method, or any other method of depreciation that would have been permissible had you adopted it initially. Moreover, if you filed your first return using an improper depreciation method, and later file an amended return before the return filing date for the next succeeding tax year, you may use the proper depreciation method on the amended return without obtaining the consent of the Internal Revenue Service.

Sum of the years-digits method. Under this method, as a general rule, you apply a different fraction each year to the cost or other basis of each single asset account *reduced by estimated salvage value.* The denominator (bottom number) of the fraction, which remains constant, is the total of the digits representing the years of estimated useful life of the property. For example, if the estimated useful life is 5 years, the denominator is 15, that is, the sum of 1+2+3+4+5. To save time in arriving at the denominator, especially when an asset has a long life, square the life of the asset, add the life, and divide by 2. Thus, the asset with a 5-year life has the denominator 5 x 5 + 5 ÷ 2 = 15.

The numerator (top number) of the fraction changes each year to represent the years of useful life remaining at the beginning of the year for which the computation is made. For the first year of a 5-year estimated useful life, the numerator would be 5, for the second year 4, etc. Thus, for property with an estimated useful life of 5 years, the fraction to be applied to the cost or other basis, minus salvage value, to compute depreciation for the first year is 5/15. The fractions for the 2nd, 3rd, 4th, and 5th years are [illegible], and 1/15, respectively. [illegible]

The [illegible] method may be [illegible] only on property that meets the require-ments for up to *twice the straight-line rate* under *Declining-balance method,* discussed previously.

Remaining-life plan. You may use the sum of the years-digits method for single asset accounts and group, classified, or composite accounts on the remaining-life plan by applying changing fractions to the unrecovered cost or other basis reduced by salvage.

Under this plan, the denominator of the fraction changes each year to a number equal to the total of the digits representing the estimated remaining useful life of the property. The numerator of the fraction changes each year to represent the years of useful life remaining at the beginning of the year for which the computation is made.

For example, property with an estimated useful life of 5 years is purchased for $6,500 and placed in service January 3, 1978. Assuming a salvage value of $500, the depreciation allowance for 1978 is $2,000, (5/15 of $6,000). The fraction of 5/15 is arrived at as already shown. For 1979, the unrecovered balance is $4,000, and the remaining-life is 4 years.

The sum of the digits 1, 2, 3, and 4 is 10, and the depreciation allowance for 1979 would be $1,600, that is 4/10 of $4,000 ($6,000 less $2,000). For 1980, 1981, and 1982, the depreciation allowances, respectively, would be $1,200 (3/6 of $2,400 ($4,000 less $1,600)), $800 (2/3 of $1,200 ($2,400 less $1,200)) and $400 (1/1 of $400, the unrecovered cost in the last year of useful life).

You can get the decimal equivalents of the sum of the years-digits fractions corresponding to remaining lives from 1 to 100 years from the Income tax regulations on depreciation available at your Internal Revenue office, and you may use them in your computations in place of the fractions you would otherwise compute.

You must obtain consent from the Internal Revenue Service by filing Form 3115 if you wish to use the sum of the years-digits method for group, classified, or composite accounts under a plan other than the remaining-life plan.

Nontaxable exchanges. Neither the declining-balance method at twice the straight-line rate nor the sum of the years-digits method may be used on property that you acquire as a separate taxable entity in a nontaxable exchange, even though the transferor used one of these methods before the exchange. The reason is that the original use of the property did not begin with you, as is required.

Any other consistent method of computing depreciation, such as the sinking fund method, may be used for Federal income tax purposes. However, during the first two-thirds of the useful life of the property, your depreciation deductions under any such method must not result at the end of any tax year in accumulated allowances that are greater than the total that could have been deducted if the declining-balance method had been used. The limitations on the use of the declining-balance and sum of the years-digits methods apply equally to any consistent method used other than the straight-line method.

If you convert to business or rental use property that you held for personal use, and you were the original purchaser and user of the property, you may select the declining-balance method or the sum of the years-digits method for computing depreciation, subject to the limitations prescribed for each method.

For example, if you bought a new home in 1963 as your residence, and converted it to rental property on or before July 24, 1969, you may compute depreciation on the property under the sum of the years-digits method, or you may use the declining-balance method and apply a rate not in excess of twice the rate under the straight-line method. But, if you acquired the residence before 1954 or if you were not the first owner, you may not use the sum of the years-digits method, and, if you select the declining-balance method, the rate of depreciation may not exceed 1½ times the rate under the straight-line method. For the basis to be used for computing depreciation in such cases, see *Property Converted to Business or Rental Use,* in Chapter 8.

After July 24, 1969. Any realty converted to a business or income producing use after July 24, 1969 is treated as used real property.

Before you select a method for computing depreciation, you should check the limitations to make sure it is available to you. Then, you decide whether you want a fixed deduction each year under the straight-line method, or a larger deduction in the first year with diminishing deductions in succeeding years under the other methods. You may use different methods for each item account and for each group, classified, or composite account. But you must thereafter apply the method consistently to each item of property in each item account, and to each group, classified, or composite account. However, see *Change of method,* discussed later.

Comparative writeoffs under three methods. Assume that a new machine with an estimated life of 5 years is bought on January 3, 1978, for $10,000. Its salvage value, which is estimated to be $500, was not taken into consideration in computing depreciation since it was less than 10% of the cost of the machine. See *Salvage value,* discussed earlier. Additional first year depreciation is not considered since the useful life of the property is less than 6 years.

Straight-line method:

Year	Cost	Rate	Deduction	Reserve Dec. 31
First	$10,000	20%	$2,000	$2,000
Second	10,000	20%	2,000	4,000
Third	10,000	20%	2,000	6,000
Fourth	10,000	20%	2,000	8,000
Fifth	10,000	20%	2,000	10,000

Declining-balance method:

Year	Unrecovered cost Jan. 1	Rate	Deduction	Reserve Dec. 31
First	$10,000	40%	$4,000	$4,000
Second	6,000	40%	2,400	6,400
Third	3,600	40%	1,440	7,840
Fourth	2,160	40%	864	8,704
Fifth	1,296	40%	518	9,222

Sum of years-digits method, general rule, used for single asset account only:

Year	Cost	Fraction	Deduction	Reserve Dec. 31
First	$10,000	5/15	$3,333	$3,333
Second	10,000	4/15	2,667	6,000
Third	10,000	3/15	2,000	8,000
Fourth	10,000	2/15	1,333	9,333
Fifth	10,000	1/15	667	10,000

Sum of years-digits method, remaining-life plan:

Year	Unrecovered Cost Jan. 1	Fraction	Deduction	Reserve Dec. 31
First	$10,000	5/15	$3,333	$3,333
Second	6,667	4/10	2,667	6,000
Third	4,000	3/6	2,000	8,000
Fourth	2,000	2/3	1,333	9,333
Fifth	667	1/1	667	10,000

Change of method. Generally, any change in the method of computing depreciation is a change in method of accounting that requires the consent of the Internal Revenue Service. See Chapter 4. However, as previously discussed, certain changes from the declining-balance method to the straight-line method do not require consent. Once you have changed to the straight-line rate you may not change back without getting permission.

A change in your depreciation method should be requested on Form 3115 which requires you to provide certain information concerning the depreciable property which is the subject of the change.

Real Estate Depreciation

Generally, real property that you acquired new before July 25, 1969 can be depreciated under the declining-balance method of depreciation at a rate not exceeding twice the straight-line rate or under the sum of the years-digits method. Used real property acquired before July 25, 1969 can be depreciated under the declining-balance method at a rate not exceeding 1½ times the straight-line rate. The straight-line method can be used for any property qualifying for depreciation.

Limitation on real estate depreciation. You are limited to a rate that is 1½ times the straight-line rate on new real estate (including commercial and industrial buildings) acquired after July 24, 1969. An exception is made for new residential rental housing. If at least 80% of the gross rental income from the building each year is derived from rentals of residential units. A residential unit means a house or an apartment used to provide accommodations, but does not include units in a hotel, motel, inn, or other establishment in which more than one-half of the units are used on a transient basis. You may still use a rate that is twice the straight-line rate for this property.

The 80 percent test is computed each year. Therefore, if your gross rentals are only 79% for 1978, you may use the 150% declining-balance for that year. If your gross rentals are 80% for 1979, you may use the 200% declining-balance or sum of the years-digits method for new residential property. A change in the method of [illegible] computing depreciation which is permitted or required because of the operation of this test does not require consent of the Service since it is not considered a change in method of accounting.

You may depreciate used real estate (other than certain residential property) acquired after July 24, 1969, only under the straight-line method. Used residential rental property with a useful life of 20 years or more, acquired after July 24, 1969, is limited to a rate that is 1¼ times the straight-line rate.

Refer to Publication 534 for a detailed discussion of real estate depreciation.

Low-income rental housing. The taxpayer may elect to compute depreciation of rehabilitation expenditures incurred for low-income rental housing after July 24, 1969, and before 1982, by using a 60-month useful life. Rehabilitation expenditures incurred after 1981 may be eligible for the 5-year life, if these expenditures were incurred pursuant to a binding contract entered into before 1982 or if the rehabilitation was begun before 1982. For this purpose the straight-line method is used, and no salvage value is used in computing depreciation. Rehabilitation expenditures eligible for this treatment are limited to $20,000 ($15,000 for expenditures incurred before 1976) per dwelling unit. The term low-income rental housing means any building in which the dwelling units are held for rent to families and individuals of low or moderate income. See Publication 534 for more detailed information.

Accounting for Depreciable Property

The cost or other basis of every asset subject to depreciation is recorded in an asset account. You may establish as many accounts for depreciable property as you wish. You may either itemize each asset separately, or combine two or more assets into one account.

Single item accounts. Under this accounting practice, each individual item of property is treated as a separate account. For additional information see Publication 534.

Component accounts. The components of depreciable property (such as wiring or a roof) may be set up in separate accounts and depreciated separately. This method can be utilized for new property. However, to use this method for used property, the cost of acquisition must be properly allocated to the various components and useful lives must be based on the condition of the components at the time of acquisition and based on competent appraisal. The rate of depreciation for the various structural components of a used building acquired after July 24, 1969, is limited to the amount computed using the straight-line method, or the 125% declining-balance method for used residential rental property.

Multiple asset accounts. A number of assets with the same or different useful lives may be combined into one account, using a single rate of depreciation for the entire account. Multiple asset accounts generally are broken down into group, classified, and composite accounts.

In the case of group accounts the rate of depreciation is determined by using the average of the useful lives of the assets.

In the case of classified or composite accounts, the rate of depreciation generally is computed by determining the total amount of one year's depreciation for each item or each group of similar items. The total depreciation amount is then divided by the total cost (or other basis) of the assets in the account. The average rate so determined is to be used as long as subsequent additions, retirements, or replacements do not substantially alter the relative proportions of different types of assets in the account.

Group accounts contain assets similar in kind with approximately the same useful lives.

Classified accounts consist of assets classified according to use without regard to useful life, such as machinery and equipment, furniture and fixtures, or transportation equipment.

Composite accounts include assets without regard to their character or useful lives.

Group, classified, or composite accounts also may be set up on the basis of location, dates of acquisition, cost, character, use, or any other basis you consider necessary for your business.

Reserve for depreciation (Accumulated depreciation). Depreciation allowances are computed separately for each account and should be recorded in a separate depreciation reserve account.

Adjustments to asset or reserve accounts must be shown in detail in the appropriate account.

Redeterminations of life or rate for depreciation should be made in classified or composite accounts whenever additions, retirements, or replacements substantially change the proportion of types of assets in those accounts.

Idle assets. You must claim a deduction for depreciation on an idle asset if it is usually used in your business but is temporarily idle due, for example, to the lack of a market for the item produced with such asset or for other reasonable causes. Such an asset is treated as being used in your business for Federal income tax purposes.

A manufacturing or processing concern that must include depreciation as part of the cost of goods sold must attach a schedule to its return showing the details of the depreciation computation. This depreciation may not be deducted again as a separate business expense on your return, but you may deduct depreciation allowances as a separate business expense to the extent that they are not required to be included in the cost of goods sold. See Chapter 8.

Abandonment of Assets

If for some unforeseen change in business conditions, it suddenly becomes necessary for

Senator BYRD. The next witness will be the distinguished Secretary of the Treasury, William E. Miller.

Mr. Secretary, the committee is delighted to have you this morning. I remember so well when you testified some months ago before this committee, I felt that your comments in regard to depreciation were the most direct and the most effective that I had heard from any witness who appeared before the committee.

I was much impressed with that, and I rather suspect that this legislation now before us resulted, to some degree, I gather, at least from your previous testimony.

We are pleased to have you today and you may proceed as you wish.

STATEMENT OF HON. WILLIAM E. MILLER, SECRETARY OF THE TREASURY

Secretary MILLER. Thank you very much, Mr. Chairman. I would like to make a few opening remarks and perhaps refer to some charts, which I hope my associates can make available to you so that perhaps I can make my points by referring to a few of these charts as a more appropriate and faster way to come to the bottom line of what I would like to say this morning.

For some time, as you know, I have testified here that this country has been lagging in our productivity gains, and this is a serious concern.

No doubt, a number of factors account for this, but a good deal of it may well be related to the fact that we have been falling behind in our capital investment.

If you will just look at chart 1 for a moment, you can see the business fixed investment as a percent of GNP we have had in the United States going back to 1955.

The total has varied not too much around 10 percent. Since 1965 it has been up a little bit, but generally it has been fairly flat.

In terms of producers of durable equipment, it has moved up in the last 10 years somewhat, but this would have to be adjusted by the degree to which producers durable equipment has been made up of mandated environmental and safety equipment as distinguished from productive equipment. There is somewhat of an overstatement, unless you account for these mandated expenditures.

Nonresidential structures have been declining.

I think that this committee well knows that other major industrialized countries have been spending considerably more than this for their fixed capital investment. Japan, over 20 percent; Germany over 15 percent. As compared with other nations who have had good records in productivity, it would seem that we are underspending.

If you look at chart 2, you can see some of the consequences of low investment spending relative to today's requirements. Looking back on the whole post-war period, our productivity gains were quite satisfactory for 20 years after the war. You can see the trend line. For the nonfarm sector of our economy, we were running about 2.5 percent annual productivity gains. For the economy as a whole, including farm, it was about 3.1 percent.

Looking at just the nonfarm sector you can see for the last 10 years how we have come down in our productivity increases we

have shown a very poor performance over this period, and, in recent times, even more so.

If you will look at chart 3, you will also see what has been happening in the present business upswing from the recession in 1974 and 1975 compared with previous cycles.

Productivity tends to vary with business cycles. During the five cycles before the last one, you can see by the solid line that output per hour in the nonfarm sector came up to the business cycle quite satisfactorily.

In the current upswing, performance has not been so good.

This has been another way of stating the obvious, that we have not been doing well enough.

If you look for a moment at the next chart, chart 4, you will see a little more of this phenomenon broken down by industry. I think that it is important that we begin to look at the sectors of our economy in order to identify where this problem may lie.

The most obvious thing, looking at chart 4, is that there have been very substantial productivity gains in the communications industry. This, no doubt, is because the major technological breakthroughs and because of very heavy capital spending.

Utilities had done well, for a period, until about this decade and have been slowing down in this decade. Manufacturing overall has been a long upward trend. Trade has been less. Construction has actually been losing ground in productivity. That perhaps is one of our most serious areas for concern.

If you will flip to chart 5 we will look at this another way. We were looking at broad sectors of the economy including trade and construction. We now breakdown the manufacturing sector. An interesting note here is, that motor vehicles have done fairly well. Nondurables are plotted on the first solid line there, durables below.

Of course, this is not an effort to plot all sectors, but to point out some other phenomena. Primary metals, one of our basic industries, has done very poorly. This is one of the reasons that we have ceased to be competitive worldwide, and it has caused some problems.

Now, with this background, it is clear that there is a great deal of merit for some program of combining the objectives of simplification of capital recovery and increased incentives for investment.

The 10-5-3 proposal that you have before you is certainly intended to accomplish these things.

There are reasons to believe that this general approach is well worth pursuing. I would like to leave you with a few impressions this morning, however.

One is, that while this is a very meritorious approach, I think we need to dig deeper into the proposal to see, to make sure, that it would be directing itself to all of the intended purposes.

Is it, in fact, targeted in on the problems that we are trying to attack, or are there some other things that we need to do?

I might mention in passing that 10-5-3, which I will not describe because it is well known here, does have some revenue impact. It is phased in to try to moderate that impact in the early years; but in the first year, if this were enacted, our calculation would be on the

gross effect on the economy would be a revenue loss of about $4 billion and this would run up to $50 billion by 1984 in lost revenue.

Senator CHAFEE. $15 billion?

Secretary MILLER. $50 billion.

There is a dramatic effect from this, of course. There are other activities in the economy, job-creating activities that will give us revenues and our calculation is that there would be about a 30 percent recovery so that by 1984, this program would probably have a net revenue cost of $35 million.

I just mention that in passing.

There is no doubt that our present system is somewhat cumbersome. It may be particularly cumbersome for small businesses.

There are many choices that business has to make under the present system of capital cost recovery. The first thing a business has to do is to decide whether it wants to follow the asset depreciation range approach that has been permitted now for some time and, if so, then the business would have to choose the particular useful life within the range that is allowed.

A second major choice, of course, is among the various ways of depreciation itself. Will it be sum-of-the-digits, double-declining, or straight-line depreciation? Those do add to complexity.

There is something to be said for moving toward a more simplified structure but let me just begin by pointing up that as we move to simplification we may have to be aware of the different effects on different kinds of industries.

If you go to table 2, which is a little table there that shows you the best allowable ADR depreciation periods compared to 10-5-3, we have just selected five major industry categories and compared them with a 10-5-3.

If you look at the first column, it shows that in all industries autos and light trucks would be written off in 3 years. Under 10-5-3—up to a limited amount. Average life for these assets are now 3½ years and they vary from 3.1 in the motor vehicle industry to utilities with 4.5.

If you look at other machinery and equipment, 10-5-3 would have these depreciated over 5 years. You would see that this varies considerably under present law with the lowest numbers being for the construction industry, which is already at 5.1, and the highest being for utilities, 20.4.

If you take buildings, of course, moving to 10 years means a substantial change from the 30-plus years that are used now by all industry.

For your information, we have also attached table 3 which shows industry details for a wide range of industry. I will not bother you to go through them. Present practice needs to be compared in this way with 10-5-3 so that we have a good understanding of what we think might happen.

Now, because of differential effect among industries, it might be worth looking at chart 6, just for a moment, which shows in these same five illustrative categories what would happen under 10-5-3. Here we show the dollar savings as a result of 10-5-3, per dollar of projected investment.

This shows for example that the construction industry would move up a bit. By 1984, it would be getting close to 5-percent tax savings per dollar invested.

Motor vehicles would actually have a dropoff in 1981 because of the changing treatment of tooling. By 1984, this industry would be getting 7.5 cents per dollar of investment. Primary metals would be getting very large improvements, communications also very large, and utilities the largest of this particular sample.

Again, we have attached table 4, which gives you the same information for a much larger list of industries.

Finally, if you would just turn to chart 7, we begin to see how this works out in terms of the relation of the dollar savings from 10-5-3 as compared to the productivity experience.

So here we have, on the left side, the tax savings in 1984 as a percent of investments. On the right side, the average of last 5 years of productivity growth.

If you look at construction, construction would get very little benefit from 10-5-3 and it has a very poor productivity experience. So, in a sense, the target does not seem to fit.

On the other hand, utilities is a case where there would be very large benefits. They have had very low productivity and there seems to be a good match there for providing incentives for investment that might attack a productivity problem.

Communications would receive a very large tax savings, but they already have one of the highest productivity gains. So 10-5-3 would be targeting the incentive for investment in an industry that is already highly productive.

Primary metals has a substantial improvement in its tax saving, and apparently, it needs it because its productivity has been quite poor.

The purpose of this is not to come to any bottom line conclusion, Mr. Chairman, about how tax reductions should be distributed, but merely to illustrate as we go about this program, it may be worthwhile for us to dig deeper. We should make sure that our objective of simplicity does not so limit the outcomes of such a program, that a good deal of reduced tax revenues goes into areas that do not have such a heavy claim upon their use.

These varying effects among sectors are worth noting.

I would also just note a couple of other points. One is in trying to achieve what I believe is a very worthwhile objective of liberalized depreciation, I think that we need to look at all of the facets.

For example, the combination of a 10-percent investment tax credit, a 5-year writeoff for machinery and the use of double-declining depreciation actually works to give a better tax benefit, out on a discounted cash flow basis, than expensing machinery in 1 year, if there were no tax credit. You start off paying only 90 percent of the asset price and then within 3 years you have depreciated 76 percent. The effect of that is you get a better benefit from such a writeoff schedule than if there was just an expensing in 1 year.

So I think that we have to weigh this kind of mathematics into the discussion of what we are trying to accomplish here.

If, in fact, the proposal is to be more beneficial than the expensing, it might even be simpler to expense everything and not go through all the accounting.

This raises some other issues that we want to examine.

One is that productivity is a major national problem. It is essential that we reestablish conditions for productivity gains if we are to overcome inflation. To do this, we are going to need conditions that will encourage additional investment—we are underinvesting. The next point is that we perhaps should try to target that incentive for investment using accelerated depreciation in a way that puts the revenue losses where they can do the most good in helping us overcome our productivity shortfall.

I would stop at this point and merely say that I hope that we will have the opportunity for future hearings and otherwise to share our thinking, so that we can develop programs in due course that would be responsive to these problems.

I cannot close my remarks without pointing out that the administration does have a series of priorities. One priority is to assure that we have established fiscal discipline, that we do meet our objectives to reduce Federal deficits and move toward a balanced budget as rapidly as possible. I think in the administration we will want to weigh that objective against the needs of attacking this productivity problem. We will want to make our recommendations as to timing of any such program consistent with what we believe to be the proper direction of the fiscal posture.

Thank you very much, Mr. Chairman.

Senator BYRD. Thank you, Mr. Secretary.

Would it be fair and accurate to say that you feel that there should be a liberalization in the depreciation schedule but that you are not totally sold on the 10-5-3 formula?

Secretary MILLER. Mr. Chairman, your statement is accurate. I feel that liberalized depreciation is an appropriate way to proceed and I have only two questions about it: One, the timing when we would put it into effect, and two, the precise formula that we would use so that we would accomplish the intended objective.

Senator BYRD. On your chart 7, why should there be such great disparity between the annual productivity growth as a result of the adoption of 10-5-3?

Mr. MILLER. Chart 7 shows on the right side the actual productivity experience in the last 5 years.

Senator BYRD. The actual experience. I misread that.

Secretary MILLER. This shows the purpose of chart 7. It is a very important chart.

It is intended to show where we had poor productivity gains—and obviously, we have had very poor productivity gains in construction and primary metals in the last 5 years. They both have been negative.

The left side of the chart shows how much savings per dollar of investment would go to those industries. Here construction which has had a poor record on productivity would get a modest savings from 10-5-3, while communications which actually has a productivity gain would get a high dollar saving.

So, if you will, we would give, through accelerated depreciation, the equivalent of a tax-free loan to an industry because you create

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the tax flow faster than the consumption of the capital. This is a good way to provide incentives.

In the communications case, we would be creating that in an industry that already has a very high productivity record.

I must say—and we all note—that the past is not always the mirror of the future. We must not be too simplistic. I am not suggesting here that the communications industry should not have proper incentive for future investment because that productivity might slip if we did not have continued investment.

I am not trying to prejudge where we come out, Mr. Chairman. But we should try to discover, based on the past record, whether it is likely that 10-5-3 would target the moneys in the most effective channels.

These results would lead us to believe that we might want to make some sector judgments in depreciation allowances rather than just going to one formula for all industry.

The purpose of attaching the tables to the testimony is to show that now we do have various sector approaches. Maybe the lives are too long or the methods too complicated. Maybe they can be simplified, but maybe there is something to be said for retaining some difference among types of assets or industry classes in choosing our depreciation program.

Senator BENTSEN. You suggested a more cognitive method than the 10-5-3?

Senator BYRD. Are you suggesting that we should intentionally pick out certain industries for this liberalized depreciation?

Mr. MILLER. I think the study we have made would indicate that we would like to explore in more depth—and we will do so—the possibility of developing some hybrid between 10-5-3 and what we now have. This hybrid might accomplish the purpose that I think the sponsors have in mind without having a revenue impact for which there is not the same equivalent need.

If we could minimize the revenue impact and get the same bang for the buck, we would be better off.

Senator BYRD. If a change were to be made in the formula, the 10-5-3 formula, which segment of that formula would you direct attention for change?

Secretary MILLER. I think that the 3 years is limited in amounts so that is fairly minor in these calculations. In the case of the 5-year class, it might be necessary to have different lives for different major sectors of industry. It might be desirable to consider whether or not accelerated techniques of depreciation should be allowed if we shorten the lives so much.

As I pointed out, the 5-year feature here with the 10-percent investment tax credit discounted at 12 percent, or even more, would create more of a savings taxwise than the expensing of a piece of equipment in the first year of acquisition.

This has to be examined in terms of whether it was really intended or whether it is just a mathematical consequence that ought to be examined.

Senator BYRD. Thank you, Senator Bentsen.

Senator BENTSEN. Mr. Chairman, I think that we are indeed fortunate to have a man of the Secretary's experience who has

been through the problems of having to buy modern equipment and finance it; develop cash flows that are necessary.

But on page 4, a $35 billion tax revenue loss—and that is a nonstatic analysis; including feedback; that is of concern, of course.

But I think that we ought to keep it in perspective. We ought to take a look at the second concurrent budget resolution, 1980 and what the Senate Budget Committee projected.

On page 37 of the Senate Budget Committee report, it assumes a tax cut in fiscal year 1984. Out of $100 billion, we are talking about a $35 billion tax revenue loss here, but the Senate Budget Committee resolution assumes $100 billion tax revenue reduction, tax cut.

So I think it is in manageable numbers for us, as vast as those numbers may be.

One of the concerns I have here is that people who work with 130 classifications of assets for accelerated depreciation develop almost a vested interest in it. They fought for every one of those. Whatever that definition is they have fought for it in the accounting profession and they have fought for it in Treasury.

It is a very difficult departure to talk about going dramatically to three simple classifications of assets. That is a profound departure. This is a difficult thing to adjust to.

Mr. Secretary, you are going to be under a great deal of pressure from your associates for them to be able to give a monopoly on all of this information. And their authority on that kind of information, because I am sure that no one knows it better than they do.

But I would sure like to get them a new textbook that gets down to 3 instead of 130 classifications and what a boon it would be to the small businessman.

Secretary MILLER. There would be tremendous unemployment for accountants and tax lawyers.

Senator BENTSEN. Thank you.

Secretary MILLER. I would say, Senator Bentsen, I would hope I would not leave the impression that I want to maintain that many categories, but it is just that it is all shaken down to just three. It has to be examined, but I think your points are well taken.

Senator BYRD. Senator Long?

Senator LONG. I will pass for now.

Senator BYRD. Senator Nelson?

Senator NELSON. I appreciate your very thoughtful presentation and the excellent charts you have prepared.

Let me ask a broad question.

As I recall it—I do not want to paraphrase you, but when you testified before the Finance Committee some time back, and correct me if I am wrong, you stated that capital recovery through depreciation was the most significant thing that we could do in terms of increasing productivity.

Is that roughly correct?

Secretary MILLER. Yes, sir.

Senator NELSON. Will the administration come to the Congress with a proposal of its own on the depreciation question?

Secretary MILLER. We are endeavoring, Senator Nelson, to develop that and I believe—I cannot speak for the President, because he has made no decision—that the probabilities are quite high that

the administration will present its own program along these lines in due course, yes, sir.

Senator NELSON. As I am sure you are aware, it is important, useful and maybe vital that this administration and any administration have a proposal in which they positively are at least endorsing the concept, rather than having the whole initiative coming from the private sector and the Congress itself.

So I think it is imperative that the administration, at some stage, come forward with a proposal backed up with their arguments supporting it. After all, the administration has at hand more resources than any other single group I would suppose in the country in terms of research and expertise all gathered in one place.

On chart 7 on communications, for example, you have a breakdown. Do you have anything like this respecting Japan or West Germany?

In other words, do you know what the increased productivity in Japan is for communications in the 1973-78 period?

Secretary MILLER. We do not have it at the moment by industry perhaps. We could see if we could obtain it. It may be available. Perhaps we could ask our associates in Japan if they could supply us with that.

You might be interested in having it submitted later.

[The following was subsequently submitted for the record:]

Data assembled by OECD provide comparisons of productivity growth in manufacturing among several of its member countries. Comparisons for the average of all manufacturing over various periods are given in the following table for 11 countries:

Output Per hour,
In Manufacturing, Eleven Countries 1950 - 1978
Average Annual Rates of Change

COUNTRY	1950-78 (1)	1960-78 (1)	1960-65	1965-70	1970-75	1970-78 (1)	1976	1977	1978
UNITED STATES	2.6	2.6	4.9	1.4	2.0	2.4	4.4	3.3	1.1
CANADA	4.1	4.0	4.5	4.5	3.2	3.1	4.6	4.8	4.2
JAPAN	8.7	8.5	8.5	13.4	4.5	4.5	8.1	5.6	8.3
BELGIUM	NA	7.4	4.8	8.2	8.1	7.8	9.7	6.2	NA
DENMARK	5.7	6.9	5.4	8.7	6.4	5.8	7.5	2.1	2.8
FRANCE	5.3	5.6	5.2	6.7	4.6	5.0	8.5	5.0	4.9
GERMANY	5.8	5.5	6.0	5.5	5.6	5.4	5.9	5.4	3.7
ITALY	6.2	6.2	7.2	6.7	5.8	4.6	8.5	1.1	2.9
NETHERLANDS	6.3	7.4	5.3	9.1	7.0	6.4	9.9	3.5	NA
SWEDEN	5.3	5.6	6.8	7.3	4.7	2.9	.7	-.6	5.5
UNITED KINGDOM	3.2	3.2	4.4	3.7	3.1	1.8	3.0	-1.0	1.6

NA = NOT AVAILABLE.

(1) FOR BELGIUM AND THE NETHERLANDS, DATA RELATE TO PERIOD ENDING 1977 ONLY.

NOTE: DATA RELATE TO ALL EMPLOYED PERSONS IN THE UNITED STATES AND CANADA; ALL EMPLOYEES IN THE OTHER COUNTRIES.

Comparative rates of productivity growth among four countries - United States, Japan, Germany, and the United Kingdom, - are given in the following table for 13 manufacturing industries.

Productivity in 13 manufacturing industries
Average annual rates of growth

Industries	United States			Japan			Germany			United Kingdom[a]		
	1963-1973	1973-1977	Change	1963-1973	1973-1977	Change	1963-1973	1973-1977	Change	1963-1973	1973-1977	Change
Food and tobacco[b]	2.5	3.3	0.8	5.8	-0.4	-6.2	5.3	6.1	0.8	3.2	1.6	-1.6
Textiles	3.4	2.7	-0.7	8.0	8.3	-0.3	6.3	7.2	0.9	6.0	-0.1	-6.1
Pulp, paper and paper products[c]	4.6	-1.0	-5.6	9.8	2.9	-6.9	6.1	5.3	-0.8	3.9	-0.8	-4.7
Chemicals	4.6	0.6	-4.0	11.3	5.4	-5.9	9.0	3.0	-6.0	6.9	2.1	-4.8
Petroleum and coal products	3.7	0.4	-3.3	9.5	-0.9	-10.4	4.0	3.0	-1.0	6.9	-2.2	-9.1
Non-metallic mineral products	1.5	0.5	-1.0	7.0	-2.2	-9.2	6.0	7.1	1.1	5.3	-0.8	-6.1
Basic metal	1.7	-3.6	-5.3	13.2	-1.0	-14.2	6.4	-0.5	-6.9	2.9	-3.3	-6.2
Processed metal products	1.9	0.2	-1.7	10.4	-1.4	-11.8	4.7	5.2	0.5	1.8	0.1	-1.7
Machinery	2.2	-0.7	-2.9	9.0	6.3	-2.7	3.9	2.8	-1.1	4.2	-1.4	-5.6
Electrical machinery, equipment and supplies	4.8	1.4	-3.4	12.5	11.1	-1.4	6.5	7.3	0.8	5.3	0.3	-5.0
Transport equipment[d]	2.9	3.6	0.7	9.2	10.8	1.6	3.5	2.7	-0.8	2.3	-2.4	-4.7
Precision instruments	2.6	1.3	-1.3	6.0	14.9	8.9	4.8	3.7	-1.1	6.5	2.8	-3.7
Others	2.5	0.9	-1.6	9.1	3.3	-5.8	5.5	4.7	-0.8	4.3	1.0	-3.3
Total manufacturing	2.8	1.2	-1.6	9.4	4.9	-4.5	5.6	4.5	-1.1	4.1	-0.1	-4.2
Variance	1.1	1.8	0.7	2.2	5.4	3.2	1.4	2.2	0.8	1.7	1.7	0

a) Great Britain only.
b) Excluding tobacco for Japan
c) Including printing and publishing for the United Kingdom.
d) Including ordnance for the United States
Sources: DRI (Data Resources Incorporated) data bank for the United States; National Accounts annual report, 1979 for Japan; DIW (Deutsches Institut für Wirtschaftsforschung) for Germany; and various sources for the United Kingdom.

International comparisons of productivity in the steel industry have been made by the Bureau of Labor Statistics. The average of their minimum and maximum estimates of productivity growth over the period 1964 to 1972 are as follows:

Annual Rate of Increase
in Output per Hour in the
Iron and Steel Industry, 1964-1972.

U.S..................2.6%

Japan...............11.8%

France...............6.8%

U.K..................3.4%

Senator NELSON. I think it might be useful to see what has happened, particularly in Japan and West Germany in the 1973-78 period, in the various fields of construction, motor vehicles, primary metals, communications, and utilities.

Secretary MILLER. May I just comment? I will not take your time.

I think the motor vehicle experience is surprising to most people. We have had good productivity in that industry.

Communications, in my opinion, is not just capital but also technological breakthroughs and that emphasizes the point that we have to keep focusing on. It is not just investment, but innovation and technology that are important. In this particular cage, the microprocessor is, no doubt, a good share of the reason that you get more done out of each hour of input.

Senator NELSON. We have, off and on—the staff of the Small Business Committee, including members of this committee—have had conversations with the Canadians. We have been trying to find out what the net cost to the Treasury is, of the Canadians going from their system to basically a 2-year depreciation system.

I asked the British representative of the Government who was here a couple of weeks ago. He did not know. It would seem to me if there was any way to find out what happened in a real situation, it would be more valuable to us than some econometric model.

Is there any way that can be done?

Secretary MILLER. Yes. We took a look at the British. I do not have the figures at hand, but when the British liberalized, there was an immediate pick up in investment. The problem is, of course, whether it was sustained or whether it was affected by the other problems that the economy had. It is hard to analyze over time.

The immediate impact was increased investments.

Senator NELSON. Treasury lost how much?

Secretary MILLER. That I cannot tell you off the top of my head. Again, I think that is available.

[The following was subsequently supplied for the record:]

Corporate Income Tax Revenues in the United Kingdom and Canada after the Liberalization of Depreciation Deductions

Since March 1972, the United Kingdom has permitted the deduction of 100 percent of cost of equipment in the year of expenditure. However, this was not an abrupt change. The U.K. had permitted generous allowances before 1972. For example, 80 percent of the cost of equipment could be deducted if it was acquired between July 1971 and March 1972. Earlier, a 25 percent declining balance rate was allowed for almost all types of equipment.

In May 1972, the Canadian government introduced a 2 year write-off for all equipment used in Canadian manufacturing and processing. Prior to this change, depreciation of equipment was generally at a 20 percent declining balance rate. At the same time, Canada lowered the corporate tax rate on manufacturing and processing income from 49 to 40 percent.

Estimates of corporate taxes paid in Canada and the United Kingdom are reported in Revenue Statistics in OECD Member Countries 1965-1978.

Annual Estimates for 1969-77 are shown below as absolute amounts, as a percentage of Gross Domestic Product (GDP), and as a percentage of total taxes for each of these countries and, for comparison, for the U.S.:

United Kingdom	1969	1970	1971	1972	1973	1974	1975	1976	1977
Taxes on Corporate Profits									
in millions of Pounds Sterling	1178	1545	1526	1501	1688	2356	1877	1997	3355
as a percentage of GDP	2.64	3.24	2.84	2.51	2.46	2.97	1.95	1.75	2.51
as a percentage of total taxation	7.15	8.57	7.97	7.30	7.90	8.25	5.25	4.80	6.86

Canada	1969	1970	1971	1972	1973	1974	1975	1976	1977
Taxes on Corporate Profits									
in millions of Canadian dollars	2828	2417	2388	2912	3707	4829	5741	5370	5818
as a percentage of GDP	4.46	3.80	3.22	3.52	3.75	4.36	4.49	3.78	3.69
as a percentage of total taxation	13.93	11.26	10.33	11.08	11.95	12.82	13.60	11.81	11.55

United States	1969	1970	1971	1972	1973	1974	1975	1976	1977
Taxes on Corporate Profits									
in millions of U.S. dollars	35578	31729	25910	31122	34630	36990	38997	40153	53080
as a percentage of GDP	4.43	3.83	2.98	3.32	3.39	3.31	3.26	3.02	3.50
as a percentage of total taxation	14.72	12.71	10.37	11.19	11.40	10.96	10.79	10.31	11.54

It is virtually impossible to make any inferences on the revenue impact of the changes in depreciation rules from this data. As noted above, the United Kingdom change was not a sharp break with previous practice.

An interagency committee of the Canadian government evaluated the combined impact of the two measures. This evaluation is based on an opinion survey of Canadian firms which were asked to estimate the impact of the tax measures on their plans.

The study concludes that the tax measures increased plant and equipment investment in Canadian manufacturing by a total of $1.48 billion for the years 1972 through 1974. This amount to 14.7 percent increase over what fixed investment would have been.

The direct revenue cost of the two measures was estimated to be $650 million in the 3 years from 1972 through 1974. The study then uses the Bank of Canada enconometric model of the Canadian economy to estimate the net revenue cost after the changes in the economy induced by the tax measures are considered. When these indirect changes are considered, the revenue cost estimate decreases to $430 million, about 2/3 of the direct cost, for the 3 years.

Senator NELSON. My time is up, but may I ask one more question?

Is it not in theory, if not in practice, maybe both, a fact that if you have a rapid writeoff it becomes, at some stage just a plain wash?

Secretary MILLER. Yes. It is a deferral of taxes.

Senator NELSON. It does not cost the Treasury anything?

Secretary MILLER. Ultimately, you pick it up for any year's investment, but the Treasury never catches up with growing investment.

Senator NELSON. Thank you.

Senator BYRD. Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Secretary, I think these charts you produced are very helpful. This chart 7 is really a combination of your indexing of productivity in selected industries plus a comparison—I do not have the numbers of these charts, but one of the things that is interesting to me, if you look on your chart, that shows the best allowable ADR depreciation as compared to Conable-Jones.

You see, in construction they have in fact been writing off their equipment in 5 years, 5.1 years and yet they have been going down on your chart that shows index of productivity. They have been going down.

In chart 7 you show this. It is a combination that has been giving us some challenge here. Our whole theory was with this more rapid writeoff and thus, in theory, greater investment in capital equipment that productivity would go up.

I suppose there must be a whole variety of other factors involved, construction being heavily labor-intensive and so forth.

Do you have any explanation as to why that particular industry would be failing to follow what we thought would happen with more rapid writeoff?

Secretary MILLER. The construction industry, by its nature, consumes its capital very rapidly because quite often the equipment is consumed in the process of a job, so what we find when we look at construction is that we have something else that is impeding productivity gains. Undoubtedly it relates to the method by which we have organized the work and the fact that we have had a high amplitude variation in activity over time. This buildup and dropoff of activity, I believe is quite expensive and impedes productivity.

I think there is an organizational problem that will not be solved alone by faster writeoff. But remember we cannot reason from the experience of the construction industry to other more continuing businesses, like primary metals that do not have the same project orientation. I would not take the construction industry as evidence that there would not be a substantial improvement from modernization of equipment.

The reason to present these figures is, of course, to show that there are differences, that there is a difference with trade, with services, with construction, and there may be with communications, motor vehicles, construction of some other industries.

Senator CHAFEE. The other question that I have, in your remarks, you mentioned that about 70 percent of business investment now is in pollution control equipment. Do you have any

suggestions that that should be more accelerated, the depreciation on mandated pollution control than in the 10-5-3 proposal?

Secretary MILLER. Of course, now recently there have been some additional liberalizations in that area. We have an increased investment tax credit for some of the items—related to energy, for example.

I had felt that we should look at faster writeoffs for mandated equipment so that we recover the capital as rapidly as possible and free it up for the productive investments.

Senator CHAFEE. Would you have a suggestion of a 1- or 2-year writeoff?

Secretary MILLER. I would assume that the 5 years proposed in Conable-Jones is equivalent to—in fact, it is a little better than expensing for a 5-year writeoff, so I think you have that effect already in this proposal.

Originally I had thought of it in terms of a faster writeoff for pollution-mandated equipment and a slower writeoff for equipment but not allowing some of the other features, such as double-declining depreciation. If I may say so, because the percentage is small, this is not going to be a controlling factor.

To take 7 percent of the investment and write it off one way or the other, will not be the controlling feature of what we finally want to do.

Again, I think we have to look at the impact of these regulations by industry because they may be hitting the utilities or primary metals harder than somewhere else. This may be a factor that we will want to consider for this industry.

Senator CHAFEE. With the primary metals, it must be pretty expensive.

Secretary MILLER. It is.

Overgeneralizing can be a mistake and I think we are going to have to look at a little more what this means. We may come to the conclusion that it means that it is diverse enough and uncertain enough that maybe an oversimplified category is the best way to solve the problem.

But I think we do need to look at these particular sectors and know what we are doing before we make a final judgment.

Senator CHAFEE. Thank you.

Thank you, Mr. Chairman.

Senator BYRD. Senator Bentsen?

Senator BENTSEN. Mr. Secretary, for the record, you may not have those numbers with you, but I would like to have the percentage of inflation and the percentage of growth, the rate of growth and inflation which is used for your estimates on revenue in order that we may have the assumptions.

It would be very helpful to us in checking your numbers, compared to our numbers.

Secretary MILLER. Yes, sir. We will be glad to supply that.

[The material referred to follows:]

The estimates of annual revenue cost presented here were based upon a series of estimates of expenditures for nonresidential business fixed investment that averaged 11.6 percent growth over the 10 year period 1979 to 1989. The growth rate in nominal GNP consistent with this investment series averages 10.8 percent per year, and the associated annual rate of inflation averages 7.5 percent per year over this period.

Senator BENTSEN. Thank you very much.

Senator BYRD. Mr. Secretary, on page 10, you give a very clear definition of depreciation. You say, "Depreciation is a cost of employing capital. As such, it must be deducted to arrive at net income, the same way that a wage deduction is taken for payments of labor."

That is the clearest definition that I have seen, I might say.

Further on that page, you say, "Inflation, however, increases capital consumption as measured in current dollars and therefore, depreciation allowances based on historical costs may be inadequate. Acceleration of tax depreciation may compensate for the general understatement of depreciation."

That is the situation we now find ourselves in; is it not?

Secretary MILLER. Yes; it is.

Senator BYRD. On page 12, you say the treatment of equipment under 10-5-3 would be better for the taxpayer than immediate expensing.

Would you be more inclined to immediate expensing?

Secretary MILLER. That would be one choice. If the taxpayer makes the election of the 5-year writeoff using the accelerated method and in the first year, 90 percent is paid for the asset and 100 percent is depreciated then the discounted value of the cash flow is worth more than writing it off in 1 year.

So, if the Congress and the administration finally came down believing that this was an appropriate treatment, it might be just as easy to allow the taxpayer merely to expense it and do it all at once.

I am not suggesting that solution, but that is what works out in terms of values.

Senator BYRD. On page 16, you say, "The simpification objectives of 10-5-3 could be achieved through other depreciation proposals." What other depreciation proposals do you have in mind?

Secretary MILLER. For one thing, if you had a 5-year writeoff you could for example, require straightline depreciation which still would make the depreciation schedule more attractive than the present one for many industries. It would be simple, but it would not make it more attractive than expensing. So you have those kinds of considerations.

Senator BYRD. Senator Long?

Senator LONG. People ask me about this proposal and I tell them—I am reducing their taxes. I am for more rapid depreciation. I am against double taxation of corporate dividends. I am in favor of giving a tax credit for the first $100 of interest income. I am all for that.

But first, I think we better try to balance the budget, but I think we will get that done right soon, as soon as we get that worked out. I think all the other things can fall in line.

I take it from your statement that you would like to do a lot more in the way of capital recovery, but that you feel that you would have to try to see how much of all of this you can accommodate within fiscal limits. That is basically about your position with regard to this type of thing, I take it?

Secretary MILLER. Yes, sir.

My feeling has been that as we can afford tax initiatives that this is a high priority area, at least for the business sector. We also have to think of individuals.

Senator LONG. Sometimes I think rather than trying to balance the budget, we ought to be more imaginative and come up with a plan to pay off the national debt. Just get this thing out of the way.

The logical way to do it, it would seem to me, is to come up with a plan where we would start out by assessing everybody for his share of it. The average fellow thinks he is a lot richer than he really is.

If a fellow has a net worth of $1 million, he does not realize that he owes his share of the national debt.

We could pay it off if we just assessed him and everybody who is in a like situation for about 30 percent, which should not be any great pain to that fellow if he has $1 million. We could leave out the welfare people.

Secretary MILLER. Are you talking about Senators or Secretaries of the Treasury?

Senator LONG. I think there are some of us here who could make a contribution. If we could do that, we would save enormous amounts of money because we would not have so many interest expenses to pay and it will help set the stage for a lot of these things. A fair tradeoff after you ask a man to make his contribution is that we give him a lower tax rate on what he makes to give him a chance to make it back or perhaps give him a credit against the estate tax.

Unless and until we can get this budget in balance I do not see how we can do as much as I would like to do along this line. I take it that you have that same problem to contend with in your present job.

Secretary MILLER. I certainly do, Senator Long.

Senator LONG. I would not be surprised if we had asked you 3 years ago when you were chairman of the board of Textron that you would have been enthusiastic about everything in this proposal. You have to look at it a little differently when you are managing the books of the Federal Government.

Secretary MILLER. I think that we have to rank our desires for change according to their priority. I agree with you, we have to do them in a timely fashion. Many things that you mentioned should be done.

I think this one comes early on the list, and when we can afford it.

Senator LONG. Thank you.

Senator BYRD. Senator Nelson?

Senator NELSON. I would like to go back to the question that was raised by Senator Chafee on the pollution control devices just for some understanding on my part.

These requirements to meet certain air and water quality standards, which I think are very important and have a nationwide impact that does affect our productivity in a way that we need not get into discussing, do not add to the productivity of a particular plant in producing a particular product.

Since it does not add to that productivity, is there any reason why you should not design anything you can to allow recovery as

soon as possible, since there is no benefit except in some rare circumstances, no benefit that occurs to the company. They need their capital back.

What difference does it make if they write it off in 1 day, 6 months, 1 year, whatever is most advantageous so they can get their capital to get it into productive activities.

If my memory is correct, in the paper industry—which is very large in my State—I am going by my recollections from a discussion sometime back on a plant built by one of the big companies in my State. I think their pollution control devices were something like 25 percent of the total capital investment in the brandnew plant. This is an industry producing a huge amount of sulfide in certain paper processes that have to be pulled out and it is a very expensive business.

Is there any reason in the world why you should not design anything you can to let them have their money back the next day? It would not make any difference; would it?

Secretary MILLER. I tend to favor a faster writeoff in these mandated areas regardless of the other considerations. I was trying to indicate to Senator Chafee that you cannot overgeneralize about pollution control.

While overall it is small it may be high in a particular industry, such as the paper industry or the steel industry.

Let me make a couple of comments. One is in regard to productivity. We have produced something else for our society in the form of cleaner air and cleaner water that is useful and socially beneficial. Unfortunately, it is an output from our investment that we cannot measure in terms of physical output.

So we are kidding ourselves a little. We are overstating a little when we look at the productivity figures I have shown you, not to be able to find a way to indicate we have made some other gains. Nonetheless, because we have wanted those gains and we need them, I do agree with you in principle. Treasury is under a mandate from the 1978 act to come up with suggestions in this regard and we are studying how we can do that now.

That might be part of a proposal we would make along the line of depreciation.

Senator NELSON. That is the question I raised. If there is any reason you should not write it off in any way that is the most conceivably advantageous because they get nothing out of it from the productive standpoint, except indirectly.

Sure, it is true that if you cleaned up all the water in America then the company does not have to clean it up before they use it, the municipality does not have to do as much work, et cetera. In fact, there is a tremendous gain, but as to that plant and that product, there is not.

I would think we simply give them the option of a series of ways to recover their money in the most advantageous way possible to get it back into productive equipment. Anything wrong with that in your view? Anything wrong with that concept from any philosophical or tax standpoint?

Secretary MILLER. As a businessman and a Chairman of the Federal Reserve, that was a very good concept. In my reincarnation as a Secretary of Treasury, I just wanted to make sure I have time

for my staff to brief me on it. I tend to agree with you. I do not disagree.

Senator NELSON. Thank you.

Senator BYRD. Senator Chafee?

Senator CHAFEE. No questions.

Senator BYRD. Just one brief comment, Mr. Secretary. Mention has been made of a balanced budget and, of course, there are two ways to balance the budget. One is to increase revenues—and the Government has done very well in that respect.

Inflation is a boon to increased revenues on the part of the Government, but I prefer the other way, namely to get spending under control. What we need to do is reduce the rate of increase in Government spending. Government spending has been increasing at the rate of 9 to 14 percent a year. We need to reduce that rate of increase. I do not advocate going below what we are spending now. I do advocate that we reduce the weight of increase in Government spending. That would get the budget into balance, and the adequate revenues also be available to do some needed things in the field of increased productivity, such as this legislation we are considering this morning.

Thank you, Mr. Secretary. We agreed to get you out of here by 11 o'clock and it is only 10 minutes before 11.

Are there any other questions of the Secretary?

Senator BENTSEN. I would only like to make one comment. It is my amendment to the 1978 Treasury tax bill calling for a fast study on writeoffs and Government-mandated expenses and I would be hopeful that you would have that ready for us in the very near future.

I appreciate your helping start what I think is a national debate on a very important piece of legislation by coming here this morning.

Secretary MILLER. I commend this committee. I agree that this is an important debate and one in which we need education and enlightenment so we will be prepared to make wise decisions in this area.

I also commend the committee for getting me out earlier. In my philosophy, there is no penalty for overachievement.

Mr. Chairman, you have overachieved. Thank you.

Senator BYRD. Thank you, Mr. Secretary.

[The prepared statement of Secretary Miller follows:]

TESTIMONY OF THE HONORABLE G. WILLIAM MILLER

SECRETARY OF THE TREASURY

BEFORE THE SUBCOMMITTEE OF TAXATION

AND DEBT MANAGEMENT OF THE SENATE FINANCE COMMITTEE

Thank you for inviting me to discuss S. 1435, a very significant proposal to restructure the system of depreciation allowances. I am pleased to see the broad interest in legislation to encourage capital formation and increase productivity.

The 10-5-3 proposal would restructure the system of tax allowances for capital recovery. It would greatly shorten the periods over which most capital expenditures can be written off. The proposal provides for non-residential buildings to be written off over 10 years, in a pattern so accelerated that 70 percent of the acquisition cost could be deducted in the first 5 years. Expenditures for most machinery and equipment could be fully written off, also in an accelerated pattern, over 5 years. A limited amount of expenditures for cars and light trucks used in businesses would be written off over a three-year period.

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This proposal would also liberalize the investment tax credit, by allowing the full 10 percent credit (instead of 6 2/3 percent) for equipment depreciated over 5 years, and a 6 percent credit (instead of 3 1/3 percent) for the 3-year class of assets. A phase-in over 5 years is proposed whereby the write-off periods, starting from a 1980 base, are reduced year-by-year. The 1980 lives are determined by reference to the current Asset Depreciation Range (ADR) system. Advocates of 10-5-3 argue that it would promote simplification and certainty, aid small business, and provide incentives for capital expansion. These are laudable goals, and should be considerations in evaluating any tax structure. Evaluation of our current system shows that there is room for improvement.

Economic Background

The increase of 2.4 percent in real GNP for the third quarter of this year is further indication of strength in the economy, but prices continue to show rapid increase. I want to emphasize that the Administration intends to sustain a firm and consistent policy to reduce inflation. This policy has a number of aspects, but none is more important than the maintenance of strict fiscal discipline. At the present time, the action of steady budget pressure to slow the rate of inflation offers the strongest promise of restoring the health of our economy, reducing economic uncertainty, and reversing expectations for future inflation.

I believe that a commitment to widen the budget deficit by the magnitude of S. 1435 would be premature at this time. However, we should study possibilities for a program that will promote longer-range economic objectives as effectively and fairly as possible. At the appropriate time, you should be prepared to act on a program carefully structured to expand economic capacity, to reduce production costs, and to promote productivity. Appropriate depreciation allowances can help to accomplish these goals and should be given serious consideration as an element of any future tax package.

Revenue Costs of 10-5-3

Looking specifically at the 10-5-3 proposal, I would first point out that it would have a massive budget impact. The cost of S.1435 rises from about $4 billion in the first year to over $50 billion in 1984 and over $85 billion in 1988 (see Table 1).

These estimates have been carried out further into the future than we would normally show in order to see the full effect of the proposed phase-in rules. Because the program would be implemented gradually during the first five years, it is not until 1984 that the full benefit of the more liberal depreciation allowances would be given to investment

for any one year. For this reason, the revenue costs continue to build until 1988, after which revenue losses begin to fall. Eventually, the level of these losses stabilizes and thereafter they grow at about the same rate as investment expenditures. By 1987, when corporate tax receipts are expected to be $116.7 billion, S.1435 would provide corporate tax reduction of nearly half that amount. The total revenue cost also includes a reduction in individual income taxes resulting from deductions taken by unincorporated businesses. This is equal to about 15 percent of the total revenue cost.

The year-by-year revenue costs do not take account of the additional tax receipts resulting from economic expansion induced by the tax reductions. These "feedback" revenues amount to about 30 percent of the static revenue loss and are reflected primarily in increases in individual tax receipts. If these "feedback" revenues are taken into account, the result is a net revenue loss of about $35 billion in 1984. It should be noted that the additional tax receipts that would be induced by this tax cut are about the same as that from any tax reduction having a comparable impact on GNP.

Background on Depreciation Allowances

The present tax depreciation system is cumbersome and complex. It involves a number of choices and uncertainties,

and is especially burdensome for small businesses. It should be simplified. The present system provides an insufficient incentive for capital expansion in periods of rapid inflation and financial uncertainty. These incentives should be strengthened as much as our budget resources will allow.

Under the present rules, the business taxpayer is confronted with a myriad of choices. The first choice is whether to use the Asset Depreciation Range (ADR) System or to justify tax allowances on taxpayer's particular facts and circumstances. For those electing ADR, there is a choice of useful life within the allowable range for each class of assets. For all taxpayers there is also a choice of depreciation methods over the chosen lifetime. For some types of assets, especially buildings, there may be no ADR class and there may be a restricted choice of methods. With regard to types of equipment having allowable lives less than 7 years, the taxpayer must choose whether to foresake some portion of the investment tax credit in favor of more rapid write-off. For large firms having computerized accounting systems, these options present no formidable problems. They elect ADR, using the most rapid method of depreciation, and the shortest available useful life after taking account of the investment credit rules. These large firms own the great bulk of depreciable assets.

A very small percentage of small business taxpayers have chosen to elect the ADR system. Despite recent changes in regulations to reduce requirements for reporting, small businesses apparently believe that ADR dictates a more complicated accounting system and involves more complex regulations. If these small businesses choose not to elect ADR, but to use the shorter lives that are allowed without question to ADR electors--and we believe many small businesses so choose--they face the possibility that upon audit they may be required to justify those lives on facts and circumstances. For these reasons, small businesses may regard the ADR system as not addressed to their needs and circumstances.

Productivity and Investment

The stimulation of investment and improvement of productivity performance must be among the foremost objectives of economic policy. The share of business fixed investment in GNP has varied around a nearly flat trend for about the last 15 years (Chart 1). However, in the last expansion it neither grew as rapidly nor reached as high a peak as during the previous cycle that peaked in 1974. Investment in nonresidential structures has shown a persistent downward trend since 1966, while the equipment component has tended to increase as a percentage of GNP. This is partly explained by mandated expenditures for pollution control equipment, which are now about 7 percent of equipment spending.

Aggregate productivity growth has exhibited a pronounced decline in the last decade and output per hour worked is now well below its post-war trend (Chart 2). For the 20 years ending 1968, the annual rate of growth in output per hour worked was about 2 1/2 percent. More recently, and beginning even before the oil embargo and the recession of 1974 and 1975, the rate of this productivity growth has markedly slowed. In the years 1968 through 1973 the growth rate was only about 1 3/4 percent.

In the last recovery cycle, the upturn in productivity growth that normally accompanies expansion occurred later and was generally weaker than in other post-war recoveries (Chart 3). The average for this latest period, 1973-78 was an annual productivity gain of only one percent. This slowing of productivity growth has helped to perpetuate a spiral of inflationary wage price adjustments in the economy and has eroded our ability to compete in international markets.

While the recent growth in average productivity throughout the economy is unmistakably lower in recent years, this record is by no means uniform across major productive sectors (see Chart 4). The communications sector has experienced rapid and even accelerating growth in productivity throughout the period, while at the other

extreme, the construction industries have suffered declines in productivity in absolute terms since the late sixties, particularly over the most recent years. Among the public utilities, productivity growth has also slowed markedly since the late 1960s after rapid and steady increases up to that time. The record in manufacturing also shows a decline in the productivity growth throughout the 1970s but that growth has continued up to the present time, except for a one-year downturn in 1974. In the trade sector, output per hour has grown at less than a 2 percent annual rate over the entire period and is nearly flat in recent years.

Within the manufacturing sector, productivity growth has been and continues to be somewhat stronger in non-durables manufacturing as compared to the durables sector (see Chart 5). Among the durable goods industries the record of the motor vehicle industry has been particularly strong since 1974, while a pronounced decline in productivity has occurred in that some period for the primary metals industry.

The wide diversity in productivity gains across sectors and industries illustrates the importance of looking behind the aggregate trends. To the extent that declines in productivity in particular sectors can be attributed to lagging capital formation, we should pay close attention to the distribution of tax incentives among sectors of the

economy, in addition to the aggregate amount of incentive. This is not to suggest that we attempt to direct all of the tax relief to particular industries that have poor productivity records (or those that have performed well) in the recent past but we should know the degree to which any proposal matches the incentives to the economic objectives.

Acceleration of depreciation allowances can be effective in providing investment stimulus. The direct tax savings that accompany the acquisition of capital provides additional cash flow to business firms for further investment and replacement. It is as if interest-free loans from the government were provided in the early years of a capital asset's use to be repaid out of the future productive output of these assets. These accelerated deductions reduce the "tax wedge" that is interposed between the returns to the physical investment and the rewards that can be paid to those who supply funds for investment. The reduction in the tax wedge reduces the cost of capital and, thereby, increases the amount of capital that can be profitably employed for the benefit of the company, its employees, and its customers.

The Concept of Capital Recovery

Before I get to a specific analysis of some of its likely consequences of the 10-5-3 proposal, I would like to discuss briefly the concept of capital recovery allowances.

Many people regard depreciation as an arcane topic involving "useful lives," complicated formulas such as double declining balance and sum-of-years-digits, vintage accounting, and numerous other technicalities. Although the subject of depreciation is replete with imposing terminology, the underlying concept is straightforward. Depreciation is a cost of employing capital; as such, it must be deducted to arrive at net income, the same way that a wage deduction is taken for payments for labor.

In order to impose a tax on net income, the timing of receipts and expenses must be matched, and this requires that the cost of assets be deducted as they are consumed by use in a business. The Internal Revenue Code provides that there shall be a reasonable allowance for exhaustion, wear and tear, and obsolescence.

Of course, the determination of capital recovery allowances in any tax system is more difficult than for wage deductions because there is no current payment that measures the exact amount of capital consumed from one year to the next. The cost of depreciation each year is, therefore, estimated to be some proportion of the acquisition, or historical, cost of the asset. Inflation, however, increases capital consumption as measured in current dollars, and, therefore, depreciation allowances based on historical cost may be inadequate. Acceleration of tax depreciation may compensate for the general understatement of depreciation.

If the allowable depreciation deduction is greater for any year than the amount of capital consumed, the government is in effect extending an interest-free loan to the business. In the opposite case, inadequate depreciation allowance will prematurely increase taxable income, impose prepayment of taxes, and reduce internal cash flow.

The Effects of 10-5-3

The 10-5-3 proposal is a major departure from current practice in the determination of depreciation or capital recovery allowances. It would allow a large share of the acquisition cost of equipment and structures to be deducted for tax purposes much more rapidly than currently. The proposal deals with the problem of complexity by substituting a single mandatory system in place of the existing complex of choices. The proposed system has simple categories, certain recovery periods, and a fully prescribed pattern of recovery allowances. This approach to both investment incentives and simplification deserves condieration, but there are deficiencies that should be examined carefully.

For example, the proposal is not as simple as it first appears. As drafted, the 10-5-3 proposal would have to establish mandatory guidelines lives during the five year

phase-in that are tied to the ADR classification system. Each year, for five years, every taxpayer would apply a new schedule of depreciation rates to assets acquired in that year until they are fully written off. The phase-in rules also create a perverse incentive effect that postponment of investment until the following year will increase the rate of capital recovery allowances. The phase-in is intended to postpone the revenue losses, but it also increases complexity and uncertainty. To the extent that investment is delayed, feedback revenues are also delayed.

When the 10-5-3 rules are fully effective, their combination of rapid write-offs of and increased investment credit for machinery and equipment would be very generous, indeed. The investment credit would immediately pay for 10 percent of the cost of acquiring new equipment. Then 76 percent of the gross cost could be written off in the first three years; the entire amount in 5 years. The present value of the tax saving from the combination of the investment credit and the accelerated deductions is greater than full, first-year write-off would be. The treatment of equipment under 10-5-3 would be better for the taxpayer than immediate expensing.

Such a dramatic increase in capital allowance is not only expensive in terms of the budget, but it could also greatly increase tax shelter activity. The proposed

deductions and credits would be most attractive to high-income individuals who could obtain the tax benefits through net leasing of machinery and equipment. Tax shelter opportunities could also increase for those investing in buildings, such as offices and shopping centers, as the proposed bill both shortens the recovery period for these buildings and accelerates the depreciation method. A tougher recapture rule for buildings is proposed in the bill, but this only offsets a portion of the potential tax-shelter benefits.

Another result of 10-5-3 is a wide range of differential benefits among businesses according to the types of assets that they use and their present industry classification. For example, machinery and equipment (other than automobiles and light trucks) are now depreciated as if they had an average depreciation lifetime of 10.2 years (Table 2); the recovery period prescribed in S. 1435 is less than half that current average. For buildings, present practice is equivalent to an average lifetime of 32.6 years. The proposal would allow these buildings to be written off in less than one-third that time. For autos and light trucks, the reduction is relatively small from 3.5 years to 3.0 years, although, in many cases, autos and trucks would benefit from an increase in the investment credit.

The variation in benefits provided by 10-5-3 is most pronounced when industry categories are compared. After the five year phase-in, all major industry classes would have higher depreciation allowances under 10-5-3. However, the share of projected total investment "paid for" by accelerated depreciation is generally higher for those industries employing longer-lived assets. For machinery and equipment, you can see (Table 2) that the reduction in the recovery period is minimal in the case of construction and very small for manufacture of motor vehicles. Toward the other end of the spectrum, the recovery period for assets used in the primary metals industry would be nearly half the present ADR lives, communications would be about one-third, and public utilities about one-fourth. (Table 3 attached to this statement provides quarter industry detail.)

The Treasury Department has simulated changes in depreciation periods, together with the changes in the investment credit, to estimate potential tax savings during the period of phase-in. These estimates are then used to compute the tax saving per dollar of projected investment. Not surprisingly, the relative magnitudes generally follow in the same order as the degree of reduction in write-off periods (Chart 6). In 1984, the tax saving per dollar of projected investment in the construction industry would be less than 5 percent; for motor vehicles it is 8 percent; for

primary metals it is around 15 percent; for communications just less than 20 percent; and the tax saving would pay for more than 20 percent of investment in the public utilities.

You may wonder about the apparent revenue increase in motor vehicle manufacturing for 1981. This results from a phase-in rule that immediately increases the recovery period for the auto companies' special tools from three years up to five years. In later years, the year-by-year reduction prescribed for longer-lived assets becomes dominant.

Highway transportation, services, agriculture, wholesale and retail trade, fabricated metals, and electronics are among other industries with relatively smaller benefits (Table 4). Among the other larger gainers are railroads, shipping, and oil pipelines.

The benefits estimated here are "potential" in the sense that no allowance is made for the possibility that certain companies will have insufficient tax liabilities against which to take the full amount of any additional deduction. Likewise, the estimates for public utilities take no account of the rule that disallows the use of 10-5-3 to utilities that "flow through" the benefits of accelerated depreciation to consumers.

Among industries with relatively poor productivity performance over the last five years, the construction industry has the smallest amount of potential benefit from 10-5-3 among all industries and utilities has the largest (Chart 7). Looking at the stronger productivity sectors, communication is among the larger gainers from 10-5-3, while communications and motor vehicles are among the more modest beneficiaries. In general, there is no discernible relationship between the amount of additional capital formation incentive provided by 10-5-3 and the relative strength of productivity performance over the past five years. The point here is not that these should be exactly matched, but rather that it is very difficult to see any purpose to the vastly different amounts of investment incentive provided across industries by 10-5-3.

I do not come to you today with any specific proposal nor, in view of the deficiencies of 10-5-3, can I support S.1435. I am obviously concerned about the large revenue cost, and the implication that greatly differing amounts of investment stimulus would be scattered about indiscriminantly among industries and asset types.

The simplification objectives of 10-5-3 could be achieved through other depreciation proposals. I would further suggest that you should consider the continuation of some administrative mechanism for the system to assure that

the capital recovery deductions allowed for tax purposes are consistent with changes in true depreciation costs. I believe we should analyze carefully a wide range of depreciation plans, and I will continue to develop and work with you to promote a depreciation or capital recovery system that we can all regard as simple, effective and fair. Such a system should be put into effect as soon as budgetary resources and prudent fiscal policy permit.

ATTACHMENT FOR THE
TESTIMONY OF
THE HONORABLE G. WILLIAM MILLER
BEFORE THE
SUBCOMMITTEE OF TAXATION
AND DEBT MANAGEMENT OF THE SENATE FINANCE
COMMITTEE

—

October 22, 1979

—

56-073 O - 80 - 12

Table 1

Revenue Estimates
($Billions)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
	Change in Tax Liability - Calendar Years									
Corporate	-3.2	-8.5	-17.9	-29.9	-44.1	-57.2	-67.6	-72.9	-73.3	-70.9
Individual	-0.6	-1.5	-3.2	-5.3	-7.8	-10.1	-11.9	-12.9	-12.9	-12.5
Total	-3.8	-10.0	-21.1	-35.2	-51.9	-67.3	-79.5	-85.8	-86.2	-83.4
	Change in Receipts - Fiscal Years									
Corporate	-1.5	-5.6	-12.7	-23.3	-36.2	-49.8	-61.7	-69.8	-73.0	-72.1
Individual	-0.2	-0.9	-2.1	-4.0	-6.2	-8.7	-10.8	-12.3	-12.9	-12.8
Total	-1.7	-6.5	-14.8	-27.3	-42.4	-58.5	-72.5	-82.1	-85.9	-84.9

Office of the Secretary of the Treasury
Office of Tax Analysis

October 19, 1979

Chart 1

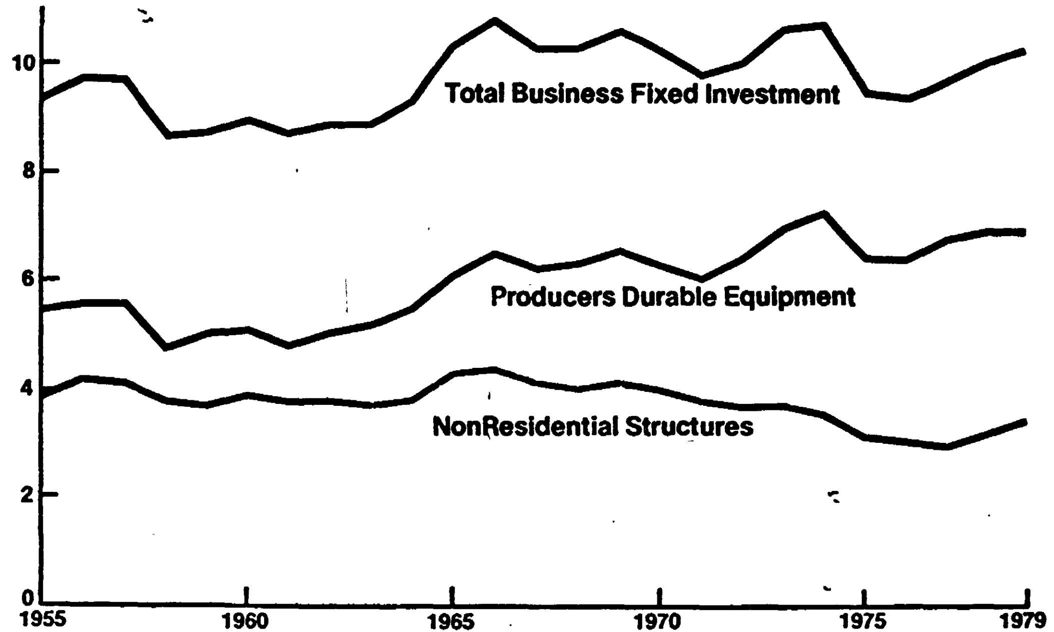


Chart 2

Output Per Hour, Private Nonfarm Business Sector

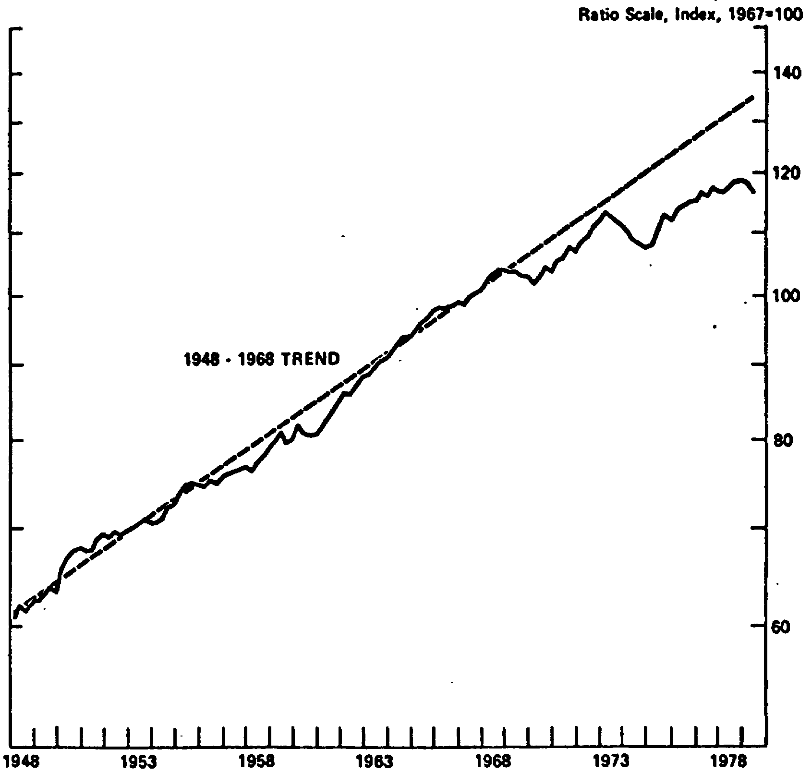
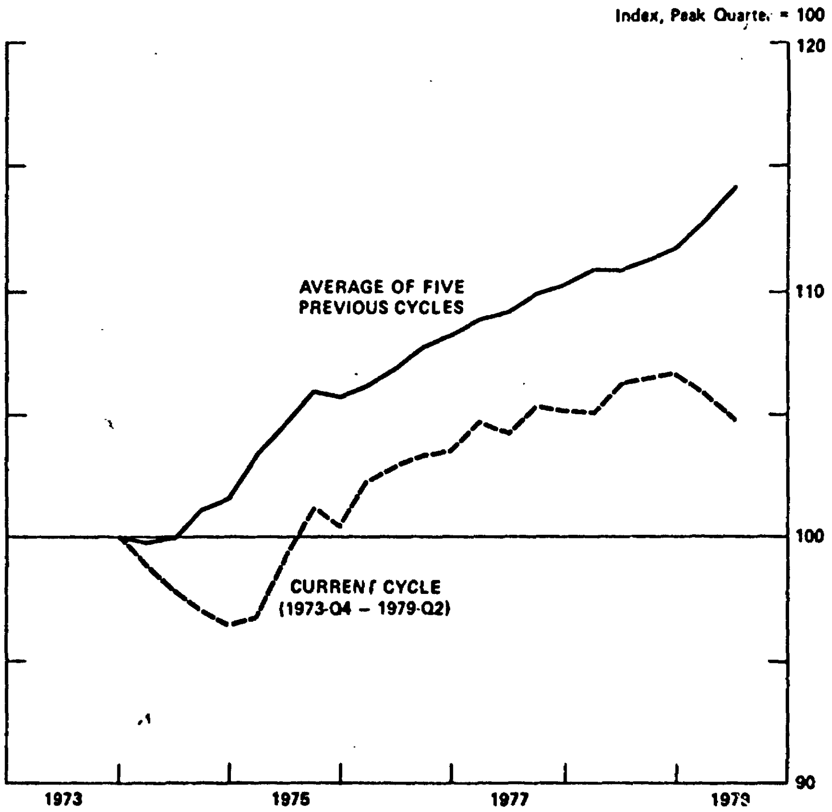


Chart 3

Cyclical Comparisons of Output Per Hour, Private Nonfarm Business Sector*



* Changes following the cyclical peaks as specified by NBER.

Chart 4

INDEX OF PRODUCTIVITY, SELECTED INDUSTRIES (1955=100)

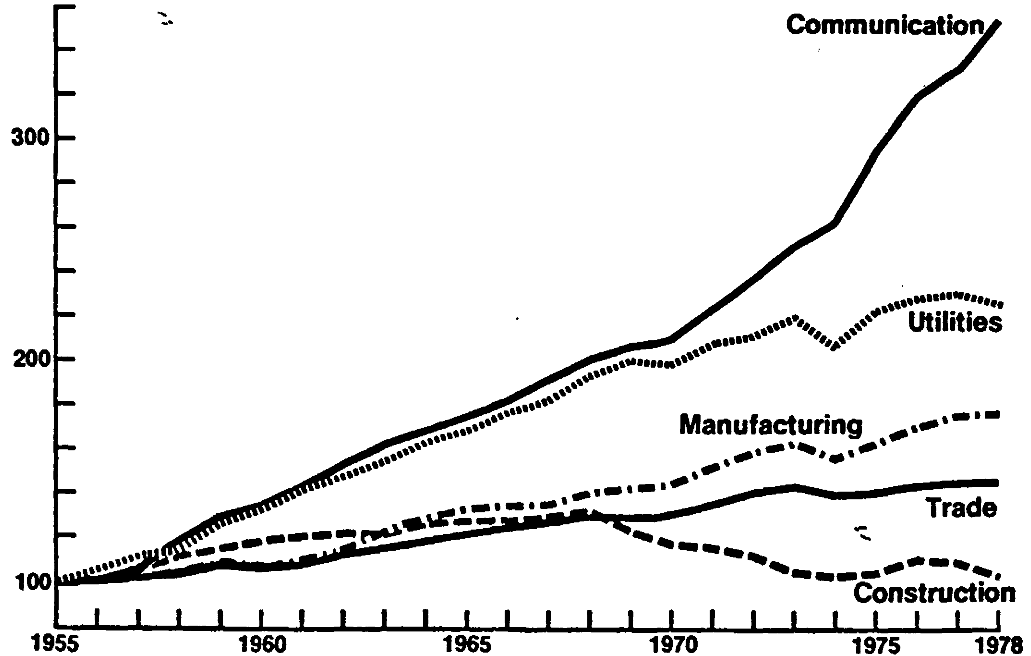


Chart 5

INDEX OF PRODUCTIVITY, SELECTED MANUFACTURING INDUSTRIES (1955=100)

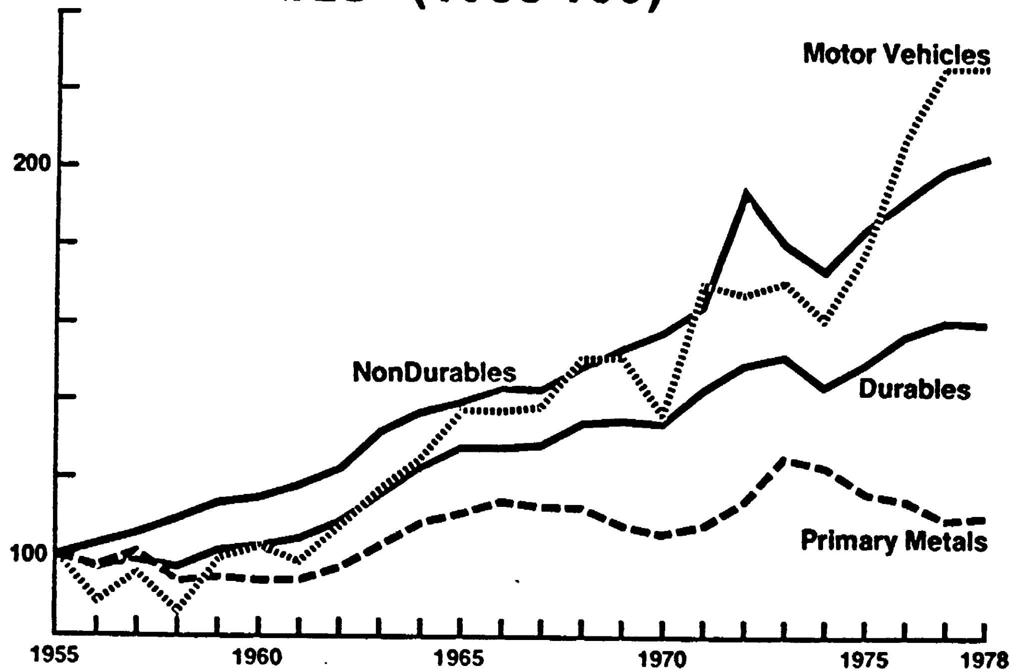


Table 2

"BEST ALLOWABLE" ADR DEPRECIATION PERIODS AS COMPARED TO 10-5-3 SELECTED INDUSTRIES

	10-5-3	ADR					
Asset Class	All Industries	All Industries	Construction	Motor Vehicles	Communication	Primary Metals	Utilities
Autos & Light Trucks	3	3.5	3.8	3.1	4.4	3.2	4.5
Other Machinery and Equipment	5	10.2	5.1	5.8	14.6	11.3	20.4
Buildings	10	32.6	35.0	35.0	36.0	35.0	35.0
Total	5.9	12.7					

Table 3

"Best Allowable" Depreciation Life (Years)
Under Present Law, by Industry

	Cars and Light Trucks	Machinery and Equipment	Building
All Industries	3.5	10.2	32.6
Agriculture	3.9	7.7	20.0
Construction	3.8	5.1	35.0
Oil and Gas			
Drilling	3.2	7.0	35.0
Production	3.2	11.0	35.0
Refining	3.4	12.4	35.0
Marketing	-	13.0	13.0
Mining	3.6	7.8	35.0
Manufacturing			
Food	3.2	9.2	35.0
Tobacco	3.3	11.4	35.0
Textiles	3.2	8.1	35.0
Apparel	3.1	7.1	35.0
Logging/Saw Mills	3.9	6.8	35.0
Wood Products	3.8	7.1	35.0
Pulp and Paper	3.2	9.9	35.0
Printing and publishing	3.1	8.7	35.0
Chemicals	3.1	7.7	35.0
Rubber Products	3.1	9.6	35.0
Plastic Products	3.0	8.0	35.0
Leather	3.0	8.5	35.0
Glass	3.0	9.2	35.0
Cement	3.5	14.0	35.0
Stone and Clay Products	3.5	10.9	35.0
Primary Metal	3.2	11.3	35.0
Fabricated Metal	3.1	4.9	35.0
Machinery	3.0	7.9	35.0
Electrical Machinery	3.0	9.3	35.0
Electronics	3.0	7.1	35.0
Motor Vehicles	3.1	5.8	35.0

"Best Allowable" Depreciation Life (Years)
Under Present Law, by Industry
(continued)

	Cars and Light Trucks	Machinery and Equipment	Buildings
Areospace	3.0	7.8	35.0
Shipbuilding	3.3	9.7	35.0
Railroad Equipment	3.3	8.8	35.0
Instruments	3.1	9.0	35.0
Other	3.1	9.0	35.0
Transportation			
Rail	-	11.7	-
Air	-	9.4	35.0
Water	-	15.7	35.0
Highway	3.4	5.6	35.0
Communication	4.4	14.6	36.0
Utilities			
Electric	4.5	20.5	35.0
Gas	4.5	23.1	35.0
Pipeline	-	17.5	35.0
Wholesale and Retail Trade	3.5	6.8	35.0
Services	3.3	7.8	35.0
Amusements	3.0	9.8	35.0

Note: The "best allowable" depreciation period for an industry is a special type of weighted average of the best available depreciation periods (taking account of the investment credit effects of lives lower than five or seven years) for equipment used in the industry. The weights are estimated 1976 investment in the several types of equipment. The weighted average takes account of the time value of tax saving. In the case of builidngs not covered by ADR, the best available depreciation period is assumed to be 35 years, which is approximately the average useful life employed by taxpayers, as revealed by Treasury Department surveys in 1972 and 1973.

Chart 6

TAX SAVINGS DUE TO 10-5-3 PER DOLLAR OF PROJECTED INVESTMENT IN DEPRECIABLE ASSETS; 1980, 1981, AND 1984, SELECTED INDUSTRIES

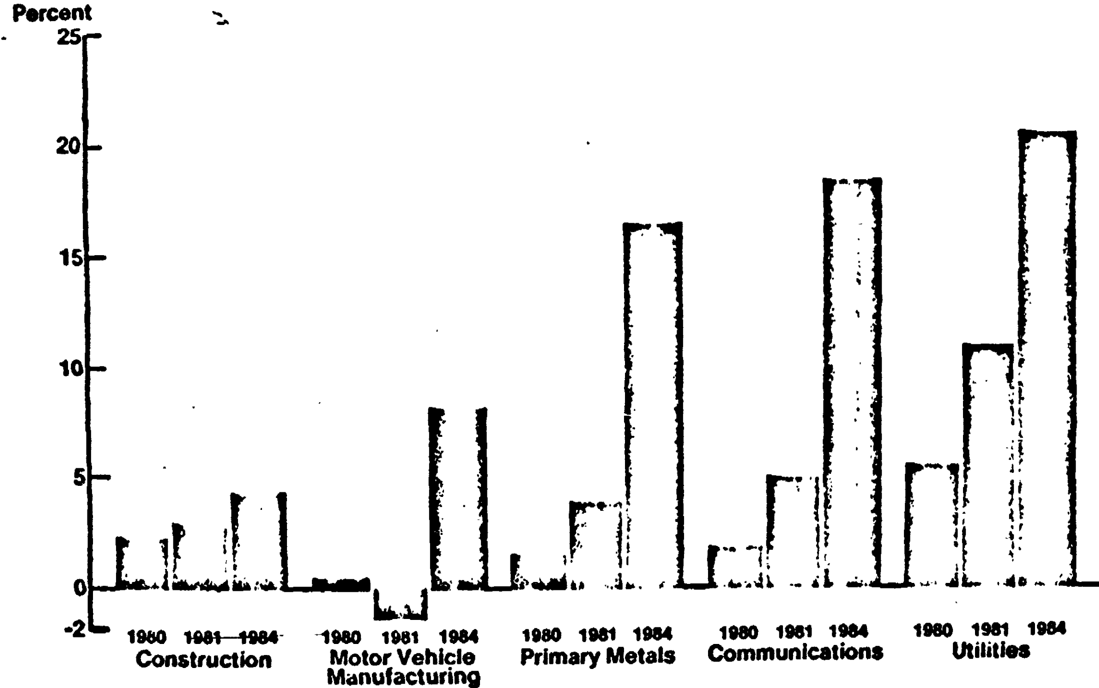


Table 4

Estimated Tax Reduction Due to 10-5-3
as a Percent of Projected Investment 1/, 1984

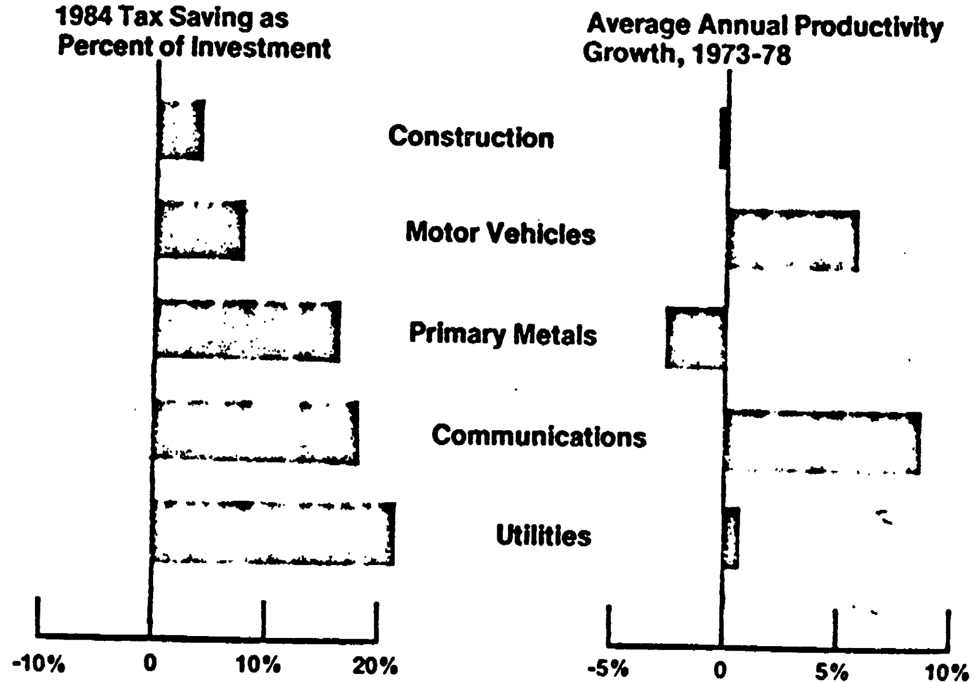
Industry Class	Estimated 1984 Tax Reduction ($ Millions)	Projected 1984 Investment ($ Millions)	1984 Tax Reduction As Percent of Investment
Manufacturing:			
Non-durables	5,729	50,016	11.5
Food	1,258	10,624	11.8
Tobacco	50	369	13.6
Textiles	332	2,757	12.0
Apparel	121	1,196	10.1
Pulp and Paper	837	7,777	10.8
Printing and Publishing	341	3,390	10.1
Chemicals	2,345	19,838	11.8
Rubber	123	927	13.3
Plastics	303	2,918	10.4
Leather	16	220	7.3
Durables	5,606	51,496	10.9
Wood Products and Furniture	98	2,100	4.7
Cement	90	622	14.5
Glass	146	1,258	11.6
Other Stone and Clay	281	2,150	13.1
Ferrous Metals	1,107	6,739	16.4
Non-ferrous Metals	421	3,004	14.0
Fabricated Metals	504	6,587	7.7
Machinery	950	8,345	11.4
Electrical Equipment	493	4,448	11.1
Electronics	266	2,884	9.2
Motor Vehicles	458	5,716	8.0
Aerospace	182	1,591	11.4

1/ Estimates of investment by purchasing sector are based on Annual Survey of Manufacturers, 1976, and data from regulatory agencies, trade associations, and other industry sources.

Industry Class	Estimated 1984 ($Millions)	Projected 1984 ($Millions)	1984 Tax Reduction As Percent of Investment
Shipbuilding	169	1,534	11.0
Railroad Equipment	17	129	13.2
Instruments	222	2,383	9.3
Other Manufacturing	202	2,006	10.1
Transportation	4,048	40,504	10.0
Railroads	562	3,362	16.7
Airlines	814	6,175	13.2
Water Transport	1,432	9,492	15.1
Highway Transport	1,240	21,475	5.8
Communication	5,956	32,130	18.5
Utilities	9,162	42,187	21.7
Electric Utilities	7,533	35,853	21.0
Gas Utilities and Pipelines	1,629	6,334	25.7
Mining, except oil and gas	1,120	10,796	10.4
Oil and Gas Drilling	238	2,945	8.1
Oil and Gas Production	5,079	38,390	13.2
Petroleum Refining	1,207	8,785	13.7
Petroleum Marketing	142	1,254	11.3
Oil Pipelines	2,202	10,175	21.6
Construction	1,114	25,085	4.4
Wholesale and Retail Trade	3,823	44,097	8.7
Agriculture	2,069	27,220	7.6
Services	3,337	41,109	8.1
Grand Total	51,912	435,725	11.9

Chart 7

BENEFITS OF 10-5-3 AS COMPARED TO RECENT GROWTH IN PRODUCTIVITY, SELECTED INDUSTRIES



I do not believe Representative Conable and Representative Jones are here yet.

The next witnesses will be a panel consisting of: Mr. Dave Roderick, chairman of United States Steel Corp. testifying on behalf of the American Iron & Steel Institute; Mr. Richard D. Hill, chairman of the board, First National Bank of Boston, testifying on behalf of the Business Roundtable; and Mr. George A. Strichman, chairman of the board, Colt Industries, Inc., testifying on behalf of the Committee for Effective Capital Recovery.

Welcome, gentlemen.

I assume Mr. Roderick will lead off.

STATEMENT OF DAVE RODERICK, CHAIRMAN, UNITED STATES STEEL CORP. TESTIFYING ON BEHALF OF THE AMERICAN IRON & STEEL INSTITUTE

Mr. RODERICK. That is very fine, Senator.

Senator Byrd, Senators, I am David M. Roderick. I am appearing here as chairman of United States Steel, but for the American Iron & Steel Institute.

We have filed a statement with this committee. Consistent with your rules, we will try to make a very brief statement in support of our more expansive statement that we would like to have incorporated in the record.

Senator BYRD. Thank you. Your full statement will be published in the record.

Mr. RODERICK. First, I would like to say that the steel industry supports Senate bill 1435, the Capital Costs Recovery Act of 1979. That bill provides for just what the steel industry needs and that is more rapid recovery of capital investments in productive assets.

The bill will make us more cost-competitive internationally. It will create and maintain jobs domestically in the steel industry. It will decrease energy costs per ton of output. It will increase productivity and it will help to contain inflation.

The bill is important to the 600,000 directly employed in the steel industry, and the many employees of our suppliers in turn.

Presently, based on actual production costs, we believe that the American steel industry is, and continues to be, the low cost producer for this market. Because of inflation, the present tax policy, in our opinion is as obsolete as the Model T Ford and high-button shoes.

The replacement costs for productive facilities, the actual cost is three times as great as the initial cost in the steel industry and there are three principle reasons why inadequate depreciation is particularly severe to the steel industry.

First, the steel industry is extremely capital intensive. Second, it has been assigned, over a period of time, unrealistically long useful lives. Third, in an inflationary economy, our depreciation policy is intolerable and does not provide for adequate modernization and replacement.

For example, in steel, our average life is 12 years. In chemicals, 7½ years. In electronics, 6½. They are probably all too long, but certainly 12 years in a 10- to 12-percent inflation economy is economically unrealistic today.

More importantly, or equally important, it is a much longer life than our international competitors. Foreign competitors get better capital tax recovery than we do in this country.

I would like to give a very specific example of that. As has been mentioned here, Canada has a more innovative approach to capital recovery than we do in this country. Our company has been considering building an integrated steel plant on the south shore of Lake Erie near Conneaut, Ohio, that straddles the Pennsylvania and Ohio border.

If we would go ahead with that plant, we would recover our investment through present tax policy in about 12 years. Our Canadian friends are building a similar mill on the north shore. They are actually building it. They will recover their capital in 3½ years.

Their plant is going ahead. Ours is only on the drawing board, and probably will stay there.

We have a very inadequate capital recovery and it is a serious problem for this industry and, we feel, for the entire economy. We have spent $21 billion over the past decade to keep our facilities as modern as we can. Only about one-fourth of the industry's equipment was installed in this decade.

Our average age is 17 years which is totally dangerous from the standpoint of remaining competitive internationally into the next decade.

This industry needs $5.2 billion to maintain capacity and we should be spending that every year. That is to meet environmental requirements and maintain existing capacity.

If we wish to grow consistent with our 1.5 percent opportunity per year, it would take another billion. That would include the necessary working capital. We should be spending over $6 billion per year if we are going to remain modern and generate the steel that we feel this country needs.

Actually, we generate about one-half of that amount so in effect we have a cash shortfall in this industry of over $3 billion a year.

As you can well appreciate, what that ultimately means is a capacity shortfall over time. That has been taking place, and it will continue to take place until our tax laws are modernized.

I believe very strongly that our Nation needs a modern fully cost-competitive growing steel industry to support the industrial strength of this Nation. As Secretary Miller said, the metals industry needs the benefit of S. 1435 and we strongly urge its passage.

Thank you, Senator Byrd.

Senator BYRD. Thank you, Mr. Roderick.

The next witness will be Richard D. Hill.

STATEMENT OF RICHARD D. HILL, CHAIRMAN OF THE BOARD, FIRST NATIONAL BANK OF BOSTON, TESTIFYING ON BEHALF OF THE COMMITTEE FOR EFFECTIVE CAPITAL RECOVERY

Mr. HILL. My name is Richard D. Hill. I am the chairman of the First National Bank of Boston and I represent the Business Roundtable which strongly supports the enactment of S. 1435.

In accordance with the practice of this committee, sir, I have filed a full statement with you which I hope will be read into the record.

Senator BYRD. Yes; it will be placed in the record.

Mr. HILL. Future U.S. economic policy must address our declining investment in modern tools of production as well as the declining productivity of our work force. Failure to do this in a prompt and significant way will accelerate our slide toward the condition of stagnant growth, low competitiveness worldwide, high levels of unemployment, and chronic inflation.

Very few figures will illustrate this quite graphically. I will not repeat them because my figures are very close to those given by Secretary Miller which, in effect, show that our good friends, the Japanese, are investing approximately twice the percentage of the gross national product than we are and that their rank in productivity growth is at the very top of the list where ours is at the very bottom in connection with the industrial nations.

Under our own capitalistic system, the savings in the investment-employment cycle is crucial to the success. When it fails, the arguments of those who would experiment with other systems become quite persuasive and if we continue to believe that our way is a better one, we must not allow this to happen.

Savings flow into investment from individuals and institutions which are attracted to the risk by a fair return and confidence in the underlying security. Savings flow from corporations in the form of reinvested cash flow resulting from earnings and depreciation.

S. 1435, the so-called Recovery Act will help to strengthen the investment cycle by strengthening cash flow and making more funds available for the tools of production. This also adds to the security of the enterprise and will help to attract additional investment from individuals and institutions.

Beyond the need for encouraging investment, is there any other economic rationale for this change in depreciation computation? I believe there is and one need only refer to approaching requirements of the financial accounting standards encouraged by the Securities and Exchange Commission for corporations to disclose parallel financial statements to their shareholders.

The traditional historic cost statements and new ones recognizing the inflated replacement costs and fixed assets and inventory. Had we done this in 1978, the additional depreciation resulting from the higher costs attributed to the existing asset would have been about $28 billion greater than the figure permitted by tax-rate collections.

For these reasons, both in terms of economic benefits to the people of the United States and in terms of ultimate fairness, I have no hesitation in recommending passage of S. 1435 with simplified depreciation schedules.

While I believe this could be a keystone of our attempts to encourage investment in enhanced productivity, it will not do the job alone and we ask also to remove the existing tax penalties on individual savings and on the unfair limitation on the interest rates paid to the small and less affluent citizens.

Senator BYRD. Thank you.

Mr. Strichman?

STATEMENT OF GEORGE A. STRICHMAN, CHAIRMAN OF THE BOARD, COLT INDUSTRIES, INC., TESTIFYING ON BEHALF OF THE COMMITTEE FOR EFFECTIVE CAPITAL RECOVERY

Mr. STRICHMAN. I am George Strichman. I am chairman of the Committee for Effective Capital Recovery and chairman of the board of Colt Industries, Inc.

The Committee for Effective Capital Recovery is a voluntary coalition of 396 business firms and 53 business associations. It is representative of virtually all segments of industry including manufacturing, retail, minerals, transportation, and utilities.

The committee believes that the central economic challenge facing America in the eighties will be to fulfill our enormous needs for capital—for an ever-expanding population, for dramatically increased energy prices, for environmental protection, and for plant modernization.

Not long ago, the Joint Economic Committee issued a warning that the average American is likely to see the standard of living vastly reduced in the eighties unless productivity is accelerated. All members of your subcommittee understand the need for increased productivity and what it takes to achieve it. We have been talking about that today.

The problem we have faced for years, which has put us in the position we are in today, I believe, is that other people in and out of Congress do not have this understanding. As a matter of fact, President Carter, in a very recent article, stated that the United States is going through an inevitable historical period when the rate of increase in productivity is low.

The truth is that there is nothing inevitable about the decrease in the amount of productivity that now exists. We have caused it ourselves by discouraging investment while our partners in the free world have been growing at rates two to three times ours. At the same time, we have been declining since 1965.

It is easy to understand why this is happening. We have the lowest investment rate of any of our competitor industrialized nations and, of course, simultaneously we have the lowest savings rates. This has to be true because it is from savings and investment flows.

As usual, there are several reasons for our decline in productivity, but I wish to dwell on the most important one of them—that is, savings, investment, and cash flow.

Savings in this country is currently about 15 percent of GNP. Roughly 40 percent of the savings comes from individuals and 60 percent come from business and industry. Of the 60 percent that comes from business and industry, three-quarters of that, or 45 percent of the total comes from capital recovery allowances. This has gone up by a large amount in just the last 3 years because the rest of the savings have dropped so dramatically.

Compared to other industrialized countries around the world, our depreciation ideas and methods are slow, antiquated, and do not allow for the fast reinvestment of capital.

The first change we can make, which is in your program, is the depreciation rate—to cut loose from the ADR useful life concept which is peculiar to us in this country and go to a straight, time-

limited depreciation rate whose sole purpose would be to recover investment rapidly so that it can be reinvested.

Your 10-5-3 program, advocated in Senate bill 1435, does just that.

I would like to add just one point from my prepared remarks and then, if you would allow me, Mr. Chairman, make some comments on what has been said here today.

Martin Feldstein has estimated that the 10-5-3 system would just about take care of current rates of inflation. When he said that just a few weeks ago, he was talking on the assumption that the current rate of inflation would be 8 percent. We feel if we can get back to 8 percent we will be doing pretty good.

The 10-5-3 bill will increase savings and investment rates substantially and it is mandatory that some action like this be taken promptly to take care of all the things associated with productivity that you have been hearing about over and over again.

I would like to stop at this point, and if you will give me a little time to talk about two things that have become paramount in your considerations today. The first is the 10-year life of buildings, and I was glad to hear you say that you would not just throw it away but you wanted to consider it further.

I would like to point out to you that when you talk about equipment, a plant is a part of it—in fact, it is a very great part of it. In many cases, it is as much as 50 percent part of it.

The building is special. It has special equipment that the building must be designed to house, special floor loadings, special foundations, sometimes going as many as three or four stories down in order to put the equipment on top of it and the equipment and services beneath it.

You cannot just say you are going to take care of the equipment and forget about the building. The building is an essential part and when you are talking productivity, buildings are an essential ingredient.

Second, you have wisely built some great safeguards into the bill because of the problems you are talking about. Senator Bentsen hit it right on the head that the current method may be better than the bill that is being proposed for people who are seeking tax windfalls. Let's go through it quickly, and this is what you have in the bill.

First of all, let's define tax avoidance. First, the purpose of the bill is to stimulate investment in plant and equipment, including commercial buildings and to the extent that the bill attracts investment, it is serving its objective.

Tax avoidance exists when taxpayers obtain unintended benefits.

You have in this bill full recapture on disposition of capital recovery property. Under section 5 of the bill, the full amount of gain on disposition of capital recovery property, including buildings, is recaptured as ordinary income to the extent that capital recovery deductions have been claimed. That is much worse than the current situation in which only depreciation on equipment but not buildings is fully recaptured.

The intent of this provision is to insure that ordinary income cannot be converted to capital gains through the Capital Cost Recovery Act.

In addition, you have a minimum tax built into it. Under section 6 of the bill, the accelerated allowance of the capital recovery bill, that is, the difference between the double declining balance rate and the straight line rate, is treated as tax preference income and hence is subject to the minimum tax where the taxpayer is a noncorporate lessor of property.

So you have already covered that one and covered it very adequately. Senator Chafee, you asked about that question before, too.

Last, but not least, you did not ask about it, but we have recommended to you that there should not be any trafficking in capital lost recovery carryovers to the extent a taxpayer does not fully utilize a CCRA deduction in any year, the balance may be carried forward. Under section 7 of the bill, the existing code section which restrict trafficking in net operating loss carryovers are extended to CCRA carryovers, so I think you have very adequately covered that area.

One other thing. In the amounts of revenue loss that would be incurred, the bill is based on a 5-year phase-in of the 10-year building deductions. You could also consider a 10-year phase-in. It is not as difficult as Secretary Miller implied it would be and under those circumstances in 1984, according to the DRI estimates, it would only account for 20 percent of what the total revenue losses, as calculated and before feedback, would be.

That is, with respect to buildings, you cannot just forget about 10-year life because it is an important cost because of cost recovery for those portions of the things that are necessary for productivity.

The other half is that with respect to the Treasury Department, I would like to remind you of something. You know, there is nobody that does a worse job of forecasting what the results of feedback in the business world will be to the revenues than the Treasury Department. We have in our business all over—Mr. Roderick has it, Mr. Hill has it, everybody has it, what we call NIH—not invented here. I think we have a little bit of that today.

If you recall, when we put in the investment tax credit, there were predictions from the Treasury Department of immediate loss of $5 billion to $10 billion of revenue a year. Low and behold, what happened, there was an increase of $5 billion to $10 billion because they had not planned on what would happen in the economy and then later on it was taken off and they predicted again and got just about as big a loss instead and that happened three times, gentlemen. Each time, the Treasury predictions were totally wrong.

Well, we had DRI estimate the feedback for us, and they estimate that it would be 50 percent instead of 30 percent. There is no calculation that Treasury made for that, no way to calculate it. It has to be your estimate of what will happen in the business world.

At 50 percent, it makes those numbers of loss look far lower so I just want to leave that thought with you because it is there and it is one of those kinds of things that you will have to decide for yourselves. But in your own Congressional Budget Office, you have a third set of numbers that do not agree with any one of these, that we understand are being developed. We believe yours are far more reasonable, also from the feedback that we have gotten.

I do believe that you have to take this and look at it on the basis of the benefit that it will do and on the fact that it is totally supported by all business, large and small, as they sit and talk to you today and that it benefits productivity. It is something that we need now and not some vague plan that we might have some day in the future.

Senator BYRD. Thank you.

Mr. Roderick, could you put in capsule form the basic reason, or reasons, for the noncompetitive situation in which the American steel industry apparently finds itself?

Mr. RODERICK. We believe, Senator, that we are cost competitive basically with our major competition today abroad.

The problems we are encountering today, if you measure inefficiency, output per man-hour, we are equal to Japan or slightly ahead, and substantially ahead of Europe.

One of the problems we are having today is that very clearly about 50 percent of the capacity in the world, international capacity, is directly owned by foreign governments. They are being highly subsidized, massive loans later converted to non-interest-bearing capital, permits them to, in effect, capitalize losses.

If we take, for example, the French steel industry, which would be a very typical one, over the last 3 years, their losses have exceeded $3 billion. Nevertheless, they continue to exist and export to this country obviously below their cost of manufacture.

We hope that, under the Trade Act and the MTN agreements that we will begin to get relief from this type of dumping but what we are saying, Senator, is that the only way we can continue to be cost-competitive is to begin to invest larger sums of money to improve productivity.

The question was asked, how do our productivity improvements compare with Japan? You take the last 10 years. They have improved at a compound rate of about 4.5 percent per year. The American steel industry has been about 2 percent.

Currently, it is probably less than 1 percent.

If you take fuel efficiency, the Japanese are using about 30 million Btu's per ton of product produced. We are using 36 million Btu's per ton of product produced. They have more modern facilities.

We need to accelerate our modernization so that we can continue to be cost-competitive and maintain the infrastructure and capacity in this industry.

Senator BYRD. Generally speaking, U.S. plants are not as modern as foreign plants?

Mr. RODERICK. You would have to break that down, Senator. Generally speaking, we are about as modern as Europe. We are less modern than Japan. Our average age is 17½ years; in Japan, the average age is 10 years. In the less-developed countries the average age, as I recall it, is 8 years.

So we need to modernize to a much greater extent than we have, let's say, over the last decade, when only one-fourth of our equipment that is in place today was put in place during the decade of the 1970's.

We have to get going and we have to just about double what we have been putting in the hardware.

Incidentally, I would like to fully endorse the statement that was made that in the steel sector when we call something a building, it is a building that is especially designed to house productive equipment. It is an integrated part of that productive equipment.

In three out of four cases, it is totally unusable for other purposes.

Senator BYRD. Thank you, Senator Bentsen.

Senator BENTSEN. Thank you, Mr. Chairman.

I would guess that the other members are thinking the same as I am concerning buildings. When you are talking about buildings, it involves a manufacturing process. Nobody is questioning that, frankly, and realizes what that ads to productivity.

But Mr. Roderick, I am deeply concerned about the steel industry and a lot of other basic industry in this country and although I am very much for this legislation, it is not going to do you a lot of good unless you have some profits that you can charge it to, because that cash flow does not amount to anything unless you are making money.

I am deeply concerned about the policies of not only this particular administration but administrations for some time as to what we have not done in trying to build up our exports.

I look at a situation like we have in Taiwan and South Korea where they are supposed to double their production of steel to 150 million tons by 1985 and much of that is targeted for this market.

I look at a situation that just happened in Egypt. We are sending billions of dollars to Egypt and a contract is being negotiated in the middle of the night with our Embassy not being aware that that was being done at the time, being unaware that the contract was going to be allowed over a period of years. You had a massive contract negotiated where we were not fully informed of what was being done and it was given to other people, not serious consideration being given to the U.S. companies in there bidding and trying.

I do not think our administration did anything about it. I do not think they were in there trying to sell, as they should have been selling.

I look at a situation when we see them come in here with a 300,000 paper corporation totally owned by the French company and bid on some helicopters against the domestic company, Bell. You have a bid of $123 million with about $1 million difference between bids, and you have all the other factors of the backup of supply lines and parts and everything else right here in this country and see that given to the French company so that our Coast Guard would be equipped with all French helicopters under that situation.

When I talked to the Secretary he tells me he does not get involved in those kinds of things. Do you think, G'Estang gets involved? You bet he does, and so do all the heads of these other countries as they try to encourage their exports, and we ought to be doing a lot more of that in trying to sell U.S. products overseas, where we are doing so much to try to help other countries.

So, Mr. Roderick, again this can be of help but it is not going to take care of some of the basic problems in their entirety that we are facing in this country on basic industries if we do not try to push and encourage exports more.

Mr. RODERICK. I agree with that, Senator.

Senator BENTSEN. You have 18 percent of the steel used in this country coming from foreign sources.

Mr. RODERICK. That is right.

Senator BENTSEN. That can go to half by the late eighties unless we turn this thing around, and if we are dependent on oil for almost 50 percent, if that happens to us and some of our other basic products, like steel, we will even be more hostage than we are now to some of these countries in foreign policy.

Mr. RODERICK. That is very important, Senator. As I pointed out, one-half of the capacity abroad is really owned by governments and as you get a high economic recovery internationally, there is no question where the steel from the government-owned mill abroad, is going to go when the economies tend to peak.

It is just not even going to be available to this market at any price.

We are leaving our economy very, very vulnerable when we permit a high percentage of our industrial strength and the backbone of the Nation to be subject to offshore sources of supply.

I think it is something that we have to really address and I fully agree with the earlier testimony also that it is something that we cannot wait too long to address. When you see a man drowning, I do not like to see the lifegurds debating as to what the method is going to be to try to save him.

Senator BYRD. May I say to Mr. Hill, Senator Tsongas had hoped to be here this morning to present you to the committee. He has another committee meeting and could not make it.

Senator Long.

Senator LONG. I have no questions.

Thank you.

Senator BYRD. Senator Chafee.

Senator CHAFEE. Mr. Roderick, I would just like to briefly ask you about the depreciation for Government-mandated pollution equipment. How do you stand on that?

As you know, Secretary Miller suggested perhaps in some industries that it should be faster than the 5 years. How would it work out for your industry if we stuck to the 5 years?

Mr. RODERICK. I would actually see it faster than that. I think, as has been pointed out, it is totally unproductive from the standpoint of a single plant. I am not talking about the impact into the economy and as a result, it is really by definition—it is really not a capital goods producing asset. I think it should be written off either immediately or certainly no longer than 2 years.

Senator CHAFEE. How long do you write it off right now?

Mr. RODERICK. If you take the ADR and apply it to that particular class of equipment, as I recall, it would come out to something in the area of about 6 years. But it is far too long of a life.

This is basically short-lived equipment and I think it is very important, Mr. Chafee, that we really look at the impact on steel, as Secretary Miller said. Our capital budget next year for the United States Steel Corp. is going to be $900 million to $1 billion; $450 million of that is going to be environmental. It is not going to create anything.

Senator CHAFEE. That is way higher than I thought. That is 50 percent.

Mr. RODERICK. As we get closer to 1982, which is the deadline for air and 1984 for water, these expenditure requirements will now begin to accelerate so that we can meet those legislative deadlines that have been imposed on us by Congress.

Senator CHAFEE. Thank you, Mr. Chairman.

Senator BYRD. Thank you, gentlemen.

Mr. RODERICK. Thank you.

[The prepared statements of the preceding panel follow:]

STATEMENT OF

DAVID M. RODERICK, CHAIRMAN

UNITED STATES STEEL CORPORATION

on behalf of

THE AMERICAN IRON AND STEEL INSTITUTE

Mr. Chairman:

I am David Roderick, Chairman of U. S. Steel Corporation. I am appearing today before your Subcommittee on Taxation and Debt Management for the American Iron and Steel Institute to express the views of the domestic steel industry on S.1435, the Capital Cost Recovery Act of 1979.

At the outset, I would like to state that the steel industry strongly supports this bill. It provides for a more rapid recovery of capital investment in productive assets. It will simplify the recovery of investment in plant and equipment. Current tax law measures the capital recovery period by the asset's useful life. The approach as authorized in this bill would replace the current complex array of depreciation life schedules with a standardized capital recovery allowance for most capital assets.

This legislation will create a uniform, simple method of capital recovery. It is designed to bring the United States economy into a more competitive position internationally, create jobs domestically, and increase productivity, thereby helping to contain inflation.

Steel, A Major Factor in the U. S. Economy

Last year the industry produced 137 million tons of raw steel. To achieve this level of output, American steel companies employed a total of nearly 600,000 people; paid wages and salaries of $12.4 billion; supplied about 40,000 metal working plants; and

purchased nearly $26 billion of materials, supplies and services from others. In 1978, the industry had a return of 2.8% on sales and 7.3% on stockholders' equity. These returns compare with 5.2% on sales and 15.9% on stockholders' equity for all manufacturing industries.

In recent years, the steel industry has provided between four and five percent of the payrolls, value added, value of shipments and capital expenditures of all manufacturing industries in the U. S. It has accounted for about three percent of the Federal Reserve's Index of Industrial Production, and value added by the industry represents about 1% of total Gross National Product. Accordingly, steel is one of the largest industries in the nation, exceeded only by automotive, petroleum and food.

Inadequate Capital Cost Recovery

On the basis of actual production cost, it is my strong belief that the American steel industry is a lower cost producer for the U. S. market than most all of its major foreign competitors. However, the industry could easily lose its competitive edge in the decade ahead if rates of return do not improve and if tax laws are not revised to allow more rapid recovery of capital investment. Current rates of return do not provide adequate incentive for investment in new facilities. Cash flows are inadequate to support necessary modernization and replacement to keep the American steel industry as the competitive low cost producer and predominant supplier to the domestic market.

The nation's federal income tax laws were written during a period when inflation was not a significant economic factor affecting the replacement cost of plant and equipment. In recent years, however, inflation has become so severe that it now costs approximately three times as much to replace plant and equipment wearing out compared to its original cost. As a result, earnings after income taxes, which should be available for the stockholders and for growth of the business, have had to be used for replacement of existing equipment.

Federal income tax laws must be changed to provide more competitive rates of capital recovery, to minimize the impact of inflation on plant and equipment investment, and thus protect and increase jobs.

For the steel industry, the problem of inadequate depreciation is particularly severe -- for three reasons:

-- The steel industry is capital intensive.

-- The steel industry is required by federal income tax laws to write off the original cost of its plant and equipment over a period which is far too long. Facilities in the steel industry prior to 1979 had to be written off over 15 years, on average. In 1979 and subsequent years, this was reduced to 12 years. But this still leaves steel with one of the longest capital recovery periods in American industry; for example, 12 years for steel compared with 6.5 years for electronic equipment, 7.5 years for chemicals, 8 years for wood products, and 9.5 years for fabricated metal products.

Even today, however, no other major industrialized Western nation has a longer period, and virtually all other countries permit shorter cost recovery periods. Foreign nations have not employed the "useful life" concept, but rather have used rapid capital recovery as a policy tool to promote accelerated capital formation and increased productivity. For example, in England, capital expenditures are treated as any other expenditures and are deducted in the year incurred. In France, Italy and Sweden, over 75% of capital expenditures are recovered in the first 3 years (as compared to less than 57% in the U. S.). In Canada, full capital recovery is permitted in approximately 2-1/2 years, as compared to over 10 years in the U. S.

-- Further, steel industries abroad receive at least equal, and in some cases, more favorable tax treatment than most other manufacturing industries in their own countries. In the United States the reverse is true.

Future U. S. Demand for Steel

Over the next decade, domestic steel consumption is expected to increase by at least 1-1/2 percent per year, reaching 134.0 million net tons of finished steel products or some 17 million product tons above the current level.

Unless the U. S. economy is willing to become increasingly dependent upon foreign sources of supply to fill its steel needs, then the United States must take appropriate action to promote increased

capital formation and thus cash flow to enable the domestic steel industry to continue to supply at least the current share of the U. S. market that has been supplied from domestic sources. But the time for decision is at hand. Without substantial investment for modernization and replacement of existing facilities, without some modest expansion of capacity, steel imports -- at today's prices -- could well rise in the next decade to $20 billion annually. This would cause further major steelworker employment losses, and accelerating obsolescence in the industry. So we urge the U. S. Government to act now to put in place public policies which will permit our industry to invest adequately to meet this nation's steel needs. Enactment of S.1435 would be a major step in the right direction.

Inadequate Capital Investment --
A Serious Problem for the American Steel Industry

Over the past ten years (1969 - 1978), American steel industry capital investment has averaged nearly $2.2 billion per year. That this level was inadequate is amply demonstrated by the age of facilities in our industry. The current average age for machinery and equipment in the steel industry is now more than 17 years. Despite investment of more than $21 billion over the past decade, only about one fourth of the industry's current productive equipment was installed in that decade. The rest is older, and that is not good enough. We must continue to modernize to maximize productivity, to decrease energy usage, to preserve current jobs and to create new ones. Part of the problem is that a significant portion of the total investment had to be diverted to investments to meet non-productive regulatory requirements such as environment, OSHA, etc.

For the American steel industry to remain a viable world competitor and the low cost source of supply for the domestic market, capital investments will have to be made which will provide dramatic improvements in our energy efficiency, in labor productivity, and in cost competitiveness. Achieving this will require a substantial increase in capital expenditures in the very near future. For the industry to have the resources for substantially higher capital expenditures, additional capital cost recovery allowances and additional profitability are badly needed. It is essential to recognize that real rates of return in the American steel industry have declined substantially during the past three decades.

Steel Industry Capital Expenditures Need to More than Double in the Next Decade

Capital expenditures of American steel companies during the next decade for modernization and replacement of existing productive capability and to meet environmental and health requirements will require more than $5 billion annually. Modest expansion of capacity will require another $0.5 billion. The steel segment of the industry's operations alone will require capital expenditures of nearly $6 billion annually. Other capital needs of the industry add up to an additional $1 billion annually. In total, we project capital requirements of approximately $7 billion annually for the steel industry. Such a sum is more than double capital expenditure levels of recent years.

Need for More Rapid Capital Recovery and an Improved Rate of Return

The two principal sources of funds to meet these requirements must be improved capital recovery and an improved profitability.

Companies in the American steel industry do not have enough capital funds, given current tax laws and rates of return, to finance the capital expenditures needed for modernization of the domestic steel industry. This shortfall would be significantly reduced if an improved capital cost recovery bill, such as Jones-Conable, is enacted into law. But a shortfall would still exist, since with current rates of return, steel producers do not have sufficient gross income (total revenue minus operating costs) to fully deduct the capital recovery allowances (tax basis) the proposed CCRA would provide.

For reinvested earnings to hold promise as a source of funds to cover capital shortfalls, return on equity must approach levels commensurate with that of all manufacturing. These additional funds plus improved capital recovery would permit the industry to accomplish a revitalization which will result in significant cost decreases. By the time the full revitalization effort is complete, the efficiency improvements inherent in this effort would reduce operating costs by over 35% and total costs by approximately 20 percent. The difficulty, however, is that the increased net income from new investment will lag the capital expenditure outlay by some years. A gain in real margins will be necessary, but in the long run, the net effect of increased margin and faster capital recovery will be anti-inflationary. It will preserve and protect American jobs and provide this nation with a competitive, low cost source of supply for steel made by American steelworkers. The American steel industry would be the continuing source of supply of at least 85 percent of the domestic requirements, and I believe entice more economy-minded steel consumers to choose American steel products.

Accordingly, we urge the Congress to act quickly to approve the Capital Cost Recovery Act of 1979. By encouraging further modernization and expansion in steel, it will provide major benefits to the U. S. economy and to our industry.

SUMMARY
Statement of Richard D. Hill
Chairman of the Board
The First National Bank of Boston
on behalf of
THE BUSINESS ROUNDTABLE
Submitted to the
Subcommittee on Taxation and Debt Management
of the
Senate Committee on Finance
October 22, 1979

The Business Roundtable supports the enactment of S.1435 which would replace the existing and outmoded system of tax depreciation with a capital recovery allowance system to enable American business to increase the level of capital investment in productive plant and equipment.

S.1435 would introduce a simplified and accelerated method of writing-off the cost of business assets (i.e., the "10-5-3" system). The "10-5-3" system responds to the capital formation needs of all segments of the domestic economy and, as a result, has broad-based support throughout the business community.

The U.S. economy is suffering from spiraling inflation while the rate of capital formation and growth in productivity are declining. In comparison to other major industrialized countries, the U.S. has the lowest rate of private capital investment and the lowest rate of growth in labor productivity.

The U.S. needs to boost output through the removal of impediments to growth in business investment and production. The enactment of S.1435 would generate an increase in capital investment by American industry, thereby permitting it to:

- improve the declining productivity rate,
- modernize and expand domestic plant and equipment,
- combat chronic inflation,
- contribute to a higher standard of living for the nation's citizenry, and
- compete more effectively in domestic and foreign markets.

STATEMENT OF RICHARD D. HILL
Chairman of the Board
The First National Bank of Boston
on behalf of
THE BUSINESS ROUNDTABLE
Submitted to the
Subcommittee on Taxation and Debt Management
of the
Senate Committee on Finance
October 22, 1979

Mr. Chairman: My name is Richard D. Hill. I am the Chairman of the Board of The First National Bank of Boston. I am testifying today before your distinguished Subcommittee on Taxation and Debt Management on behalf of The Business Roundtable in support of S. 1435, the Capital Cost Recovery Act of 1979.

The Business Roundtable has long supported the concept of replacing the existing and outmoded system of tax depreciation with a capital recovery allowance system that would enable American business to increase the level of capital investment in plant and equipment. S. 1435 would introduce a simplified and accelerated method of writing-off the cost of business assets, sometimes referred to as the "10-5-3" system, which would represent a significant improvement over today's complex and unrealistic tax depreciation system. S.1435 has been constructed to respond to capital formation needs in all segments of our economy, and as a result, this proposed legislation has broad-based support throughout the entire business community.

The overriding challenge to our domestic economy today is the need to encourage capital formation and establish a long-term pattern of sustained economic growth. Capital formation is essential for economic progress. Accelerating the rate at which businesses recover their cost of investment in plant and equipment will improve rates of return and enhance business cash flow and thus, contribute importantly to increasing the level of capital investment by American industry, thereby permitting it to:

- improve the declining productivity rate,
- combat chronic inflation,
- modernize and expand its facilities,
- contribute to a higher standard of living, and
- compete effectively in domestic and foreign markets.

There is an acute need for capital investment to attain these goals. Over the past decade, while there has been a significant increase in the labor force, there has been a significant decrease in the rate of growth of plant and equipment. This has reduced the growth of labor productivity, reduced the growth rate of real wages and contributed to the nation's expanding list of economic problems. If the United States is to overcome these problems, the Federal government must reorder its priorities and adopt public policies, including tax policies, that will influence businesses-both large and small-to invest in productive plant and equipment for the long-term health of the nation's economy.

International Comparisons

The United States currently has the lowest rate of private capital investment and also the lowest rate of growth in labor productivity among the principal industrialized countries of the world. This weak performance is borne out by government statistics.

Ratio of Nonresidential Fixed Investment to Gross Domestic Product and Growth Rates of Labor Productivity

	Investment Ratio[1]		Average Annual Percent Change in Productivity[2]			
	Percent	Rank	1967-72	Rank	1972-77	Rank
Japan	26.4	1	9.2	1	3.5	1
West Germany	17.4	2	4.8	2	3.5	1
France	16.7(a)	4	4.5	3	3.1	3
Canada	17.2	3	2.8	5	0.8	5
U.K.	14.9	5	3.0	4	1.2	4
U.S.	13.5	6	1.1	6	0.6	6

(a) 1970-75

1 Measured as real nonresidential fixed investment as a percent of real gross domestic product, 1966-76.

2 Measured by growth in real domestic product per employed civilian, using own country's price weights.

Source: Economic Report of the President, 1979 and Joint Economic Report, 1979.

Some portion of the poor relative productivity performance of the U.S. economy can be attributed to technological catch-up by other countries. However, the Joint Economic Committee noted in its 1979 Report that the higher rates of capital formation in other countries played an important role in their productivity performance. The Joint Economic Committee concluded that, if the 1967-77 trends in productivity should continue into the 1980's, output per worker in France, Germany, Japan and Canada would all exceed that in the United States by 1985 or shortly thereafter. The most recent data on U.S. productivity growth do not dispel this outlook. In 1978, real domestic product per employed civilian declined by 0.3 percent, and the even greater rate of decline in the first half of 1979 makes it likely that U.S. labor productivity will again show no gain at all for 1979 as a whole.

Despite a large dollar investment by U.S. companies in recent years, the United States is still lagging behind other major industrial countries, including West Germany, Japan and Canada, in the rate of capital investment. Over the last 15 years, the ratio of real business fixed investment to real Gross National Product (GNP) has averaged only about 10 percent (both in 1972 dollars). Real nonresidential fixed investment will have to total about 12 percent of real GNP in the years ahead in order to meet vital national economic and social goals.

Many of our principal international competitors have stimulated capital investment and productivity increases by improving their capital recovery allowance systems. Recent enhancements to the investment tax credit have somewhat improved the competitive position of U.S. businesses vis-a-vis their foreign competitors. Enactment of S.1435 would accelerate the recovery period for depreciating business assets and more closely align the capital recovery allowances in the United States with those of other industrialized countries.

U.S. Economic Climate

The U.S. economy is suffering from spiraling inflation while the rate of capital formation and growth in productivity decline. Some of the reasons cited for the productivity slowdown range from faster employment growth, a more service-intensive economy and increasing government regulation to lackluster research and development activities and rising energy prices. However, the most important single cause of the productivity slowdown has been the weakness of business fixed investment over the past several years.

The Council of Economic Advisers has pointed out that between 1948 and 1973, high rates of U.S. private investment led to a growth in the capital-labor ratio amounting to almost 3 percent per year (measured by the ratio of net nonresidential capital stock to aggregate hours worked in the private non-farm sector). Since 1973, however, that growth rate has dropped to 1.75 percent per year. At the same time, the rate of growth of labor productivity in the non-farm business economy fell to 1.0 percent per year from its 1948-73 average of 2.4 percent. In its analysis of these trends the 1979 Report of the Joint Economic Committee concluded: "The cumulative loss of capital stock during the recession, combined with projections for continued rapid labor force increase, strongly suggests that special measures to promote capital spending are needed if productivity growth is to recover even the modest levels of 1967-73."

Inflation is the nation's number one economic problem. Controlling inflation without producing politically unacceptable levels of unemployment is, at best, a very difficult task. However, there is a growing awareness among public officials, economists, academicians and others that increasing supply rather than restricting demand is a more appropriate way of combating inflation. There is a correlation between savings and investment and increased productivity, job creation and lower prices. Therefore, emphasizing public policies aimed at increasing productive capacity and output is highly desirable. Consistent with this need, S. 1435 would generate an increase in business investment and production.

Understatement of Capital Costs

Inflation causes business profits to be overstated because they are based on accounting practices that undervalue the cost of depreciation and inventories. Current tax depreciation, based on historical cost, was designed in a noninflationary environment and does not provide sufficient deductions to recover replacement costs. It acts as a deterrent to capital investment.

Although Congressional actions in 1971, principally enactment of the Class Life Asset Depreciation Range (ADR) system, went part way to improve the rate of capital recovery in the United States, existing capital recovery, based on the "useful life" concept of depreciation, still does not adequately take into account the ever-increasing cost of asset replacement in an inflationary economy. The extent to which nonfinancial corporations have understated their capital costs is shown in the following tabulation comparing current-cost double declining balance (DDB) depreciation with depreciation allowed nonfinancial corporations for Federal

income tax purposes. As can be seen from the tabulation, the excess of current-cost DDB over tax depreciation has grown from a negative amount in 1965 to $28.2 billion in 1978.

Nonfinancial Corporations
Excess of Current-Cost DDB Over Income Tax Depreciation

1965-1978

(Billions of dollars)

	(1) Current Cost DDB(a)	(2) Income Tax Depreciation(b)	(3) Excess of (1) over (2)
1965	$ 35.7	$ 36.4	$-0.7
1966	39.6	39.5	0.1
1967	44.2	42.9	1.3
1968	48.5	46.7	1.8
1969	53.8	51.3	2.5
1970	59.5	54.6	4.9
1971	64.5	58.7	5.8
1972	68.8	65.3	3.5
1973	75.7	70.5	5.2
1974	89.3	77.8	11.5
1975	105.8	85.0	20.8
1976	115.1	92.3	22.8
1977	124.7	100.8	23.9
1978	137.0	108.8	28.2

(a) 75% of Bulletin F lives.

(b) Estimate of depreciation allowed for Federal income tax purposes.

Source: Department of Commerce.

Either full indexing of the tax system or adoption of some form of replacement cost depreciation probably represents the only real solution to the problem of understated capital costs during periods of inflation. Short of adopting either of these concepts, enactment of the "10-5-3" system, which would significantly shorten the capital recovery period, would contribute importantly to alleviating the problem.

Proposed Capital Recovery Allowance System

S.1435 would, in essence, provide a capital recovery allowance system under which:

- the recovery period for industrial, distribution and retail buildings is 10 years,
- the recovery period for machinery and equipment is 5 years,
- the recovery period for automobiles and light trucks (up to $100,000 per year) is 3 years, and
- a full (i.e, 10%) investment tax credit is allowed for all eligible property in the 10 and 5-year classes and a 6% credit is allowed for all eligible property in the 3-year class.

The enactment of the "10-5-3" system would be a major step toward the simplification of our tax laws which would be especially beneficial to the nation's smaller businesses. It would eliminate most of the complexities of the present depreciation tax law including the determination of useful life, proper guideline classification and estimated salvage.

The new "10-5-3" capital recovery allowance system would contribute significantly to improved cash flow for businesses investing in productive facilities. Essential to the acceptability and effectiveness of the proposed capital recovery allowance system are both the availability of the investment tax credit and the use of accelerated methods. Accelerating the recovery makes after-tax funds available sooner for maintaining, upgrading or expanding the stock of capital assets. Furthermore, by increasing the return on investment, the proposed capital recovery allowance system would increase the likelihood that important, but otherwise financially marginal, projects would be undertaken. This, in turn, would lead to more employment.

Over the past decade, expenditures for research and development (R&D) in the United States, exclusive of the space program, have barely kept pace with the growth of the economy. R&D is critical to successful innovation, but it is only the first step through which technological knowledge is translated into commercially viable products. This process usually involves substantial investment in new plants, modern machinery and equipment, market development,

employee training and the like. Investment in R&D is governed by the same risk/reward considerations as investments in tangible business property. Acceleration of R&D can be promoted by correcting the same economic and political factors that caused the decline in the growth of business investment generally. Enactment of the "10-5-3" system would improve the crucial risk/reward ratio which is the basic determinant of the level of business investment. By contributing to a more favorable business investment climate, enactment of S.1435 would help to reverse the decline in R&D investment and innovation.

S.1435 is not "targeted" to help one particular geographical area of the United States or segment of industry. The "10-5-3" system of capital recovery is aimed at stimulating investment in new plant and equipment by all businesses, large and small, located in all areas of the domestic economy, in order to achieve the vital national economic goals of increasing productivity, controlling inflation, improving the balance of trade, and providing jobs and a better standard of living for the citizenry. In the area of competitiveness in domestic and international markets against foreign companies, it is essential that the industrial plant in the United States be upgraded and modernized because the technological lead which the U.S. once had over the rest of the industrialized world has been substantially narrowed in recent years. If the national economy is strong, growing and competitive in international markets, all areas of the country and types of businesses will benefit.

SUMMARY AND STATEMENT OF

GEORGE A. STRICHMAN
CHAIRMAN OF THE BOARD
COLT INDUSTRIES INC

ON BEHALF OF THE

COMMITTEE FOR EFFECTIVE CAPITAL RECOVERY

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

SENATE FINANCE COMMITTEE

WASHINGTON, D.C.

OCTOBER 22, 1979

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SUMMARY STATEMENT OF

GEORGE A. STRICHMAN

The Committee for Effective Capital Recovery is a voluntary coalition of 395 business firms and 53 business associations. It is representative of virtually all segments of industry including manufacturing, retail, minerals, transportation and utilities. A list of the member companies and supporting associations is attached (See Appendix A).

The Committee believes that the central economic challenge facing America in the 1980s will be to fulfill our enormous needs for capital—for an ever expanding population, for dramatically increased energy prices, for environmental protection, and for plant modernization.

To help solve this problem, it is essential that Congress amend the capital recovery provisions of the Internal Revenue Code with a view toward improving both capital recovery allowances and the investment tax credit. The Committee for Effective Capital Recovery is pleased to have been a part of the broad consensus within the business community which has developed in support of the proposed Capital Cost Recovery Act.

The United States has fallen far behind its trading partners in productivity, capital investment, savings and other key economic indicators. Other nations have recognized the importance of adequate capital recovery

allowances for their economic success and have changed their tax laws accordingly. The United States has not followed suit. As a result, our capital recovery provisions are far out of date. Indeed, our Asset Depreciation Range system has proven to be so cumbersome that it is used by less than one percent of all U.S. corporations.

As a result of our failure to revise U.S. tax laws to take into account economic realities, corporations are paying huge federal taxes on illusory profits--profits that result solely from the impact of inflation. These taxes have led to reduced corporate cash flows and inadequate capital investments, which have had a slow but serious impact on the economic health of our nation.

Our standard of living, while still the highest in the world by most measures, is rapidly losing ground to other nations whose productivity growth has outstripped ours. Unemployment continues high and unresponsive to high levels of output. The United States is losing its formerly strong competitive position in world markets.

All signs point toward the need for bold action by the Congress on the economic front. Enactment of S. 1435 would do more for capital formation and our nation's economic health than any other proposal currently before the Congress.

STATEMENT OF

GEORGE A. STRICHMAN

The Committee for Effective Capital Recovery is a voluntary coalition of 396 business firms and 53 business associations.

Formerly called the Ad Hoc Committee for an Effective Investment Tax Credit, the Committee has long been active in efforts to improve, strengthen, and make permanent the investment tax credit.[*]

In addition to its work on the investment tax credit, the Committee has always had the improvement and restructuring of depreciation allowances as one of its key objectives. Indeed, in late 1978 the Committee changed its name to the Committee for Effective Capital Recovery to reflect more accurately the breadth of its policy goals.

I. The Economic Justification for Improved Capital Recovery

A. Low Rates of Productivity Growth

Of the many economic indicators which argue forcefully for more realistic capital recovery provisions, none is more

[*] The Committee has been pleased with the recognition by the Congress of the importance of the investment tax credit, most recently in the Revenue Act of 1978. The Committee believes that after consideration of S. 1435 is completed, the Congress at an early date should consider further improvements in the investment tax credit. Attached to this testimony as Appendix B is a summary of recommended changes.

significant than the alarming decline in the rate of growth of U.S. productivity. Indeed, the U.S. has fallen dramatically behind its trading partners in this important respect. Table I shows the average annual percentage change in productivity for the U.S. compared with five of our major trading partners. The United States ranks a dismal last.

TABLE I

Average Annual Increases of Output Per Hour
in Manufacturing 1960-1978

Country	Increase
Japan	8.5 percent
France	5.6 percent
Germany	5.5 percent
Canada	4.0 percent
United Kingdom	3.2 percent
United States	2.6 percent

Source: U.S. Department of Labor, Office of Productivity and Technology, Division of Foreign Labor Statistics and Trade, July 1979.

Moreover, the trend for U.S. productivity is ominous. From 1955 to 1965, U.S. productivity increased at an average annual rate of 3.1 percent; from 1965 to 1973, at a rate of 2.3 percent; from 1973 to 1977, 1.0 percent. During 1978, productivity was almost stagnant, registering a 0.4 percent increase. For the first half of 1979, output per hour in the private business sector actually <u>decreased</u> at an annual rate of 3.3 percent.

Continuation of this trend threatens to destroy America's position as an industrial power.

B. Low Rates of Capital Investment

There are, of course, a great many causes of this decline in productivity in the United States. Increased expenditures to comply with environmental regulations, a slackening of expenditures for research and development, increased governmental regulations, and changes in the American work force have all played an important role.

Few factors, however, have had a more significant impact on the reduction of productivity in the United States than the low rate of capital investment. Table II compares United States investment as a percent of gross domestic product with that of five other industralized nations. Again, the United States ranks last, indeed having a ratio of approximately half that in Japan.

TABLE II

Average Annual Ratio of Capital Investment as a Percent of Output*/

	1960-77
Japan	27.8
Canada	19.7
Germany	19.5
France	19.2
United Kingdom	17.0
United States	14.7

Source: U.S. Department of Labor, Office of Productivity and Technology, Division of Foreign Labor Statistics and Trade, July 1979.

*/Capital investment, excluding residential dwellings, as a percent of gross domestic product at factor cost, in current prices.

Many economists have concluded that there is a direct correlation between declining capital investment and the drop in productivity in the United States:

- Paul McCracken, former Chairman of the President's Council of Economic Advisors: "The most important explanation for this growing inability of the economy to deliver gains in productivity and real income is almost certainly the sluggish rates of capital formation that have prevailed during much of this decade."

- Economic Report of the President, January, 1979: "... between 1948 and 1973 high rates of private investment led to a growth in the capital-labor ratio (measured by the ratio of the net non-residential capital stock to aggregate hours worked in the private nonfarm sector) amounting to almost 3 percent per year. Since 1973, as a result of low rates of investment, that growth rate has dropped to 1 3/4 percent per year. Although the precise effect of slower growth in the capital stock is hard to measure empirically, analytical studies estimate that it could well have reduced productivity growth by up to one-half of a percentage point per year from earlier trends."

- J. R. Norsworthy, Michael J. Harper, and Kent Kunze, Bureau of Labor Statistics, "The Slowdown in Productivity Growth: Analysis of Some Contributing Factors": "The 1973-78 slowdown [in productivity] is dominated by the effects of reduced capital formation .... The decline in capital formation accounts for more than 70 percent of the total slowdown" [in productivity in 1973-78].

C. Capital Recovery is Key to <u>Total Savings and Investment</u>

Few factors are more important to capital investment and productivity than our rate of savings as a nation. Table III shows that the United States ranks last among our trading partners in total savings relative to total disposable personal income.

TABLE III

Total Savings as a Percent of
Total Disposable Income (1977)

Country	Savings
Japan*/	26 percent
West Germany	13 percent
France	13 percent
Canada	12 Percent
United Kingdom*/	7 percent
United States	6 percent

Source: United Nations, Yearbook of National Accounts Statistics, (1978).

*/Statistics for Japan and the United Kingdom are based on 1976 data, the most recent year for which information is available.

Based on Department of Commerce statistics, business saving as a percent of total national savings was 61.7 percent in 1978. Consequently, business saving is now the largest factor to be considered in an examination of the issue of total national savings.

In turn, the major factors in business saving are the capital recovery allowances of the Internal Revenue Code. According to the Commerce Department figures, these allowances accounted for 75.5 percent of total business savings in 1978.

It therefore becomes clear that the most effective means of increasing national savings would be to improve our capital recovery allowances. Indeed, Allen Sinai of Data Resources, Inc. estimates that the increase in saving in the nonfinancial corporate sector resulting from enactment of the Capital Cost Recovery Act ranges from $5.5 billion in 1980 to $48 billion in 1984.

D. Important Effects of Low Rates of Productivity Growth, Capital Investment, and Savings on the United States Economy

1. Inflation and Growth of Real Income

a. Economic Report of the President

The Committee for Effective Capital Recovery strongly agrees with the statement made by President Carter in his 1979 Economic Report to the Congress:

> With slower productivity growth, our living standards individually and as a Nation cannot rise as fast. Slower productivity growth means that the resources available for carrying out governmental programs becomes scarcer. It means that large increases in wages and other incomes put greater upward pressure on costs and prices. If we ignore the realities of slower productivity growth--if governments continue to press forward with unabated claims on resources, and private citizens continue to demand large gains in money incomes--our inflationary problem will worsen.

b. Relationship Between Capital Investment, Productivity, Wages, and Prices

There is a striking correlation between capital investment and wage rates by industry in this country. Table IV shows the most recent data from the Department of Labor on this subject. It shows 1971 capital investment data and compares it with production worker average earnings by related industry group.

TABLE IV

CAPITAL INTENSITY AND WORKER EARNINGS

Industry	Capital Per Employee		Production Worker Average Earnings	
	CPE	Rank	Per Hour	Rank
Group 1				
Petroleum & Coal	$ 87,190	1	$ 4.57	1
Chemicals	36,450	2	3.94	3
Primary Metals	35,060	3	4.23	2
Paper	29,440	4	3.67	4
Stone, Clay & Glass	20,550	5	3.66	5
Food	14,160	6	3.38	7
Rubber/Plastics	14,140	7	3.40	6
Tobacco	12,690	8	3.15	8/9
Lumber	10,270	9	3.15	8/9
Miscellaneous	6,490	10	2.97	10
Furniture	5,210	11	2.90	11
Leather	2,530	12	2.60	12
Apparel	2,110	13	2.49	13
Group 2				
Transportation Equipment	12,080	1	4.41	1
Non-Electric Equipment	11,640	2	3.99	3
Fabricated Metals	11,540	3	3.74	5
Ordnance	10,560	4	3.84	4
Instruments	9,410	5	3.52	6
Electrical Equipment	8,830	6	3.48	7
Printing	8,580	7	4.20	2
Group 3				
Textiles	10,840		2.57	

Source: Department of Labor.

Reviewing this data during his testimony before the Joint Economic Committee in mid-1975, then-Secretary of Labor Dunlop concluded:

> ... creation of jobs through investment capital broadens opportunities, thus allowing more upward mobility in salary and skills as people are promoted and new jobs created ... the most basic and far-reaching objective for national policy in this context should be to encourage development of new technologies and the formation of new capital .... Also, the increase in output and income implied by new capital formation means a higher level of living and income for all Americans, whether or not they are employed by the industries involved with new capital formation and productivity gain.

The National Association of Manufacturers has prepared an analysis of the direct relationship between productivity, wages and prices. For example, in 1955 wages increased 3.7 percent and productivity rose 4.1 percent. The cost of production attributed to labor, the unit labor cost, declined by 0.4 percent. That same year there was a 0.4 percent drop in the Consumer Price Index (CPI). In 1978, wages rose 9.3 percent and productivity increased at only 0.4 percent. Unit labor costs increased 8.9 percent. The Consumer Price Index rose at a rate of 9 percent in 1978.

c. Analysis of the Council on Wage and Price Stability

The Council on Wage and Price Stability, in A Special Report on Inflation (April, 1978), highlighted the relationship between productivity and inflation:

> Trends in labor productivity are important elements of the inflation process. Improvements in output per man hour reduce unit labor costs and provide a wedge between wage increases and higher prices. Thus, productivity growth is a means of improving living standards for all participants in the economy. In its absence increased incomes for some can come only at the expense of reduced real earnings for others.
>
> A sharp falloff in productivity growth has been an important cause of the disappointingly small gains in real income over the last decade and it has exacerbated the inflation .... The effect of this slowdown [of productivity] has been to reduce total real incomes by 19 percent in 1977 (the equivalent of $280 billion in today's prices) compared to what would have been achieved by a sustained growth of productivity at the rate of the prior two decades.

d. Impact of "Productivity Gap" on Average U.S. Household Income

There are a number of ways of expressing our poor productivity performance. Willard C. Butcher, the President of the Chase Manhattan Bank, in a September 25, 1979 speech on "Closing our 'Productivity Gap': Key to U.S. Economic Health," reviewed the impact of the gap between actual and potential

productivity in the United States on the average U.S. household income. Since 1960, this gap has steadily grown wider to the point where it now means that actual average household income is now $3,900 less than it would have been had we managed to maintain our earlier productivity growth levels. This trend is shown clearly in Table V.

TABLE V

Impact of "Productivity Gap" on Average U.S. Household Income

Year	Actual Income	Potential Income
1960	$12,900	$12,900
1961	13,100	13,100
1962	13,500	13,300
1963	13,800	13,600
1964	14,400	14,100
1965	15,000	14,700
1966	15,600	15,300
1967	16,000	15,900
1968	16,400	16.300
1969	16,500	16,900
1970	16,500	17,300
1971	16,600	17,400
1972	17,100	17,900
1973	17,600	18,600
1974	17,000	19,100
1975	16,600	18,900
1976	16,800	19,100
1977	17,200	19,700
1978	17,500	20,400
1979	17,500	21,400

Source: The Chase Manhattan Bank, September, 1979.

e. International Comparison: Productivity and Wage Rates

There appears to be an inescapable correlation between growth in productivity and improvements in a nation's standard of living and in wage rates. Table VI compares the United States with five industrialized nations in terms of productivity increases and increases in the wages received by workers in those countries. There is a striking similarity in the rankings in each category.

TABLE VI

Comparison of Productivity and Increases in Hourly Wages

1960-1978	Ave. Annual Increase of Output per hour in Manufacturing		Ave. Annual Compound Rate of Change in Hourly Wage for Production Worker	
		Rank		Rank
Japan	8.5%	1	14.9%	1
France	5.6%	2	11.9%	2
Germany	5.5%	3	9.8%	4
Canada	4.0%	4	8.2%	5
United Kingdom	3.2%	5	11.9%	2
United States	2.6%	6	6.5%	6

Source: U.S. Department of Labor, Office of Productivity and Technology, Division of Foreign Labor Statistics and Trade, July 1979.

2. U.S. Balance of Trade

In its days of ever-improving productivity, the United States was not only a major exporter but was also able to keep its imports and exports in a favorable balance. Unfortunately, this is no longer the case. Table VII shows the discouraging trends with respect to the U.S. trade deficit, which reached a level of $34 billion in 1978.

TABLE VII

U.S. Balance on Merchandise Trade

(millions of dollars)

Year	Balance	Year	Balance
1960	4,892	1970	2,603
1961	5,571	1971	-2,260
1962	4,521	1972	-6,416
1963	5,224	1973	911
1964	6,801	1974	-5,343
1965	4,951	1975	9,047
1966	3,817	1976	-9,306
1967	3,800	1977	-30,873
1968	635	1978	-34,187
1969	607		

Source: Survey of Current Business, June 1979, U.S. Department of Commerce.

Underlying this trend is the decline in the U.S. share of total manufactured exports worldwide. As a nation, we are falling further behind in international economic competition. To reverse this decline, we simply must act boldly to improve our productivity performance.

In recent years, policymakers have begun to pay closer attention to the relationship between our trade deficit and the value of the dollar, domestic inflation, and the overall strength of our economy. There is now a widespread consensus that we need a strong, coherent, and effective export program. Improved capital recovery allowances can and should be an important ingredient of that program.

E. Impact of Inflation on Real Value of Depreciation Allowances

In January of 1979 Martin Feldstein and Lawrence Summers published a paper on "Inflation and the Taxation of Capital Income in the Corporate Sector." The paper examined the effect of inflation on the taxation of capital used in the nonfinancial sector of the U.S. economy. It concluded that:

> ... the effect of inflation with the existing tax laws was to raise the 1977 tax burden on corporate sector capital income by more than $32 billion, an amount equal to 69 percent of the real after tax capital income of the nonfinancial corporate sector .... This extra tax raised the total effective tax rate from 43 percent to 66 percent of capital income in the nonfinancial corporate sector.

The paper concluded that the principal reason for this increase in the effective tax rate on capital income is that the historic cost method of depreciation causes a major overstatement of taxable profits.

Specifically, Messrs. Feldstein and Summers found that inflation reduced the depreciation allowed on existing plant and equipment by $39.7 billion in 1977. Thus, the impact of inflation on depreciation allowances alone increased corporate tax payments by $19 billion or almost one-third of the $59 billion of corporate tax liabilities for 1977.

The increased taxes resulting from inflation in 1977 should be compared with the revenue cost of the Capital Cost Recovery Act (see page 27). It will be seen that the revenue "losses" resulting from this proposed bill are far less than the increase in corporate taxes due to inflation described and, although a start in the right direction, do not fully restore business profits to the level necessary to offset inflation.

F. International Comparison of Capital Recovery Systems

As indicated earlier, one of the key reasons for improved capital recovery allowances is to bring our system in line with the most progressive of our trading parners.

Based on the implications of productivity data and other information, it is widely assumed that some of our trading partners (Japan and West Germany, for example) already have relatively more modern plants and equipment than does the United States. In contrast, the United Kingdom and Canada have levels

of plant and equipment modernization far closer to those of the United States than the levels of Japan or Germany (see productivity data set forth on page 2).

However, the British and Canadians, recognizing the importance of adequate depreciation, have liberalized their systems and are now far more effective in providing for more adequate capital formation than is the United States.

Specifically, the United Kingdom permits 100 percent of the cost of machinery to be written off in the year of purchase. Similarly, Canada permits machinery and equipment to be written off over a two-year period. By these standards, the United States is obviously far out of date.

A full comparison of the major industrialized nations has been provided by Price Waterhouse and it is attached as Appendix C.

II. The Capital Cost Recovery Act of 1979

Clearly, there is overwhelming evidence of the need for improved capital recovery allowances in our tax system. Although there are other ways to move toward this goal, the Capital Cost Recovery Act of 1979 seems to be the most practical and effective approach.

The "10-5-3" proposal would greatly simplify and improve our capital recovery system. It would remove the useful life concept from our tax code and replace it with a far simpler method of computing depreciation allowances. It would remove the factor of salvage values in capital recovery computations. It would improve and simplify the investment tax credit. Capital recovery allowances and the investment tax credit would no longer be deferred until the property is placed in service but rather would be allowable in the taxable year in which funds are expended to acquire the property. The Capital Cost Recovery Act would also remove the distinction between investments in new and used property for purposes of capital cost recovery allowances.

The bill would substantially benefit small businesses by replacing the current complexity of the asset depreciation range system. A Treasury Department study completed in 1974 (the most recent data available) found that only one-half of one percent of all corporations with less than $5 million in total assets elected the ADR system. Thus, even the modest benefits of the last major improvements in depreciation (ADR) are readily usable for only a small portion of American businesses. By way of contrast, the Capital Cost Recovery Act is simple, direct, and can be used by large and small businesses alike. Table VIII shows the results of the Treasury study.

TABLE VIII

Use of ADR by U.S. Corporations

Size of Total Assets	Total Number Of Firms In Population	Firms Electing ADR	
		Number	Percent
$1 to $500,000	1,493,000	5,482	0.4
$500,000 to $1M	56,000	1,064	2.0
$1M to $5M	42,000	1,788	5.0
$5M to $10M	5,000	665	13.0
$10M to $50M	4,000	991	38.0
$50M to $100M	625	804	49.0
$100M to $200M	396	242	61.0
$200M to $300M	156	107	69.0
$300M to $600M	203	167	82.0
$600M to $1B	88	80	91.0
Over $1 Billion	166	152	94.0
Total	1,601,634	11,042	0.7

Source: 1974 Statistics of Income, Department of Treasury.

A. Effectiveness of "10-5-3" in Stimulating Investment

There appears to be a growing consensus that enactment of legislation along the lines of "10-5-3" would be an extremely effective and efficient way to stimulate increased capital investment. The following items are submitted as evidence of this view:

- Unanimous report of the Joint Economic Committee, March, 1979: "Some of the tax changes in the Revenue Act of 1978 will stimulate investment. But these are not sufficient. The Committee believes that per dollar of revenue loss, liberalization of depreciation allowances would be the most effective stimulant."

- Statement by the Honorable G. William Miller, then-Chairman of the Federal Reserve Board, before the Commonwealth Club of California, July 19, 1979: "My own proposal has been that we endorse a simple formula: 1-5-10. 1-5-10 stands for a new policy of liberalized depreciation under which all mandated investments for environment, safety and health would be written off in one year; all new investments for productive equipment would be written off in five years; and all capital in structures and permanent facilities would be written off in 10. This acceleration of the depreciation allowance offers the most direct and efficient way to boost investment, for two reasons: first, accelerated depreciation ties each dollar of revenue loss directly to capital investment; and, second, because this formula reduces risk and thus gives strong incentive for investment in the cost-saving and modern production facilities. Our estimates indicate that 1-5-10, after five years, could raise the investment share of output close to 1 per cent higher than what it would otherwise have been."

- Statement by Allen Sinai before the Committee for Effective Capital Recovery, September 13, 1979: "Of the various tax incentives to capital formation most often considered, the impacts from the accelerated capital recovery rank near the top in terms of instrument effectiveness. Only the investment tax credit would produce an equivalent or greater bang-for-a-buck."

- In addition, the Capital Cost Recovery Act has been cosponsored by 250 Members of the House and is supported by the National Association of Manufacturers, Business Roundtable, Chamber of Commerce, National Federation of Independent Business, and the American Council for Capital Formation.

B. Application of the Capital Cost Recovery Act to Structures

Notwithstanding the evidence in support of the Capital Cost Recovery Act, a degree of controversy has arisen with respect

to the provision of S. 1435 which would require a ten-year write-off for nonresidential buildings and structures.

The Committee for Effective Capital Recovery believes that the ten-year depreciation schedule is an extremely important component of the "10-5-3" bill. We subscribe to the views outlined by then-Secretary of the Treasury Michael Blumenthal in his testimony before the House Ways and Means Committee on January 30, 1978:

> ... a particularly weak aspect of the current economic recovery is the low rate of business investment in long-lived structures; investment in structures reached its peak almost four years ago and is now 11 percent below that level. The tax preference for depreciation of structures has been reduced through the operation of the 'recapture' rules and the minimum tax ....

While Secretary Blumenthal's statement was in support of the Administration's proposal to have structures qualify for the investment tax credit, the argument applies equally well to the need for improved depreciation allowances for buildings and structures.

Furthermore, we should note that President Carter recently assured the building and construction workers union of his Administration's determination to see that construction was not unduly burdened by the economic recession we face. Short of a major and costly program of direct federal funding

of building construction, we can think of few better ways to help the President keep his promise than to lend his support to a proposal which would improve depreciation allowances for buildings.

C. Similarity of the Effects of Capital Cost Recovery Act and Indexing

One of the principal arguments for improved capital recovery allowances is that inflation significantly erodes the real value of depreciation allowances, thereby increasing the net cost of corporate investments.

One method of addressing this problem is to simply index depreciation allowances, *i.e.*, adjusting the value of allowable depreciation each year for the rise in the consumer price index since the previous year.

Dr. Martin Feldstein ~~published~~ circulated a paper in October, 1979 comparing the effectiveness of indexing with accelerated depreciation[*] in eliminating the impact of inflation on the net cost of capital investments.

---

[*] The specific accelerated depreciation proposal studied by Dr. Feldstein was the proposed Capital Cost Recovery Act of 1979.

The paper concluded that "for moderate rates of inflation and real discount rates, the acceleration proposal and full indexation are quite similar."*/

The following is an excerpt from the Feldstein analysis:

> The figures in [Table IX] indicate that the specific acceleration proposal is a quite close approximation of indexing at moderate rates of inflation and real interest. This also implies that the acceleration would essentially offset fully the effects of inflation under existing historic cost depreciation. Consider, for example, equipment with an allowable depreciation period of 13 years, an economy with an 8 percent rate of inflation, and an investor with a 4 percent real rate of discount. ... [Table IX] shows that the acceleration proposal would eliminate almost all of the increased cost under these circumstances. In particular, the real net cost is only three percent higher with the shortened depreciation life than it would be with complete indexation.
>
> ... The relative net cost of acceleration and indexing remains between 0.9 and 1.1 for almost all combinations of real discount rates between 4 and 7 percent, inflation rates between 4 and 12 percent, and lives between 3 years and 25 years. ...

---

*/It should also be noted that Dr. Feldstein found that "For low rates of inflation, high discount rates, or very long-lived investments, the acceleration proposal causes greater reductions in net costs than would result from complete indexing. Conversely, for high rates of inflation, low discount rates, or very short-lived investments, the acceleration method fails to offset the adverse effects of inflation."

TABLE IX

The Relative Net Cost of Equipment Investment

with the Acceleration and Indexing Proposals

Real Discount Rate	Inflation Rate	Allowable Depreciation Life Under Existing Law (Years)					
		3	8	13	18	25	35
0.0	0.00	0.87	1.00	1.00	1.00	1.00	1.00
	0.04	0.94	1.08	1.08	1.08	1.08	1.08
	0.08	1.00	1.15	1.15	1.15	1.15	1.15
	0.12	1.05	1.21	1.21	1.21	1.21	1.21
	0.16	1.10	1.27	1.27	1.27	1.27	1.27
0.04	0.00	0.89	0.96	0.92	0.88	0.84	0.79
	0.04	0.96	1.03	0.98	0.94	0.89	0.84
	0.08	1.01	1.08	1.03	0.99	0.94	0.89
	0.12	1.05	1.13	1.08	1.04	0.99	0.93
	0.16	1.09	1.18	1.12	1.08	1.02	0.97
0.07	0.00	0.91	0.94	0.88	0.84	0.79	0.75
	0.04	0.96	1.00	0.94	0.89	0.84	0.79
	0.08	1.01	1.05	0.98	09.3	0.88	0.83
	0.12	1.05	1.09	1.02	0.97	0.92	0.86
	0.16	1.09	1.13	1.06	1.01	0.95	0.89

Each figure in the table is the ratio of the net cost of equipment investment with the acceleration proposal divided by the net cost of the investment with complete indexing.

Dr. Feldstein notes that in the final analysis the choice between accelerated depreciation and indexing "requires balancing the administrative simplicity and other possible advantages of acceleration against the automatic protection that indexation offers against the risk of significant changes from the recent inflation rates and discount rates."

The Committee for Effective Capital Recovery believes that given that choice, the Congress should opt for the Capital Cost Recovery Act of 1979. It would be more practical to achieve in the Congress and would be far more likely to be used by all businesses, both large and small. Indexation would likely present enormous problems of complexity and record keeping burdens for small businesses, which are the principal reasons why the current ADR system has proven so ineffective for that sector of our economy.

D. Economic Impact of "10-5-3"

Allen Sinai, Vice President and Senior Economist of Data Resouces Inc., prepared an analysis of the proposed Capital Cost Recovery Act,[*] using the DRI Model of the U.S. economy. The DRI analysis assumes that the proposed bill is enacted and will be effective for taxable years ending after December 31, 1979. The DRI analysis is attached to this testimony as Appendix D.

[*] One difference between the simulation and the proposed legislation (S. 1435 and H.R. 4646), is that the latter uses a five-year transition period for Class I property (buildings) and the DRI analysis assumed a ten-year period. Thus, both the stimulus from the measure and revenue loss are somewhat underestimated.

Of the tax incentives for capital formation most often considered, Data Resources, Inc. found that the accelerated capital recovery proposal is particularly effective. The program would provide strong stimulus to business fixed investment, real economic growth, productivity, and employment, without a significant rise in inflation.

The analysis done with the DRI model (see Table X) indicates that the "10-5-3" proposal would raise real business fixed investment by $10 billion per year between 1980 and 1984, would boost the growth of real GNP by 0.3 percent annually, and would increase productivity growth by 0.7 percent. An additional 500,000 persons would be employed by 1984 than would be the case without enactment of the Capital Cost Recovery Act.

TABLE X

Incremental Economic Effect of the
"10-5-3" Accelerated Capital Recovery Program*/

"10-5 Phase-In," DRI Model Simulation Results

	1980	1981	1982	1983	1984
Real Business Fixed Investment	0.2	4.1	9.8	15.3	20.9
Real Equipment Spending	0.2	3.2	7.4	11.7	16.3
Real Plant Spending	0.1	0.9	2.4	3.6	4.5
Revenue Losses					
With Feedback	4.2	9.8	11.8	14.6	16.1
Without Feedback (*i.e.*, static)	4.8	12.6	19.2	26.3	32.9
Productivity Growth (%)					
Increase Over Current Law	0.1	0.6	0.7	1.0	0.9
Additional Growth in Real GNP (%)	0.0	0.4	0.3	0.4	0.4
Added Employment (Millions)	0.0	0.1	0.2	0.4	0.5

*/Billions of Dollars, Relative to Baseline.

Because of the stimulus to the economy which careful calculations show would result from this bill, it would be partially self-financing. The study shows revenue costs both with and without feedback from other parts of the economy. The benefits of cash flow are partly paid for by increases in employment, productivity, and GNP.

The large cash flow generated by the improved capital recovery would provide financing for a higher rate of capital expenditures. The ratio of cash flow to capital outlays of nonfinancial corporations should rise five to six percentage points higher than the baseline case, yielding a much stronger financial position for the nonfinancial corporate sector as a result of the measure. Particularly in view of the very high interest rates business is facing, every extra dollar of internally generated capital means a reduction in interest costs that can either be passed along to consumers in the form of lower prices or recycled again within the company in the form of additional investment.

The DRI concludes that apart from the investment tax credit the "10-5-3" plan would have a more favorable impact on the economy (more "bang for the buck") than would occur from any other tax policy change studied.

III. Conclusion

For all of these reasons, the Committee for Effective Capital Recovery supports prompt enactment of S. 1435.

It should be remembered that what is involved here is not tax forgiveness but rather deferral of tax revenues. At a reasonable cost in terms of deferred corporate tax payments, passage of this legislation will constitute a significant step in the direction of improving the productivity performance of our nation's economy. This improved productivity will mean a higher standard of living for American families, an enhanced competitive posture in world trade, a fiscally healthier business community, and, ultimately, will hold the key to breaking the inflation spiral that threatens us all.

APPENDIX A

COMMITTEE FOR EFFECTIVE CAPITAL RECOVERY

MEMBERSHIP

October 15, 1979

AMP Incorporated
A-T-O, Inc.
Acme-Cleveland Corporation
Air Products and Chemicals Inc.
Airco, Inc.
Akzona Incorporated
Albany International Corp.
Allegheny Ludlum Industries, Inc.
Allied Products Corporation
Allis-Chalmers Corporation
AMAX, Inc.
Amerace Corporation
American Brands, Inc.
American Can Company
American Financial Corporation
American Greetings Corporation
American Hoist & Derrick Co.
American International Group, Inc.
American Natural Service Company
American Petrofina, Inc.
Ampex Corporation
Amtel, Inc.
Anchor Hocking Corporation
Apache Corporation
Arcata National Corporation
Arkansas Best Corporation
Arvin Industries, Inc.
Ashland Oil, Inc.
Atlantic Richfield Company
Avnet, Inc.
Avon Products, Inc.

Bache Halsey Stuart Shields Inc.
Ball Corporation
Baltimore Gas and Electric Co.
BankAmerica Corporation
Baxter Travenol Laboratories Inc.
Beatrice Foods Co.
Beech Aircraft Corporation
Belden Corp.
Bemis Company, Inc.
Betz Laboratories, Inc.
The Boeing Company
Brunswick Corporation
Bucyrus-Erie Company

The Budd Company
Bunker Ramo Corporation
Burlington Industries, Inc.
Burroughs Corporation
Butler Manufacturing Company

CBS Inc
CCI Corporation
CF Industries, Inc.
CPC International, Inc.
Carlisle Corporation
Carnation Company
Carpenter Technology Corporation
Carrier Corporation
Castle & Cooke, Inc.
The Ceco Corporation
Cessna Aircraft Company
Champion International Corp.
Chemetron Corporation
The Chesapeake Corporation of Virginia
Chesapeake and Ohio Railway Company
Chesebrough-Pond's Inc.
Chicago Bridge & Iron Company
Chicago Pneumatic Tool Company
Chromalloy American Corporation
Cincinnati Incorporated
The Citizens and Southern National Bank
City Investing Company
Clark Equipment Company
Clow Corporation
Coachmen Industries, Inc.
Coastal States Gas Corp.
The Coca-Cola Bottling Co. of New York, Inc.
Collins & Aikman Corporation
Colt Industries Inc
Columbia Gas System Service Corporation
Columbus McKinnon Corporation
Commercial Shearing, Inc.
ConAgra, Inc.
Congoleum Corporation
Conoco Inc.
Consolidated Foods Corporation
Consolidated Freightways, Inc.
Consumers Power Co.
Container Corporation of America
Continental Group, Inc.
Continental Illinois Corporation
Continental Machines, Inc.
Continental Telephone Corporation
Cooper Tire & Rubber Company

Copper Range Company
Crankshaft Machine Company
Crocker National Bank
Crouse-Hinds Company
Crutcher Resources Corp.
Cubic Corp.
Cyclops Corporation
Cyprus Mines Corporation

Dana Corporation
Dart Industries, Inc.
Dataproducts Corporation
Daylin, Inc.
Deere & Company
DeLaval Turbine, Inc.
Dennison Manufacturing Company
Detroitbank Corporation
Diamond Shamrock Corporation
Dibrell Brothers, Inc.
A. B. Dick Company
Di Giorgio Corporation
Digital Equipment Corp.
Dixie Yarns, Inc.
DoAll Company
Donaldson Company, Inc.
R. R. Donnelley & Sons Company
Dover Corporation
Dresser Industries, Inc.
Dynamics Corporation of America

ESB Ray-O-Vac Corporation
E-Systems, Inc.
Eagle-Picher Industries, Inc.
Earth Resources Company
Eastern Gas and Fuel Associates
Eaton Corporation
The Echlin Manufacturing Company
Economics Laboratory, Inc.
Elgin National Industries, Inc.
Eltra Corporation
Emerson Electric Co.
Esmark, Inc.
Evans Products Company
Ex-Cell-O Corporation

FMC Corporation
Fairfield Manufacturing Co., Inc.
Farmland Industries, Inc.
Federal-Mogul
Federal Paper Board Company, Inc.

Federated Department Stores, Inc.
First Bank System Inc.
The First National Bank of Chicago
The Flintkote Company
Ford Motor Co.
The Foxboro Company
Franklin Electric Co., Inc.
Fruehauf Corporation
Fuqua Industries, Inc.

GK Technologies Incorporated
Gamble-Skogmo, Inc.
Gannett Co., Inc.
Gardner-Denver Co.
Garlock Inc
General Cinema Corporation
General Dynamics Corporation
General Portland Inc.
General Signal Corporation
General Telephone & Electronics Corp.
Getty Oil Company
Giddings & Lewis, Inc.
Gifford-Hill & Company, Inc.
Globe-Union, Inc.
Gould, Inc.
Great Northern Nekoosa Corporation
Greif Brothers Corporation
Greyhound Leasing and Financial Corp.
Grow Group, Inc.
The Guardian Life Insurance Company of America
Gulf Oil Corporation

H & H Industries, Incorporated
Harnischfeger Corporation
Harris Corporation
Harris Trust & Savings Bank
Harsco Corporation
Hart Schaffner & Marx
Hayes-Albion Corporation
Walter E. Heller International Corp.
Hesston Corporation
Hewlett-Packard Company
Hillyer Corporation
Edward Hines Lumber Company
Houdaille Industries, Inc.
Household Finance Corporation
Hughes Tool Company
Hurco Manufacturing Co., Inc.
Hyster Company

IC Industries, Inc.
Ideal Basic Industries, Inc.
Illinois Tool Works Inc.
Ingersoll-Rand Company
Inland Steel Company
Intel Corporation
International Business Machines Corporation
International Minerals and Chemical Corp.
International Multifoods Corp.
International Paper Company
International Telephone & Telegraph Corp.
Iowa Beef Processors, Inc.

JLG Industries, Inc.
Jewel Companies, Inc.
Johns-Manville Corp.
Johnson & Johnson
Josten's Inc.
Joy Manufacturing Company

Kaiser Cement Corporation
Keebler Company
Kennametal Inc.
Kennecott Copper Corporation
Kerr-McGee Corporation
Kingsbury Machine Tool Corporation
Kirsch Company
Kraft, Inc.
Kuhlman Corporation
Kysor Industrial Corp.

The LTV Corporation
Laclede Steel Company
Lance, Inc.
Land O'Lakes, Inc.
Lear Siegler, Inc.
Leaseway Transportation Corp.
Lehigh Portland Cement Co.
Liggett Group Inc.
Lockheed Corporation
The Louisiana Land & Exploration Co.
Louisiana-Pacific Corporation
Lucky Stores, Inc.
Ludlow Corp.
Lukens Steel Company

McGraw-Edison Company
McQuay-Perfex Inc.
MBPXL Corporation
MCA Inc.
Macmillan, Inc.
Marathon Manufacturing Company

Marathon Oil Company
The Marmon Group
Marquette Company
Marriott Corp.
Maryland Cup Corporation
Masonite Corporation
Massachusetts Mutual Life Insurance Company
The Mead Corporation
Melville Corporation
Memorex Corp.
Mesa Petroleum Company
Michigan General Corporation
Michigan National Corp.
Microdot, Inc.
Midland-Ross Corporation
Modern Industrial Engineering Co.
Modine Manufacturing Company
Mohasco Corporation
Monsanto Company
Moore McCormack Resources, Inc.
Morton-Norwich Products, Inc.

NCR Corporation
NL Industries, Inc.
NVF Company
Nabisco, Inc.
Nalco Chemical Company
National Automatic Tool Company
National Distillers & Chemical Corporation
National Gypsum Company
National Presto Industries, Inc.
National Starch & Chemical Corporation
Newmont Mining Corporation
Norris Industries, Inc.
Northwest Industries, Inc.

Oak Industries Inc.
Ogden Transportation Corporation
Olin Corporation
Otis Elevator Company
Owens-Illinois, Inc.
Oxford Industries, Inc.

Pantasote Company
Parker-Hannifin Corp.
Peabody International Corporation
Pechiney Ugine Kuhlmann Corporation
Pennsylvania Power & Light Company
Pepsico, Inc.
Perkin-Elmer Corporation
Peter Paul, Inc.

Phelps Dodge Corporation
Philip Morris Incorporated
Phillips Petroleum Company
Pitney-Bowes, Inc.
Pittsburgh-Des Moines Steel Company
Pittsburgh Forgings Company
Pittway Corporation
Portec, Inc.
Potlatch Corp.
Public Service Electric & Gas Company
Purex Corporation

Raybestos-Manhattan, Inc.
Reeves Brothers, Inc.
Reliance Electric Company
Republic Corporation
Riegel Textile Corp.
A. H. Robins Company, Inc.
Rockwell International Corp.
Rohm and Haas Company
Rohr Industries, Inc.
Roper Corporation
Roto-Finish Co.
Royal Industries
Rubbermaid, Inc.
Russell Corporation

SPS Technologies, Inc.
Safeguard Industries, Inc.
Safeway Stores, Inc.
St. Joe Minerals Corporation
St. Regis Paper Company
Sangamo Energy Management
Santa Fe Industries, Inc.
Scott, Foresman & Company
Scott Paper Company
Seaboard Coast Line Industries, Inc.
Sea-Land Service, Inc.
G. D. Searle & Co.
Sears, Roebuck and Co.
Seattle-First National Bank
The Signal Companies, Inc.
Signode Corp.
SmithKline Corporation
Snap-on Tools Corporation
Soundesign Corp.
Southwest Forest Industries
Sprague Electric Co.
Stanadyne, Inc.
Standard Brands Incorporated
Standard Oil Co. of California

Standard Oil Co. (Indiana)
Standard Oil Co. (Ohio)
Standard Register Co.
Standex International Corporation
Stanley Home Products, Inc.
The Stanley Works
Stauffer Chemical Company
Sterling Drug Inc.
J. P. Stevens & Co., Inc.
Storage Technology Corp.
Sun Company, Inc.
Sunbeam Corporation
Sundstrand Corporation

TRW, Inc.
Tandy Corp.
Technicon Instruments Corporation
Tecumseh Products Company
Texaco, Inc.
Texas Commerce Bancshares, Inc.
Texas Eastern Corporation
Texas Industries, Inc.
Texasgulf Inc.
Thiokol Corporation
Thomas & Betts Corporation
Tiger International, Inc.
Time Incorporated
The Times Mirror Company
The Timken Company
Todd Shipyards Corporation
Transcontinental Gas Pipe Line Corporation
Tropicana Products, Inc.
Tyler Corporation
Ty-Miles, Inc.

U A L Inc.
UOP Inc.
UV Industries, Inc.
Uarco, Incorporated
Unarco Industries, Inc.
Union Camp Corporation
Union Carbide Corporation
Union First National Bank of Washington
Union Pacific Corporation
United States Borax & Chemical Corp.
United States Filter Corporation
United Telecommunications, Inc.
U.S. Tobacco Co.
Universal Leaf Tobacco Co.

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VF Corporation
VSI Corporation
The Valeron Corporation
Van Dorn Company
Vulcan Materials Company

Wallace Murray Corporation
Ward Foods, Inc.
Warner-Lambert Company
Warner & Swasey Company
Wean United, Inc.
Western Electric Company, Inc.
Western Publishing Company
Weyerhaeuser Co.
Wheelabrator-Frye Inc.
Whirlpool Corporation
The Williams Companies
Winn-Dixie Stores, Inc.
Woodward Governor Company
F. W. Woolworth Co.
Wm. Wrigley Jr. Co.
Wylain, Inc.
Wyman-Gordon Co.

Xerox Corporation

COMMITTEE FOR EFFECTIVE CAPITAL RECOVERY

SUPPORTING ASSOCIATIONS

Air-Conditioning & Refrigeration Institute
American Boiler Manufacturers Association
American Chamber of Commerce Executives
American Consulting Engineers Council
American Dental Association
American Feed Manufacturers Association
American Iron & Steel Institute
American Land Development Association
American Machine Tool Distributors Association
American Meat Institute
American Pipe Fittings Association
American Textile Machinery Association
Apartment Owners & Managers Association of America
Associated General Contractors of America
Association of American Railroads
Cast Metals Federation
Concrete Plant Manufacturers Bureau
Dairy & Food Industries Supply Association
Edison Electric Institute
Expanded Shale Clay & Slate Institute
The Ferroalloys Association
Foodservice & Lodging Institute
Foreign Credit Interchange Bureau
The Gummed Industries Association, Inc.
Imported Hardwood Products Association, Inc.
International Quorum of Motion Picture Producers
Mechanical Contractors Association of America
Meat Machinery Mftrs. Institute
Narrow Fabrics Institute, Inc.
National Air Transportation Association
National Association of Home Manufacturers
National Association of Business & Educational Radio, Inc.
National Association of Coin Laundry Equipment Operators
National Food Processors Association
National Concrete Masonry Association
National Industrial Distributors Association
National Ocean Industries Association
National Paper Box Association
National Ready Mix Concrete Association
National Tank Truck Carriers, Inc.
National Wool Growers Association
Northeastern Lumber Manufacturers Association
Packaging Machinery Manufacturers Institute
Portland Cement Association
Printing Industries of America, Inc.
Railway Progress Institute
Rubber Manufacturers Association
Screen Printing Association International
Shipbuilders Council of America
Truck Mixer Manufacturers Bureau
United Fresh Fruit & Vegetable Association
Woodworking Machinery Manufacturers of America
Woodworking Machinery Distributors Association

APPENDIX B

Proposals to Improve and Simplify Investment Tax Credit

The Committee for Effective Capital Recovery makes the following recommendations to improve or simplify the investment tax credit:

A. Permanent 12 Percent Investment Tax Credit

Businesses must be provided a tax climate favorable to investment in order for the nation's capital investment to be sufficient to provide satisfactory economic growth in the future. We advocate the immediate enactment of a 12 percent investment tax credit as the most effective means of stimulating business investment.

B. Application to Structures

The investment tax credit should be extended to apply to new structures as well as to machinery and equipment.

C. Used Property Limitation

The maximum amount of acquired used equipment qualifying for the credit should be increased from $100,000 to $200,000. This change would recognize the impact of inflation and primarily assist small businesses.

D. Pollution Control Facilities

Under current law, the full 10 percent investment tax credit is permitted for pollution control facilities. However, the taxpayer may only receive one-half of the normal credit if the facility is financed by tax-exempt industrial

development bonds and the taxpayer elects five-year amortization under Section 169.

We make the following recommendations:

1. Permit a 20 percent investment tax credit or current expensing for pollution control facilities.
2. Permit the full 10 percent investment tax credit, even if the facility is financed by tax-exempt bonds.
3. Improve the definition of pollution control facility under Section 169 and have it apply to buildings as well as equipment.

E. Expanding the Investment Tax Credit for Retailers

Under current law, the investment tax credit is applicable, in addition to tangible personal property and elevators and escalators, to other tangible property (excluding buildings and structural components), but only if the property is used as an integral part of certain "qualifying activities." The term "qualifying activities" is limited to manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services.

The Committee feels the definition of "qualifying activities" should be expanded to include "retailing".

APPENDIX C

COMPARISON OF COST RECOVERY ALLOWANCES

The following table summarizes a comparison of cost recovery allowances for industrial machinery and equipment in leading industrial countries with similar allowances in the United States. The capital cost recoveries for each of the countries have been computed on the assumption that the investment qualifies for any special allowances, investment credits, grants or deductions generally permitted.

It is practice in some foreign countries, prior to investment in fixed assets therein, for investors to agree with the tax authorities as to the rate of depreciation and other benefits available. Such agreements would, in many cases, have the effect of substantially increasing the cost recovery allowances presented in the table below.

March 28, 1979

Comparison of Cost Recovery Allowances

	Representative cost recovery periods (years)	Aggregate cost recovery allowances (percentage of cost of assets)		
		First taxable year	First 3 taxable years	First 7 taxable years
United Kingdom	1[1]	100.0	100.0	100.0
Canada	2[2]	60.1	108.3	108.3
	2[3]	64.2	111.7	111.7
Sweden	4[4]	48.2	86.2	118.2
Italy	6[5]	25.0	75.0	100.0
Australia	6[6]	50.0	70.0	110.0
	8[7]	30.0	50.0	90.0
Japan	8[8]	37.2	66.6	96.8
France	8[9]	31.3	67.6	94.6
Netherlands	8[10]	36.0	56.0	96.0
	9[11]	24.0	44.0	84.0
Germany	10[12]	25.0	57.8	86.7
Belgium	10[13]	26.0	54.8	86.3
United States				
1962 Law	10[14,15]	30.7	56.1	86.1
1969 Law	12[16]	16.7	42.1	72.1
1971 Law	8[14,17]	35.1	64.8	97.0
1975 Law	7[16,18]	41.1	70.8	103.0
1978 Law	7[18,19]	42.8	72.5	104.7

Comparison of Cost Recovery Allowances

Footnotes

[1]Full cost recovery the first taxable year.

[2]Canada has an investment tax credit of 5 percent of the cost of new buildings, machinery and equipment to be used in manufacturing and processing and other specified activities. The cost of the property acquired is reduced for federal tax purposes by the investment tax credit received. Canada permits 50 percent of the cost of machinery to be recovered the first year and the other 50 percent in the following year.

[3]Assumes that the 7 percent investment credit as proposed by the 1979 Budget will be enacted.

[4]Sweden has a 25 percent investment allowance. The investment allowance, which does not affect the basis of the asset for depreciation purposes, is deductible for state corporation income tax purposes but not for municiple corporation income tax purposes. This results in an effective additional investment allowance of 18.2 percent.

Forty percent of a Swedish corporation's taxable income may be allocated to a reserve for future investment in fixed assets. Where the acquisition is deemed to have been made from this reserve, full cost recovery occurs before the investment is made.

[5]Straight line depreciation with 15 percent additional depreciation in each of the first three taxable years.

Price Waterhouse

[6]Depreciation in Australia is based on an estimate of "effective life" and taxpayers may elect to use either the prime cost (straight line) method or the 150 percent diminishing value (declining balance) method. In addition, a 40 percent investment allowance for new property may be deducted from the tax base in the year the property is ready for use. This investment allowance is reduced to 20 percent for assets acquired pursuant to a contract entered into after June 30, 1978 or placed in service after June 30, 1979 (regardless of the date the contract was entered into). This calculation assumes the machinery was purchased prior to June 30, 1978 and therefore eligible for the 40 percent allowance.

[7]Assumes the machinery is eligible for the 20 percent allowance (see footnote 6).

[8]A declining balance method of depreciation is used. The current rate is 206 percent on an asset with a 10-year life. The computation assumes that the 10 percent investment tax credit (equivalent to a 16.6 percent deduction at the present national and local maximum tax rate) is available. This investment credit, however, may be abolished in 1979.

[9]250 percent declining balance depreciation, which is switched to straight line after the fifth year. Although not considered, effect may be given to multiple shift operations by reducing the service life of the assets.

[10]Straight line depreciation. A 7 percent premium for new investments in fixed assets is given in the form of an investment tax credit. If the total of the premiums exceeds the tax liability, the excess of the premium over the tax liability is payable in cash to the taxpayer.

In addition, bonus premiums from 0.25 to 6 percent for small investments up to Dfl 800,000 ($398,000) is available. This calculation assumes machinery is eligible for this 6 percent bonus premium. The tax benefit for the premiums is computed using a 48 percent corporate tax rate.

[11]Assumes machinery is only eligible for the 7 percent premium for investment (see footnote 10).

[12]250 percent declining balance depreciation.

[13]Double declining depreciation which is switched to straight line after the fifth year. As a temporary measure to promote investments, a one-time special deduction of 15 percent is allowed on certain acquisitions of fixed assets made during 1979 and 1980. The special deduction will be allowed to the extent that 1979 or 1980 investments in fixed assets exceed the average annual investments for the years 1974 to 1976. The 15 percent deduction is only applicable to a maximum of 40 percent of the total new investments.

[14]The tax benefit of the investment credit is computed using a 50 percent corporate tax rate. Therefore, the investment credit increases the capital cost recovery by 14 percent the first year for a 7 percent credit and by 20 percent the first year for a 10 percent credit. The credit does not reduce the recoverable base cost.

[15]Guideline life of 12 years and 7 percent investment credit. Double declining balance depreciation, which is switched to straight line after the sixth year.

Price Waterhouse & Co.

[16]Guideline life of 12 years but no investment credit. Double declining balance depreciation, which is switched to straight line after the sixth year.

[17]ADR life of 9.5 years and 7 percent investment credit. Double declining balance depreciation, which is switched to straight line after the fifth year.

[18]ADR life of 9.5 years and 10 percent investment credit. Double declining balance depreciation, which is switched to straight line after the fifth year.

[19]The tax benefit of the investment credit is computed using a 46 percent corporate rate. Therefore, the investment credit increases the capital cost recovery by 21.7 percent for the first year. Computation assumes that the assets do not qualify fo the additional 10 percent investment credit for energy savings property or the one percent ESOP credit.

APPENDIX D

For Immediate Release
9 A.M. EST
September 13, 1979

Economic Impacts of Accelerated Capital Cost Recovery

by Allen Sinai
Vice President and Senior Economist
Data Resources, Inc.

Speech before the Committee for Effective Capital Recovery, presented in the Caucus Room, Cannon House Office Building, Thursday, September 13, 1979.

Economic Impacts of Accelerated Capital Cost Recovery

by Allen Sinai*

During the past twenty years, Federal tax policy has been used in several ways: first, as a contracyclical tool to stabilize the economy; second, to promote spending in socially desirable areas; and third, to improve the structure of the tax system. In the decade of the 60s, tax policy was designed primarily to stimulate economic growth and close the gap between potential and actual output. In the 70s, a series of adjustments to limit the drag of a tax system buffeted by inflation and measures to enhance household and business saving have been put into place.[1]

What tax policies are appropriate for the 80s? What are the goals to be accomplished? Does "accelerated capital recovery" fit into the "optimal" tax policy framework of the 80s? In particular, how would the Capital Cost Recovery Act of 1979 impact on the U.S. economy? What would be its benefits and costs? And, how does the accelerated depreciation that is the hallmark of the Capital Cost Recovery Act rank in the range of potential tax actions that could be undertaken?

In brief:

- Tax policy for the 1980's should be concerned with promoting capital formation and increasing productivity to help lessen the severe inflation that is plaguing the U.S. economy. This means tax measures favoring saving and business investment spending are preferable to more typical aggregate demand policy stimuli, such as across-the-board cuts in personal income taxes. A measure such as the Capital Cost Recovery Act of 1979 should be seriously considered for implementation, since both capital formation and business saving would be enhanced by its enactment.

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*The research reported here was based on work done with the DRI Model of the U.S. Economy, in a series of studies prepared for the Committee for Effective Capital Recovery. Terry Glomski of Data Resources collaborated in the studies that were performed.

[1] Tax policy to stabilize the economy was employed in 1964 (rate reductions for both personal income and corporate profits taxes), 1968-70 (tax surcharge on personal income and elimination of the investment tax credit), and in 1978 (personal income and corporate profits tax reductions). Tax incentives to promote business investment were enacted in 1962 (investment tax credit and shorter equipment lifetimes), 1971 (reinstatement and liberalization of the investment tax credit and ADR service lifetimes for machinery and equipment), 1975 (higher investment tax credit), and 1979 (liberalization of the investment tax credit). Changes in the exemptions for personal and corporate income taxes were enacted in 1970, 1971, 1972, and 1978, offsetting to some extent the "bracket" effect of inflation, as did the per capita tax credits of 1975, 1976, and 1977. Earned income credits were instituted in 1975. Household and business savings were aided by a reduction to 50% in the maximum tax on the earned income of persons in 1972, the 1978 reduction in capital gains taxes, the liberalized depreciation of 1971, and corporate profits tax reductions in 1971, 1975, and 1978.

- In the current environment of near full employment and high inflation, public policy should be concerned with measures to restrain growth in demand while at the same time promoting a more rapid rise in potential supply. In this way, the inflation potential for the U.S. economy in the 1980s can be limited. The U.S. economy of the late 70s is vastly different from the early 60s, when aggressive measures to stimulate aggregate demand were needed. Now, a policy mix of restraint in government spending combined with tax policies that simultaneously enhance investment demand, potential supply, and the flow of savings would be preferable.

- The Capital Cost Recovery Act of 1979, also known as the "10-5-3" program, would provide a strong stimulus to business fixed investment, real economic growth, productivity, and employment at almost no cost in additional inflation. Analysis with the DRI model of the U.S. economy shows that the Conable-Jones proposal would raise real business fixed investment by $10 billion per annum between 1980 and 1984, raise the growth in real GNP by 0.3% per year, and increase productivity growth by 0.7 percentage points compared to a situation with existing tax laws. Employment gains would range between 100,000 and 500,000 persons over the next five years. No significant rise of inflation would result.

- The net cost of the Capital Cost Recovery Act as simulated in the DRI model would be $11.3 billion per year over 1980 to 1984, ranging between $4.2 billion in 1980 and $16.1 billion during 1984. The simulated program assumes: 1) a phase-in of new structures lifetimes over a 10 year period toward a 10 year lifetime; 2) a phase-in of new equipment lifetimes, except for autos and light trucks, over a five year period toward a five year lifetime; and 3) a 10% tax credit on all equipment except autos and light trucks, which receive a 6% credit.[2] These figures are gross of all Federal tax receipts after taking account of the stimulus to the economy generated by the measure. Given the tax structure, the higher GNP that would result from the Capital Cost Recovery Act will induce additional Federal tax revenues that offset the static revenue loss obtained when considering the program in isolation from its effects on the economy.

- The Capital Cost Recovery Act is self-financing to a degree, both for the Federal Government and for corporations. Because of the stimulus provided to the economy, induced personal income and corporate profits tax receipts should offset $7.8 billion per annum of the expected tax loss, a return of $0.41 per dollar per year of the ex-ante or static revenue loss. In addition, the huge cash flow generated by the reduced lifetimes will provide much of the financing necessary to carry out a higher rate of capital expenditures. The ratio of cash flow to the capital outlays of nonfinancial corporations rises 5 to 6 percentage points higher than in the baseline case, indicating a much stronger financial position for the nonfinancial corpoate sector as a result of the measure.

- The "bang for a buck" from the Capital Cost Recovery Act, defined as the rise in real business fixed investment per dollar of revenue loss, would be $0.53 per year between 1980 and 1985, before economy feedback is considered. This is a signficantly greater impact than would occur from equivalent reductions in corporate profits taxes. When allowance is made for the full feedback effects of the economy stimulus on tax receipts, the bang for a buck of the accelerated capital recovery measure is even greater.

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[2] The actual proposed legislation, H.R. 4646, the Jones-Conable bill, uses a 5 year transition for structures. The net cost is $2 to 3 billion a year compared with a 10 year phase-in.

- Of the various tax incentives to capital formation most often considered, the impacts from the accelerated capital recovery rank near the top in terms of instrument effectiveness. Only the investment tax credit would produce an equivalent or greater bang-for-a-buck. In addition, there are side benefits to productivity and the financial markets from the improved corporate liquidity that would result. There is also essentially no rise in inflation from the highly stimulative measure, given the rises in productivity and potential output that occur.

The organization of the statement is as follows: Section I discusses the changing economic environment and its effect on tax policy. In Section II, the relation between the poor performance of capital formation, productivity growth, and inflation is indicated. Section III deals with the notion of accelerated capital recovery. In Section IV the economic impacts of the Jones-Conable Capital Cost Recovery Act of 1979 are presented and discussed. The final section summarizes the benefits of the program to the economy, as simulated in the DRI model of the U.S..

I. The Backdrop for Tax Policy in the 80s

The focus of fiscal policy is radically changing as a result of 15 years of intensifying inflation in the U.S. economy. Whereas most previous major tax measures were designed to promote economic stability and growth, the severe inflation, low productivity, and high unemployment that have been occurring suggest the need for a different approach. Regardless of the source of inflation, continually rising prices reduce the effective purchasing power of households through the bracket effect of rising nominal incomes under a progressive income tax structure. In the case of business, there is an analogous effect that arises because of historic replacement costs and FIFO inventory accounting. The inflation drag on expendable cash flows in a period of rapid inflation thus is a deterrent to private sector spending. If the spending category is business capital formation, then growth in productivity is also hampered and inflation worsened further. In addition, a high inflation environment is suggestive of excess demand pressure against supply. Tax measures designed to increase the supply of work effort, capital, and new technology appear to be warranted in light of the need for a more rapid rise in the potential supply of the economy.

Thus, tax policy in the current, highly inflationary environment must be different from what was employed in the slack economy of the 60s. Continued raises in exemptions and reductions in nominal tax brackets may be needed to sustain purchasing power. More importantly, without measures designed to promote capital formation and productivity, the inflation process will continue to be self-generating, with rising inflation dragging down capital spending, cutting the growth in productivity, raising labor costs, and bringing on more inflation. To break this loop, creative approaches to Federal taxation are required, including methods that would accelerate the depreciation writeoffs of business. Policies that stimulate the after-tax return to savings, supply of work effort, and capital formation are more approporiate if the goal is to limit inflation and reduce unemployment simultaneously.

This backdrop for tax policy in the 80s suggests measures designed to promote a balanced growth in demand and potential supply, along with enhancing the savings flows of households and business. Hints of a tendency toward such measures have already appeared, starting with the maximum tax on earnings in 1972, the reduction in capital gains taxation during 1978, and the swelling interest in measures to promote business capital formation and saving. Further evidence of the emerging trend also appears in proposals to increase the after-tax return on savings by households, through exemption or deductions of some interest earnings from taxes.

II. Capital Formation, Productivity, and Inflation

The spiraling inflation in the U.S. economy since 1966 is a national crisis. The undesirable economic and political effects of continuing high rates of inflation are well documented. Like a cancer, the ingredients of inflation are multi-dimensional. No single cure exists for the problem, the effects of which are exacerbated by secularly rising rates of unemployment. Between 1966 and 1979, inflation of the implicit GNP deflator has varied from 3% to an estimated 8.8% for this year. In only three years were the inflation rates below 5%; 1967 and 1968, and in 1972. In this last year, the low rate of inflation was the result of the wage-price freeze and Nixon Administration guidelines.

At the same time inflation has exhibited a secular rise, the rate of capital formation and growth in productivity have shown a secular decline. Table I shows the proportion of GNP devoted to non-residential fixed investment during the postwar period and, aside from a burst in the early 70s, currently reflects a lower ratio than previous peaks. In addition, expenditures on pollution and abatement equipment have taken about 0.3 to 0.4% of this ratio, with perhaps more accounted for by government mandated requirements on business capital formation.

Table I
Capital Formation in the U.S. Economy
(Business Fixed Investment Relative to GNP)

	(1) Nonresidential Business Investment/GNP	(2) (1) Less Spending on Pollution and Abatement/GNP
1953	9.4	
1954	9.3	
1955	9.6	
1956	10.4	
1957	10.5	
1958	9.3	
1959	9.3	
1960	9.4	
1961	9.0	
1962	9.1	
1962	9.1	
1963	9.0	
1964	9.4	
1965	10.4	
1966	10.8	
1967	10.3	10.2
1968	10.3	10.2
1969	10.6	10.4
1970	10.2	10.0
1971	9.8	9.5
1972	10.0	9.6
1973	10.4	10.0
1974	10.7	10.3
1975	9.8	9.4
1976	9.7	9.3
1977	10.0	9.6
1978	10.4	10.1
1979E	10.7	10.3
1980E	10.6	10.2
1981E	10.6	10.2

E - DRI forecasts.

Growth in labor productivity has been steadily declining, falling to 2.3% per annum in 1965-73 after the 3.2% growth from 1947 to 1965, and plummeting lower in recent quarters. The downward trend has contributed greatly to inflation and shows no signs of a reversal.

Table 2
Growth of Labor Productivity
(Average Annual Rates of Change)

	1947-65	1965-73	1973-78	1978:4 - 1979:4
Sector				
Private Business	3.2	2.3	1.1	-3.3
Nonfarm Business	2.6	2.0	1.0	-4.3
Manufacturing	3.2	2.4	1.6	0.6
Nonfinancial Corporations	3.7*	1.9	1.1	-1.8**

* 1958-65; Data not available for years prior to 1958.
** 1978:4 to 1979:1
Source: Bureau of Labor Statistics

The coincidence of reductions in productive capital formation and productivity with rising inflation is suggestive of an interlocking process in the U.S. economy. Though the starting point may be hard to define, growth in capital for a given labor force raises productivity, reduces unit labor costs, and therefore lowers inflation. A more rapid pace of capital formation thus is one means to raise labor productivity and mitigate inflation. Though not the only possibility, the effect of newly formed capital on potential supply, the quality of capital, the marginal productivity of labor, and the pace of innovation is likely very significant. Indeed, the periods of most rapid formation of capital, 1962 to 1966 and 1975 to 1977, were associated with a relatively strong performance in productivity, and improved results on inflation.

At the same time, higher inflation hurts business capital formation.[3] First, higher inflation causes reductions in real economic growth as purchasing power drops, interest rates rise, the stock market weakens, higher debt burdens restrain spending, and unemployment moves up. These events, which unfold with time lags, affect expectations of final sales and business plant and equipment spending through the "accelerator." Second, a more rapid rate of inflation reduces the ratio of product price to the effective price of capital, or the "profit margin" on new plant and equipment. The combination of a higher supply price of capital goods,

[3]See "Inflation and Business Capital Spending", Testimony before the Joint Economic Committee, U.S. Congress, Hearings on Aspects of Inflation, "The Fixed Investment Decision," Washington, D.C., June 21, 1978.

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increased nominal costs of financing capital expenditures, and a lower present value for the tax deductable depreciation expenses, causes the rental price of capital goods to grow more rapidly than business can increase product prices. The lower marginal return on new capital goods negatively affects business fixed invest ment. Third, higher inflation raises both short- and long-term interest rates. Bond yields rise through the effect of inflation on the premium demanded by investors for supplying savings. Short-term interest rates rise through the pressure of increased nominal loan demands against the liquidity of the commercial banking system and as a result of the tighter monetary policy that is instituted to fight inflation. Rising interest rates impact business fixed investment by raising the rental price of capital goods, and by increasing the debt service burden of nonfinancial corporations relative to cash flow. Fourth, the higher interest rates damage the stock market, causing a rise in the cost of equity financing and an increase for the rental price of capital. Fifth, business profits and the internally generated funds available to finance capital outlays are sharply diminished during periods of rapid inflation, because of illusory inventory profits and the rising replacement costs for capital goods. Corporate profits are typically overstated during periods of inflation because of FIFO methods of inventory accounting and historical cost expensing for depreciation. In both cases, actual cash outlays for replacement of inventories and capital goods are much higher. After correction for these factors, the cash flow for nonfinancial corporations is sharply reduced. Sixth, higher inflation causes the nominal external financing requirements of business to grow and increases bank loan indebtedness, commercial paper issues, and the mortgage and bond financing necessary to fund desired capital outlays. This rising indebtedness raises the debt service burden of corporations and eventually restrains spending through the increased financial risk of corporate balance sheets. Finally, an autonomous acceleration of inflation can cause reductions in capacity utilization by limiting aggregate demand. Reducing the intensity of use of existing capital lowers replacement investment.

Together, these factors make for sizeable reductions in the rate of business capital formation during periods of rapidly rising prices. To the above endogenous influences must be added the potential restraining effects on aggregate demand from tighter fiscal and monetary policies. The effects of restrictive stabilization policies on expected sales can be quite substantial and sharply diminish the planned rate of capital outlays by business.

III. Accelerated Capital Recovery

Accelerated capital recovery refers to a shortening of tax allowable or useful lifetimes to reduce the period over which capital outlays are fully expensed. While used to a high degree in some of our trading partners, U.S. tax policy has never embraced the concept. Although tax allowable lifetimes have progressively been reduced in a marginal fashion over the years, a switch to accelerated capital recovery would constitute a much greater change. The notion that capital assets should be depreciated for tax purposes as real economic depreciation occurs is well entrenched. Accelerated capital recovery departs from this traditional approach, recognizing the need to stress capital formation and business saving as a primary goal.

Accelerated capital recovery would stimulate the demand for physical capital, the supply of money capital, and potential output. The "income" and "relative price" effects of such a measure are highly potent in the DRI model framework where cash flow, interest charges on outstanding debt, stock market effects, and replacement investment loom so importantly for business capital formation. In

particular, the cash flow and interest rate impacts, both short- and long-term, combine to make policies for accelercted depreciation quite powerful. The provision of additional business saving from accelerated depreciation at the same time incentives to capital formation are being legislated is particularly appropriate in an economy that is near full employment. In addition, a program of more rapid capital recovery would move the economy closer to replacement cost depreciation and away from the anachronistic historical cost depreciation that currently exists.

IV. A Simulation Analysis of the Capital Cost Recovery Act of 1979

The accelerated capital recovery program considered was a "10-5-3" shortening of lifetimes on newly purchased plant and equipment, whether new or used.[4] The program consisted of the following elements:

1) a reduction in the tax allowable lifetimes for buildings to 10 years from the current 23 year average;

2) a reduction to five years in the tax allowable lifetimes for equipment, except autos and light trucks;

3) a three year tax allowable lifetime on investment in autos and light trucks;[5]

4) a uniform investment tax credit of 10% on all equipment, except for autos and light trucks, to which a 6% credit would apply;

5) the capital recovery is based on tables constructed using accelerated methods of recovery, i.e., double declining balance with a switch to sum-of-the-years digit methods.

Given the potential large revenue loss from this "10-5-3" accelerated capital recovery program, a transition program was instituted where equipment lifetimes, except for autos and light trucks, were phased-in toward a five year lifetime over a five year period. New 10 year lifetimes for buildings were phased-in over a 10 year period. The uniform tax credit was immediately put into effect, along with a 6% credit for autos and light trucks.

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[4]H.R. 4646; also introduced in the Senate by Senators Nelson, Bentson, Packwood, and Chafee. One difference between the accelerated capital recovery program simulated and the proposed legislation is the transition period for buildings or Class I property. The bill uses five years; the analysis assumed 10 years. Thus, both the stimulus from the measure and revenue loss are somewhat underestimated; approximately $3 to 4 billion a year in revenue loss calculated on a static basis and $2 and $3 billion on a net, full economy-feedback basis.

[5]Assets that are not autos or light trucks and that currently have lifetimes shorter than five years would be changed to five years.

Table 3 shows the revenue loss from this "10-5-3" accelerated capital recovery program, on an ex-ante (static) basis. The ex-ante (static revenue loss) corresponds to the Federal corporate tax receipts that would be lost under given assumptions on the pace of plant and equipment spending for the next five years.[6] The expected revenue loss can be seen to vary from $4.8 billion in 1980 to $32.9 billion in 1984, averaging $19.1 billion per annum.[7]

Table 3. "10-5-3" Accelerated Capital Recovery Program: "10-5" Phase-In Static Revenue Losses
(Billions of Dollars, Seasonally Adjusted Annual Rates, Relative to Baseline)[1]

Year	1980	1981	1982	1983	1984	Avg.
Class I	0.7	2.2	3.7	5.4	7.4	3.9
Class II & III[2]	3.3	9.5	14.6	19.9	24.3	14.3
Uniform Tax Credit[3]	0.8	0.9	0.9	1.0	1.2	1.0
Total	4.8	12.6	19.2	26.3	32.9	19.1

[1]Business fixed investment is assumed to grow at 9% for the baseline. Equipment lifetimes, except autos and light trucks, are phased in towards a 5 year lifetime over a 5 year period. The baseline assumes an 11 year average lifetime for equipment. Structures lifetimes are phased in over a 10 year period toward a 10 year lifetime, while the baseline assumes an average lifetime of 23 years.

[2]Class I is the National Income and Product Accounts counterpart to Sec. 1250 property (structures) including corporations, proprietorships, and partnerships. Class II is the National Income and Product Accounts counterpart to Sec. 1245 property (equipment), including corporations, proprietorships, and partnerships, except cars and light trucks. Class III property contains autos and light trucks.

[3]The investment tax credit for autos and light trucks is raised from 3.33% to 6%. All Class II property receives a 10% credit.

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[6]The assumption for the growth of nominal fixed business investment was 9% per year, based on estimates by the Joint Committee on Taxation. This assumption was imposed on the baseline solution of the DRI model used in simulations of the accelerated capital recovery program.

[7]The actual revenue loss from the Jones-Conable bill would be somewhat higher because of the five year phase-in compared with a ten year lifetime for structures. Table 3 assumes a 10 year phase-in process. Doubling the Class I revenue loss would change the figures to range between $6.2 billion in 1980 and $47.7 billion in 1984. The average would be $23.0 billion instead of the $19.1 billion reported. In ex-ante or static terms, the expected revenue losses over the five year period make this tax policy one of the most expensive in the postwar period.

In Table 3, the tax loss for Federal corporate tax receipts without economy-wide feedback, averaged $14.3 billion over the five year period and was $3.4 billion for structures.[8] The loss due to the uniform tax credit and new 6% investment tax credit on autos and light trucks was $1 billion per year. A total of $4.8 billion of Federal corporate tax receipts was lost in the first year of the program, and $32.9 billion in 1984. Appendix Tables A.7 to A.10 show the calculation of the ex-ante revenue losses in Table 3.

The basic methodology used to calculate the static revenue loss was a computation of the difference between the assumed depreciation rates under the capital cost recovery program and the DRI baseline solution. This difference was then multiplied by the relevant investment series based on growth assumptions in nominal terms from the Joint Committee on Taxation, producing increased depreciation expense over the baseline simulation. When multiplied by an assumed effective tax rate, a static or ex-ante revenue loss was produced.

The "phase-in" or transition program considered used the "10-5-3" lifetimes but phased them in over a 10 year period (for structures) and 5 year period (for equipment), i.e.,

1) Class I property was allowed a tax lifetime of 10 years, with the new lifetimes phased in over 10 years. Appendix Tables A.2 to A.6 contain the phase-in schedules for each year of investment from 1980 to 1984. This class of assets coincides with Section 1250 property, including all tangible real property (such as leases of land), but exempts Section 1245 property, buildings and their structural components.

2) Class II property has a tax lifetime of 5 years, except for certain exceptions, with the new lifetimes phased in over 5 years. Appendix Tables A.2 to A.6 contain the phase-in schedules for each year of investment between 1980 and 1984. This property coincides with Section 1245 property. Section 1245 property is depreciable property which is either personal property (tangible and intangible), or 2) other tangible personal property (not including a building or its structural components), used as an integral part of a) manufacturing; b) production; c) extraction; and d) the furnishing of transportion, communications, electrical energy, gas, water, or sewage disposal services. The resecrch facilities used in connection with these activities are also included.

3) Class III assets were allowed a lifetime of 3 years. Class III assets are the classifications of Section 1245 property that are either automobiles or light trucks.

4) Class II property received a 10% investment tax credit. There was a 6% tax credit for Class III assets.

5) All categories of eligible assets used a combination of double declining balances (DDB) and sum-of-the-years digits (SYD) depreciation methods.

6) A half-year convention was included. All assets purchased in a given year were depreciated as if bought at mid-year.

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[8]Corporations, proprietorships, and partnership tax revenues were simulated via corporate tax revenues in the DRI model. Reference to "corporate" taxes therefore includes proprietorships and partnerships.

The transitional schedule operated as follows. For the first year of the program, Class II property was broken into 5 lifetime categories, each based on ADR lower limits. These categories were 1) 5 year-or-less, 2) 6 year, 3) 7 year, 4) 8 year, and 5) 9 years, or more. Depreciation was then calculated, using the double declining balance and sum-of-the-years digits based on these lifetimes. For subsequent years, the lifetime categories were shortened so that in each successive year the average lifetime of all subgroups moved toward 5 years, ultimately reaching so by the fifth year of the program. Capital purchased in any specific year of the phase-in period was depreciated using these lifetimes and associated depreciation rates. This procedure was continued until 1984, when all Class II lifetimes reached a 5 year span. Appendix Tables A.2 to A.6 display the subgroups for Class II assets and their depreciation schedules for the first few years of their lifetimes. Table 4 shows the final capital cost recovery table in the Jones-Conable bill.

Table 4
Capital Cost Recovery Table
(In percent)

Ownership year	Class of investment		
	I	II	III
1	10	20	33
2	18	32	45
3	16	24	22
4	14	16	
5	12	8	
6	10		
7	8		
8	6		
9	4		
10	2		
	100	100	100

The accelerated capital recovery program described was then simulated in the DRI Quarterly Econometric Model of the United States.[9] The DRI Model is particularly well suited for simulating the impacts of tax incentives on business fixed investment, capital formation, productivity, real output and inflation, given its detailed treatment of business flow-of-funds, the integration of tax policy parameters into the investment equations, and the role of cash flow along with other financial ingredients on investment spending, capital formation, real economic growth, and productivity.

[9]For other studies on tax incentives and capital formation using the DRI model, and a description of the mechanism and framework behind the results, see Andrew F. Brimmer and Allen Sinai, "The Effects of Tax Policy on Capital Formation, Corporate Liquidity and the Availability of Investment Funds: A Simulation Study," Journal of Finance, May 1979, pp. 287-308; Christopher Caton, Otto Eckstein, and Allen Sinai, "Tax Reform and Capital Formation in the U.S. Economy," Data Resources Review, August 1977; Allen Sinai and Terry Glomski, "The Carter Tax Proposal: Is It Needed?" Data Resources Review, January 1978, pp. 11-17; Allen Sinai, "Tax Expenditures and Business Capital Spending," Testimony presented at the Hearings on Tax Expenditures Committee on Ways and Means, Subcommittee on Oversight, March 27, 1979, and Otto Eckstein and Allen Sinai, eds., The Data Resources Model of the U.S. Economy, (Amsterdam: North-Holland, forthcoming), ch. 7.

Each element of the accelerated capital recovery program was translated to changes in the parameters for tax policy represented in the DRI model. This included the baseline or Control values for equipment lifetimes, structures lifetimes, the depreciation rule assumed, and the investment tax credit. The baseline case assumed that the lifetime for Class I assets (structures) was 23 years, with the combined Classes II and III (equipment) at 11 years. The baseline depreciation rules were sum-of-the-years digits in Class II and a weighted average of 40% straight line and 60% 1.5 declining balances for Class I.

The method employed was to calculate the difference in depreciation rates between each program and the baseline, then to derive the additional depreciation expense by multiplying these differences by the relevant investment stream. The greater depreciation expense was then entered into the DRI model solution as an increase in book value capital consumption. This caused, without considering feedbacks, a rise in cash flow equal to the average corporate tax rate multiplied by the rise in depreciation, which was also the static revenue loss. The shorter lifetimes for Class I and combined Class II and III assets were entered explicitly into the DRI model, as the main channel of influence to business fixed investment for the Capital Cost Recovery Act. The vehicle for this effect was the lessened price of capital relative to product prices. The tax credit effects were entered by changing the value for the effective investment tax credit to a level that would produce the additional tax losses associated with the program's new 6% tax credit for autos and light trucks without model feedback.

Table 5. "10-5-3" Accelerated Capital Recovery Program: "10-5 Phase-In", DRI Model Simulation Results
(Billions of Dollars, Seasonally Adjusted Annual Rates, Relative to Baseline)

	1980	1981	1982	1983	1984	Average
Real Business Fixed Investment*	0.2	4.1	9.8	15.3	20.9	10.0
Real Equipment Spending*	0.2	3.2	7.4	11.7	16.3	7.7
Real Plant Spending*	0.1	0.9	2.4	3.6	4.5	2.3
Revenue Losses						
Total	4.2	9.8	11.8	14.6	16.1	11.3
Corporate	4.1	10.0	14.6	20.6	26.8	15.2
Personal	0.1	0.0	-1.4	-3.3	-6.0	-2.1
Social Security	0.0	-0.3	-1.2	-2.5	-4.3	-1.6
Excise	0.0	0.0	-0.1	-0.2	-0.4	-0.2
Productivity Growth(%)						
10-5 Phase-In	2.7	1.8	2.2	2.9	3.2	2.6
Baseline	2.6	1.2	1.4	1.9	2.3	1.9
Difference	0.1	0.6	0.7	1.0	0.9	0.7
Growth in Real GNP(%)	0.0	0.4	0.3	0.4	0.4	0.3
Employment(Millions)	0.0	0.1	0.2	0.4	0.5	0.2
Ratio: Increase in Real Fixed Investment to Corporate Tax Loss	0.06	0.42	0.68	0.74	0.78	0.53

The results are shown in Table 5, relative to the baseline case, i.e., as increments to the baseline, except for the productivity figures. These reflect the dynamic simulation and feedback from the effects of the tax stimulus on the economy, inflation, corporate finance, and capital stock. In the real world, the full impacts of any change in a tax policy instrument include both autonomous and induced effects. In evaluating the strength of the various tax expenditures, the full endogenous response of tax receipts to the various changes in the economy should be taken into account. Monetary policy was assumed neutral, operating to keep nominal short-term interest rates constant.[10]

In this "10-5-3" phase-in case, the loss in corporate tax receipts averaged $15.2 billion per year. The gain in real business fixed investment averaged $10 billion per annum. Growth in real GNP was 0.3% higher per year, and employment averaged 200,000 persons above the baseline solution over the five year period. Growth in productivity was 0.7 percentage points a year above the baseline value of 1.9%, averaging a respectable 2.6% for the period. The "bang-for-a-buck" was $0.53 under this accelerated capital recovery program, before feedback.[11]

Other results indicate that there would be little change for inflation from the accelerated capital recovery program. Whereas most programs to stimulate capital formation have been inflationary as the stimulus to demand outpaces the rise in supply, the effects of the Capital Cost Recovery Act on inflation were minimal. Neither the All Urban Consumer Price Index nor implicit GNP deflator showed any significant change from the baseline simulation. The inflation of wholesale prices, on the other hand, did show a slight increase in 1982 to 1984, when the program was most stimulative. The rise in the inflation of commodity prices was 0.1 to 0.2% during those years. However, the benefit to unemployment was much greater, with 0.2 to 0.4% declines in the overall unemployment rate relative to the baseline solution.

This minimal effect on inflation from the strong stimulus to business capital formation arises because the increased capital formation and improved cash flow promote a sizeable rise in productivity, declines in unit labor costs, and rises in potential output. Other tax policies, e.g., the investment tax credit, have been found to be more inflationary.[12] Thus, the cost of the program in terms of additional inflation is essentially nil with considerable benefits to capital formation, productivity growth and employment.

[10] The huge injection of additional cash flow from the accelerated capital recovery program caused a drop of interest rates in the DRI model as business external financing requirements eased and excess funds in the near-term flowed into short-term investments. Since corporate spending lagged the stimulus, the early effects pressed interest rates lower. Treasury financing of the additional deficit did not increase as much because of the extra tax receipts induced by the program. To eliminate any extra stimulus from this source, the Federal Reserve was assumed to cut bank reserves to raise short-term interest rates to their baseline values.

[11] The "bang-for-a-buck" refers to the rise in real business fixed investment per dollar of corporate tax revenue lost. It is the gain in real capital outlays per dollar of revenue cost to the Federal government. Of course, the loss in business taxes is less after allowing feedback than when the extra tax receipts generated by higher corporate profits is included. If all induced tax receipts from the stimulus are accounted for, corporate and otherwise, the gain per dollar of revenue loss would be even greater.

[12] See A. Sinai, ibid, "Tax Expenditures and Business Spending."

V. Concluding Comments

The salient features from the simulation of the Capital Cost Recovery Act of 1979 in the DRI model suggest a string of benefits to enactment of such a measure.

1) The accelerated capital recovery program has a powerful effect on business fixed investment. In real terms, business spending rises a total of $50 billion over the five year period, with increasingly larger impacts into the mid-80s. Few policies to promote business capital formation would be so stimulative, while at the same time generating a means of financing and virtually no additional inflationary pressure.

2) The net cost of the Capital Cost Recovery Act is considerably less than the pre-enactment static estimates. Taking acount of the full feedback effects from the stimulus on the economy, the revenue loss is only $11.3 per annum, varying from $4.2 billion in the first year to $16.1 billion in the fifth year. Taking account of the induced tax revenues, both personal and corporate, that arises from the policy stimulus, is necessary for a realistic assessment of the program costs. Fully $0.41 of the initial cost of the accelerated capital recovery program is recaptured because of its beneficial impacts on the economy.

3) The accelerated capital recovery program is self-financing, both for the government and for corporations. The induced tax revenues diminish the amount of deficit financing that must be undertaken and the huge rise in cash flow provides a means for business to finance the higher rate of capital spending. Few other tax policies would provide this degree of financing.

4) Growth in productivity is enhanced, rising 0.7% percentage points above the baseline. Thus, instead of the forecasted 1.7% per annum growth in labor productivity for 1980 to 1984, a respectable 2.6% pace of growth occurs. The increased productivity arises from the effects of the induced capital formation on potential output and productivity. It is primarily the large rise in the pace of business capital spending that generates the better performance on productivity.

5) The inflation costs from the accelerated capital recovery program are minimal, with virtually no change in key inflation rates arising from the policy stimulus. Most other tax stimuli push demand up faster than supply, giving rise to inflationary effects. The path for demand and supply would be more balanced under the Capital Cost Recovery Act, permitting rising employment and increased economic growth without a serious reacceleration of inflation.

6) There are substantial benefits to business liquidity from the accelerated capital recovery program, stemming from the large rise in cash flow that occurs. Some of the increased cash flow is used to finance capital outlays. Other portions are directed toward reductions in debt and improvement in the asset side of the corporate balance sheet. To the extent that these feedback effects occur, the "financial risk" of the corporate sector is diminished and a more aggressive posture on capital spending can be undertaken.

In this time of high inflation, low productivity growth, and rising unemployment, the time may well have come for implementation of a decidedly different tax policy from what has been used in the decades of the 60s and 70s. Simulation of the Capital Cost Recovery Act of 1979 with the DRI model suggests significant beneficial effects on real economic growth, capital formation, productivity, employment, and the financial position of corporations. These benefits are obtained at little cost in terms of additional inflation. Along with other advantages, such as simplification of the tax code, these quantitative impacts on the economy from accelerated capital recovery suggest the measure is well worth serious consideration instead of the more typical expansive fiscal policies that have been used to bring the U.S. economy out of past recessions. History indicates that each round of these efforts has brought more inflation and further economic instability. For the revenue loss associated with accelerated capital recovery, the potential gain appears to be substantial.

APPENDIX

Table A.1 Baseline Depreciation Schedule in DRI Model*
(Percent)

Year of Asset Lifetime	Class I	Class II, III
1	8.4	2.9
2	16.0	5.6
3	14.4	5.3
4	12.9	5.1
5	11.4	4.8

*Assumes a 23 year lifetime for Class I, 11 years for combined Classes II and III. Sum-of-the-years digits was the depreciation rule for Classes II and III, while 40% straight-line and 60% 1.5 declining balances were assumed for Class I assets. A half-year convention was assumed.

Table A.2 Phase-In Depreciation Schedule - "10-5" Program
(First Effective Year)
For Investment Made in 1980

	Class of Investment					
	Class II					Class I
Lifetime	(5)	(6)	(7)	(8)	(9)	(19)
Year After Asset Purchased						
1	20%	17%	14%	13%	11%	5%
2	32%	28%	25%	22%	20%	10%
3	21%	20%	19%	17%	16%	9%
4	15%	15%	15%	15%	14%	9%
5	12%	11%	12%	12%	12%	8%

Table A.3 Phase-In Depreciation Schedule "10-5" Program
(Second Effective Year)
For Investment Made in 1981

	Class of Investment			
	Class II			Class I
Lifetime	(5)	(6)	(7)	(18)
Year After Asset Purchased				
1	20%	17%	11%	6%
2	32%	28%	20%	11%
3	21%	20%	16%	10%
4	15%	15%	14%	9%
5	12%	11%	12%	9%

Table A.4 Phase-In Depreciation Schedule - "10-5" Program
(Third Effective Year)
For Investment Made in 1982

	Class of Investment			
	Class II			Class I
Lifetime	(5)	(6)	(7)	(17)
Year After Asset Purchased				
1	20%	17%	14%	6%
2	32%	28%	25%	11%
3	21%	20%	19%	10%
4	15%	15%	15%	10%
5	12%	11%	12%	9%

Table A.5 Phase-In Depreciation Schedule - "10-5" Program
(Fourth Effective Year)
For Investment Made in 1983

	Class of Investment		
	Class II		Class I
Lifetime	(5)	(6)	(16)
Year After Asset Purchased			
1	20%	17%	6%
2	32%	28%	12%
3	21%	20%	11%
4	15%	15%	10%
5	12%	11%	9%

Table A.6 Phase-In Depreciation Schedule
For Investment Made in 1984

	Class of Investment	
Lifetime	Class II (5)	Class I (15)
Year After Asset Purchased		
1	20%	7%
2	32%	13%
3	21%	11%
4	15%	10%
5	12%	10%

Table A.7 takes the subgroups of Class II assets and creates a single depreciation schedule for each year by taking the average across the subgroups.

Table A.7 Aggregate Depreciation Schedule for Class II Assets - "10-5" Program (Phased-In Method, Percent)

Year After Asset Purchased	1980	1981	1982	1983	1984
1	15	17	18	19	20
2	25	27	30	31	32
3	19	19	20	21	21
4	15	15	15	15	15
5	12	12	12	12	12
Average Lifetime	8.4	8.3	6.7	5.7	5.0

Since there is only one Class I lifetime assumed for each year, it is not necessary to aggregate Class I depreciation rates. Table A.8 displays these depreciation rates, derived from the lifetime assumptions for each year of the phase-in.

Table A.8 Depreciation Schedule for Class I Assets - "10-5" Program (Phased-In Method, Percent)

Year After Asset Purchased	1980	1981	1982	1983	1984
1	5.3	5.6	5.9	6.3	6.7
2	10.1	10.6	11.2	11.8	12.5
3	9.3	9.7	10.2	10.6	11.2
4	9.7	9.1	9.5	9.9	10.4
5	8.2	8.5	8.9	9.2	9.6

The DRI baseline depreciation rates were then subtracted from the new program schedules (Tables A.7 and A.8). The resulting differences in depreciation rates (Tables A.9 and A.10) were then multiplied by the relevant investment series to calculate the increased depreciation expense under the various programs. When the additional depreciation expense was then multiplied by the average effective corporate tax rate, ex-ante corporate tax losses could be computed.

Table A.9 Differences in Depreciation for Class I Assets in 10 Year Phase-In Plan and Baseline (Percent)

Year After Asset Purchased	1980	1981	1982	1983	1984
1	2.4	2.7	3.0	3.4	3.8
2	4.5	5.0	5.6	6.2	6.9
3	4.0	4.4	4.9	5.3	5.9
4	3.6	4.0	4.4	4.8	5.3
5	3.4	3.7	4.1	4.4	4.5

Table A.10 Difference in Depreciation Rates for Class II Assets in 5 Year Phase-in Plan and Baseline (Percent)

Year After Asset Purchased	1980	1981	1982	1983	1984
1	6.6	8.4	9.8	11.0	11.6
2	9.4	11.4	13.8	15.2	16.0
3	4.2	5.0	6.0	6.6	6.6
4	1.9	1.9	2.1	2.1	2.1
5	0.4	0.4	0.4	0.4	0.6

Senator BYRD. Here is Senator Tsongas. Senator Tsongas, I just inserted your statement in the record, but if you would like to make a statement, you can go right ahead.

STATEMENT OF HON. PAUL E. TSONGAS, A U.S. SENATOR FROM THE STATE OF MASSACHUSETTS

Senator TSONGAS. Thank you, Mr. Chairman.

I intended to introduce Mr. Hill, but since you already have had his testimony—I would just like to commend the committee for addressing this issue of capital formation and the issue of productivity. Clearly, from the perspective of Massachusetts and our dependence on high-technology industries, this is not just an economic issue. It is going to be important to our long-term survival and I would like to participate and help you as much as I can.

I commend you on your initiative and I suspect Mr. Hill's testimony added to that deliberation. I thank the committee.

Senator BYRD. Thank you, Senator Tsongas. We are glad to have you.

[The prepared statement of Senator Tsongas follows:]

PREPARED STATEMENT OF SENATOR PAUL TSONGAS

Good morning, Mr. Chairman and members of the Senate Finance Subcommittee on Taxation and Debt Management. I would like to thank my colleagues for granting me the opportunity to introduce a most distinguished resident of my state of Massachusetts, Mr. Richard D. Hill, who is here this morning to testify before this Subcommittee on the Capital Cost Recovery Act of 1979. Mr. Hill is Chairman of the First National Bank of Boston, the 16th largest bank in the nation, which serves New England, the nation and the international community. The First National Bank of Boston has remained a vital force in the redevelopment, capital formation and business activities of the New England region since 1784. Mr. Hill's appearance before this body as a representative of Business Roundtable is a credit to his past achievements and a vote of confidence in future accomplishments.

The subject before this Subcommittee today is indeed an important one. Most individuals assembled in the room would agree that capital formation—the accumulation of saving and its productive investment—is critical to our nation's economic health and the prosperity of our citizens.

The Joint Committee on Taxation estimates that "one dollar of additional investment in plant and equipment will increase the gross national product by about ten cents per year over and above what is needed to replace the assets as they wear out". This growth in GNP will aid in maintaining a level of economic growth and a higher standard of living that a strong economy provides all Americans.

Capital formation would also allow us to prepare more adequately to meet a number of the economic and social goals of the decades to come. Environmental protection, urban redevelopment and energy independence require a higher level of investment capital.

Increased capital formation would also improve our nation's productivity dilemma. As the members of this Subcommittee are no doubt aware, there has been a substantial slowdown in the growth of labor productivity in recent years. In part, this slowdown can be attributed to the fact that the growth rate of capital stock has not kept up with the accelerated growth rate of the labor force. This decline in the growth of labor productivity has in turn reduced the growth rate of real wages.

There are a number of legislative proposals designed to stimulate higher levels of investment. I share a commitment with many of my colleagues in the Senate to study these alternative measures, with an eye toward supporting the most effective, equitable and economically feasible policy.

I am reviewing S. 1435, the Capital Cost Recovery Act in this same vein. I will carefully consider the Senate Finance Committee's deliberations in making a final determination. I thank you, Mr. Chairman, for allowing me to make these brief introductory remarks; and I now present Mr. Richard D. Hill, Chairman of the First National Bank of Boston.

Senator BYRD. The witnesses will be Representative Barber B. Conable, Jr., from the State of New York and Representative James R. Jones from the State of Oklahoma.

Congressman Conable, Congressman Jones we are delighted to have both of you and you may proceed as you wish.

Representative JONES. Thank you very much, Mr. Chairman and members of the committee.

We have a joint written statement which we would like to submit for the record and summarize very briefly our position on H.R. 4646 or S. 1435.

[The prepared statement of Hon. Barber B. Conable, Jr., and Hon. James R. Jones follows:]

REMARKS OF HON. BARBER B. CONABLE, JR., AND JAMES R. JONES BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT, CONCERNING S. 1435

Mr. Chairman and Members of the Subcommittee, we are delighted to appear today concerning S. 1435, the Senate companion to H.R. 4646, the Capital Cost Recovery Act.

The Capital Cost Recovery Act has now been cosponsored by 252 Members of the House of Representatives. The overwhelming support in the House for this Legislation reflects the enthusiasm which the Capital Cost Recovery Act has generated in business and economic circles. The acceleeratd depreciation schedules in S. 1435 are both an end, and a means to an end. The ultimate goal is to structure a capital recovery mechanism which will permit the private sector to increase its capital investment, increase productivity, create more jobs, and reduce inflationary pressures. The means to achieve this goal is to decouple depreciation lifetimes from useful lifetimes in a manner which both simplifies and accelerates capital recovery.

The accelerated depreciation schedules in the Capital Cost Recovery Act are modeled on current methods of accelerated depreciation. It would give all taxpayers the benefits of enhanced capital recovery without cumbersome bookkeeping, such as the ADR system now requires.

Mr. Chairman, we realize that the Capital Cost Recovery Act is a significant change in the tax law and should be pursued in a systematic, careful manner. Other witnesses today will elaborate on the technical details of the Capital Cost Recovery Act as well as the effects it will have on capital formation. Some persons may have suggestions for improvements in the legislation, but we believe the legislation as introduced is sound. We appreciate the opportunity which your subcommittee hearing affords to elicit constructive feedback.

The Capital Cost Recovery Act is a positive Congressional initiative designed to create a climate for improved capital investment. The public's enthusiasm for the legislation has been remarkable. That enthusiasm is shared by more than half of the Members of the House of Representatives. We are confident that the Senate will join with us to insure its success.

STATEMENT OF HON. JAMES R. JONES, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OKLAHOMA

Representative JONES. Basically, we came here to thank you very much for holding these hearings and for pushing along the dialog and the progress on capital costs recovery.

On the House side, our identical bill is H.R. 4646. At one time, we had 253 cosponsors, which is more than a clear majority. Now we have 252 cosponsors and a circuit court judge. Abner Mikva had to get off the bill, obviously.

There is growing support in the House and by the time the Ways and Means Committee begins hearings next month, we fully expect that approximately 300 cosponsors in the House will be on H.R. 4646.

When Mr. Conable and I and others were talking about the next step to take on capital formation, we wanted to do something

constructive to follow up on what the Congress did last year to bring equity investors back into the market by cutting the capital gains rate.

This year, we thought it would be most instructive to try to generate internally the capital needed to rebuild this economy. In looking at the various options and in talking to economists across the country, it was felt accelerated depreciation would be the best approach.

With that in mind, we had another goal in addition to capital formation. That was tax simplification, something that this Congress started in the 1978 tax bill.

Clearly business supports the 10-5-3 approach. For one reason, it provides simplification. We have found that less than 5 percent of small business uses the ADR system at the present time and therefore small business strongly supports the 10-5-3 approach because it is something that they would use, something they will not have to have a lot of accounting help in order to be able to use it in their businesses.

The revenue impact has been tossed around. I am not going to argue figures at this time. We have asked DRI for estimates and their estimates are substantially below the Treasury estimates that were leaked to the press last week.

I think that it is much too early to determine what the revenue impact will be. I am somewhat skeptical without knowing the data that went into the Treasury estimates. I am skeptical of those estimates in the same manner I was skeptical of the huge revenue losses that were predicted by Treasury with regard to capital gains rates last year.

Instead of revenue losses, we are finding that there are revenue gains on capital gains taxes so far this year.

As far as amendments are concerned, obviously this legislation is not perfect and is subject to being improved through the amendment process. I can see that we may want to restrict the 10-5-3 approach with regard to certain sectors and we may want to expand the 10-5-3 approach with regard to other sectors.

For example, having a shorter immediate writeoff for certain governmentally mandated nonproductive equipment, environmental control equipment, may be desirable.

These are things that hearings and markup can work out, and we are just delighted to have the opportunity to support what you are doing.

Thank you very much for moving ahead in this direction.

Mr. Conable may want to add to this.

STATEMENT OF HON. BARBER B. CONABLE, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. Conable. Mr. Chairman, members of the committee, I would like to add my thanks to those of my distinguished colleagues for your holding these hearings. We expect, during Ways and Means hearings to be held next month on a rather broader subject, to adduce testimony there relating to this same general reform.

As usual, the eloquence of my friend from Oklahoma has pretty much preempted the field. A point to be stressed is that we feel

legislation of this sort will bring the United States into the 20th century on the issue of depreciation.

There are any number of reasons why this proposal is an idea whose time has come, including the recent completion of the MTN, the need to reach out into foreign markets where what America has to sell, in addition to agricultural products, is technology.

Technology is capital-intensive, and we are competing with other developed nations who permit much shorter capital writeoffs than we do or than even this bill would provide.

We have a great pool of capital in this country, so capital formation is not necessary, but that pool has become stagnant because of the degree to which we require people to keep their capital tied up, rather than permitting its recapture and its momentum to be regained through the tax system.

In other words, this proposal provides an opportunity for recreating capital incentives that will result in the reindustrialization of America. Unfortunately, to this point, we have been falling behind in the race for no reason other than we have refused to keep our tax law current with prevailing economic circumstance.

I acknowledge and confirm what my colleague has said about the flexibility of this proposal. We can adjust it to meet any fiscal goal we want to meet, given the economic conditions in which we find ourselves.

I hope we will still have the same broad outline of the 10-5-3 bill because as it is designed in terms of simplification and acceleration of depreciation, it is a broad, systemic reform. Whatever the final details, if we can do away with the useful life concept and all the stagnation that that has created, we will have accomplished a good deal.

We are very grateful for the understanding and support of not only the Senate cosponsors, but the many people in the Senate who have followed their lead, and we think as long as the business community remains united behind this as a broad advance, as long as we can avoid the nibbling away that goes on with respect to a proposal like this in order to get relative advantage within elements of the business community, it is almost inevitable. This is a time of high capital cost and a time of strong technological competition in the world, and the reform we advocate is a needed and timely corrective.

Senator BYRD. Both of you were very active last year in legislation to reduce the capital gains tax. I think that that was a very important and desirable piece of legislation. This legislation which is being considered today is somewhat in that category. It is a followon.

What each of you has been saying is, I take it, that our present depreciation rates are outmoded, outdated, and we need, as you expressed it, Congressman Conable, we need to get into the 20th century with our depreciation schedules.

Representative CONABLE. Senator Byrd, you suggest a very interesting point. The very success of the capital gains initiative last year has given new hope to the people who are interested in a better capital formation system and I find that there is a widespread resurgence of interest in this thrust of possible tax reform.

This particular proposal has the best chance, not only for speeding up the investment that is so needed to increase our productivity, but also for bringing together a broad, general support of those who are involved in our economic system.

Senator BYRD. Thank you.

Senator Bentsen.

Senator BENTSEN. Congressman Jones and Congressman Conable, you both made a great contribution to this. I, for one, recognize it.

Congressman Jones, you were talking about questioning some of the Treasury's forecasts. I got an early education on that when I first came up here. I proposed a piece of legislation that came back as a horrendous tax revenue loss. The next year they had a new Secretary of Treasury who decided it was his idea. It was a pretty good idea. They had a new forecast, and they came out just fine. I always worried a little about some of these.

Representative JONES. I had an experience on both ends of Pennsylvania Avenue, and I think I understand a little bit about estimating.

Senator BENTSEN. It is who is doing the forecasting. We are guilty of that up here too, I am sure. But you are making a point about business being united.

I think they pretty well are, and I think it is terribly important for the country that they are in this.

We tried this last time in the 1978 bill. I tried to increase depreciation by 50 percent, got it through this committee.

Senator Nelson had a different version. He won that one on the floor. In fact, we wound up ending up with both in conference.

But this time we are together. We have talked to various economists around the country—you have, I have, our committees have—and we have united in what I think is a far better approach than what we had last year. Much more simplified.

It is a much more dramatic—it is something that I think can really help get this country moving again and so I think it is for the benefit of trying to cut back on inflation, helping us be competitive so we help our balance of trade and simplifying it to the small businessman where he will actually take advantage of it and utilize it and it will help a lot of accountants and lawyers find more productive work.

Representative CONABLE. Senator Bentsen, your leadership on this has been extremely encouraging to us. We are most grateful.

Representative JONES. Very much so.

I would like to add, as you well know, one of the big problems we had last year was special interests wanting what they wanted in the tax bill and the consequence of that kind of attitude is to have nothing that is going to help develop the country and the private sector of this economy for the entire Nation.

Senator Bentsen and others, Barber Conable and I, talked to a number of audiences following election day, 1978, until the bill was introduced in June this year, to try to get agreement on the broader, general interest of what is going to help the country. Business has responded very well to that broader interest.

Senator BYRD. Senator Long?

Senator LONG. Let me just mention two things, and I would like to ask the two of you to give me your thoughts in regard to both of

them. One of them is we should have cut the capital gains more than we did.

We fellows in the Senate sustained a bill that would have cut capital gains to 21 percent and we had letters from Bill Simon who had been Secretary of Treasury and Henry Fowler who had served as Secretary of Treasury, and former Secretary Dillon; they thought that it would have a positive impact on the budget if we would cut capital gains to 21 percent, or to about 30 percent of the gain, and it looks like what Mr. Jones said here, and what I am hearing from other sources, is that it worked out that the cut in capital gains actually was a positive thing on revenues.

I wonder why we do not see if we can do the rest of it and cut the capital gains tax to where we fellows in the Senate started at in the beginning?

If we passed it before, I think we can pass it again.

Now, with regard to the item you are talking about, I do not think anybody would contend that it is not a big revenue cost item. I would just like your judgment, how can we handle the cost aspects of it? How can we cover the cost of it, as far as budgetary matters are concerned?

Representative JONES. Let me take the first whack at that, if I can.

I agree that we probably should have cut capital gains more last year. As you know so well, politics is the art of the possible and we achieved what was possible in the House of Representatives last year on capital gains. I think most economists will agree to this, that the most important factor on fiscal policy is a percent of the gross national product spent by the Federal Government.

The balanced budget, per se, can be monkeyed with in any number of ways and you can have on-budget, off-budget spending in various ways to put your budgets together to show it is in balance.

But what we are trying to do on the House side is to pass an amendment to the Budget Act. It is now pending before the Rules Committee. We hope to have this amendment up perhaps next month that will limit spending by the Federal Government to 21 percent of GNP next year, and thereafter to limit it to 20 percent of GNP.

That would give room for tax reductions and still be fiscally sound.

For example, if present economic projections remain true, and that amendment was added to the Budget Act, next year we would have both a balanced budget and a $15 billion surplus for tax cut purposes, and in fiscal year 1982, we would have both a balanced budget and a $77 billion surplus to be used for tax purposes. That would be my response on the revenue impact.

Representative CONABLE. Senator Long, your question is a very serious one.

One of the reason that Congressman Jones and I settled on this after long discussions with business representatives as the capital formation device which would probably be most successful and most helpful was because it does offer an opportunity for flexibility far beyond most other options that are open in the way of capital formation.

You can adjust this proposal either through phaseins or through structural alterations to fit any fiscal goal that you wish.

We assume, and perhaps this is a premature assumption, that there will be a tax cut bill next year because of the extent to which inflation has created a Government fiscal dividend. Therefore, we assume that a substantial portion of any tax cut bill, a quarter to a third, would be allocated to systemic improvement of this sort.

A quarter of a $20 billion tax cut would be $5 billion. Treasury estimates a slightly lower first-year cost than we designed through phaseins and internal structuring. One of the advantages of this proposal is that it can be varied to achieve any desired fiscal goals.

As I said earlier, if we can get away from the useful-life concept and all the stagnation that results then we will feel we have made a contribution to the way our system works and to our competitiveness.

It is our conviction that this proposal has more bang for the buck, and therefore probably more feedback ultimately than any other capital formation device you can get into and if that is so, then we think that there will be an economic dynamic that will help fiscally, ultimately.

As to the cutting of capital gains further now it is within your province, I think, to judge the political achievability of that. I happen to think that it would actually increase our revenues if we were to cut capital gains further, so I might suggest that perhaps we could cut capital gains further in order to finance the Capital Costs Recovery Act in its later stages.

Senator LONG. I think it would. I think it would, if we further cut the capital gains tax, it would raise money for what you want to do.

Representative CONABLE. Senator, your optimism is one of our great national assets.

Senator LONG. Now I will quit. I cannot do better than that.

Senator BYRD. Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Conable, I would just like to ask what you mean by the flexibility involved in structural alternatives. Secretary Miller was just here testifying and he presented some charts and in his charts he shows that in the communications industry, they have been depreciating equipment at about 14.5 years, yet at the same time, the communications industry has had one of the most startling increases in productivity.

I do not know what structural alternatives mean, but are you suggesting that, for instance, we might segregate out certain industries?

Representative CONABLE. I would hate to see us do that, Senator Chafee.

Senator CHAFEE. That is what Congressman Jones indicated.

Representative CONABLE. I would hate to see it. It would greatly complicate a simplifying change in the law. I was not talking about that, I was talking about opportunities to change the curve on depreciation. This is an accelerated depreciation device, easily adjusted as to detail.

The great big revenue loser, of course, is the speedup that occurs with respect to depreciable, nonresidential property.

You could go to an even slower phasein of that if you wanted to save additional money. I would regret that. It would have the tendency to slow construction and one of the greatest opportunities for speeded up construction and new plant facilities comes in the 10 part of the 10-5-3 proposal.

The point is, you can vary either the profile of the accelerated depreciation, or phasein the depreciable property in different ways, and achieve almost any fiscal goal that you want.

Having said that, I would deeply regret our changing the structure of this proposal for fiscal reasons so that we do not achieve a much more rapid writeoff of capital investment than we now have.

I think the great virtue of this is in the resulting economic speedup and we should be willing to take some fiscal risks in order to improve the competitiveness of American industry and the potential for a productivity curve better than our recent economic performance.

Senator CHAFEE. I see.

In any tax legislation that comes forward, obviously this would be looked on as the business side of the equation. There will be something for individuals.

We have had some testimony here from Mr. Hill urging that the taxes on interest and savings be eliminated or greatly reduced, yet that in itself is sort of a capital formation indirectly.

Would that espouse that, or would you put everything into this particular 10-5-3 formula?

Representative CONABLE. I think there should be, because of the impact of inflation on the graduated income tax, some rate adjustments to do some rough indexing of the taxes for individuals.

I must say I am attracted to some of the proposals made in the Senate for a savings package. I would prefer to see us approach the issues of savings account interest, for instance, as a part of a total savings package rather than as an isolated change because I think it would have a distorting impact on the investment patterns of small investors.

One current perception of the American people is that large tax cuts in inflationary times are irresponsible. We had better worry some about trying to design a noninflationary tax cut and, for that reason, it occurs to me that we may very well, in tax cuts for individuals, want to give additional incentives for savings beyond those inherent in rate reductions.

Senator CHAFEE. Thank you.

Senator BYRD. I thank both of you gentlemen. You made a fine contribution to this discussion today.

Thank you very much.

The next witness will be the Honorable Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy.

Mr. Lubick?

STATEMENT OF HON. DONALD C. LUBICK, ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. LUBICK. Mr. Chairman, I would like to comment briefly on the three other pieces of legislation which are the subject of this hearing. I will simply summarize them, and then respond to any questions you may have.

First is S. 1021, which is the bondholder's tax option. Under this bill a 66⅔-percent taxable credit would be given to the holder of a tax-exempt municipal bond who elected to include in his income both the interest received on the bond and the credit. In other words, let's assume a $1,000 tax-exempt bond with a yield of 6 percent. That would produce $60 interest. At the option of the holder of the bond, he could pay tax on the $60 interest. The bondholder would get a $40 credit, which is two-thirds. He would include the $40 in income, which would give him $100 of income, and then take a credit against tax of the $40. Now, obviously, if he is in a tax rate bracket below 40 percent, it would pay him to do that, because the $40 credit would be more than the 40-percent tax on the $100.

Now, the purpose of this is to increase the efficiency of the subsidy to State and local governments. In effect, by having this credit available to holders of municipal bonds, it would provide a stabilizing interest rate because the State and local governments could sell their bonds at 60 percent of the taxable rate on taxable bonds. Today, we find that because of the increase in the number of issues the State and local governments have to market their bonds to the 30-percent bracket. In effect, they have to issue bonds at approximately 70 percent of the taxable rate. This would allow them to market their bonds at an interest rate which would be about 60 percent of the taxable rate.

Now, this would also result in a net savings to the Treasury because the average rate bracket of purchasers of municipal bonds is 42 percent. So while the municipalities are getting only about 30 percent as a subsidy, the Treasury is paying out 42 percent, and the difference is obviously going into the pockets of investors with tax rates above the rate at which the bonds are being targeted. The bonds are being targeted to be effective at a 30-percent bracket, but everyone in a bracket above 30 percent is getting a better return compared to a taxable investment than that required to make the investment profitable. We think that the bondholder's tax option is essentially a good idea. It is similar to the idea we proposed last year of a taxable bond option, except it takes the program out of the appropriations process and puts the option in the hands of the individual investor.

We think the bondholder's tax option would enable municipalities to broaden their market. They would be able to sell to small investors and pension funds that are currently tax exempt. The one serious problem with it is that it would give further incentives to tax-exempt financing for nongovernmental purposes.

Senator LONG. If I may interrupt you for a moment, if you wouldn't speak directly into that mike, I think we could hear you better.

Mr. LUBICK. Right. And we have seen in recent years a great proliferation in the use of tax-exempt bonds for nongovernmental purposes. In 1970, only about 9-percent tax-exempt issues were for nongovernmental purposes. In the first 6 months of 1979, it is estimated that at least 41 percent of all issues are for nongovernmental purposes. Therefore, we reluctantly ask the committee to defer favorable consideration of this proposal because it would in effect insulate the tax-exempt market from a rise in interest rates.

As long as this taxable bond option, whether it be ours or the bondholder's election, is available, the tax-exempt issuers would be insulated from a cost of putting out more and more issues, and that, we think, would undermine the discipline that is necessary to get a hold on the use of tax-exempt financing for nongovernmental expenditures.

At such time as the Congress is able to cut back on the use of tax-exempt financing for nongovernmental functions, then we think the bondholder's tax option is a good approach to the problem of efficient delivery of the subsidy.

Now, do you want me to talk about the other two bills, Senator?

Senator BYRD. Let me ask you a question at that point. Incidentally, I want to say for the record that Senator Danforth is very much interested in this legislation. He would have been here today except that he is in Cambodia.

You started out speaking, I thought, in support of the proposal, but ended up in opposition. Am I correct?

Mr. LUBICK. You are correct. It is a good idea, if we could find some way to limit it to tax-exempt bonds for governmental functions. Unfortunately, we don't think we can do that until we get a control on the proliferation of the use of tax-exempt financing for nongovernmental functions, industrial development bonds, pollution control bonds, and things that are not related to the function of State and local governments.

Senator LONG. Mr. Lubick, do I understand that you are both for and against this proposition? [General laughter.]

Mr. LUBICK. We are for it later, Mr. Chairman, after you have done some very important things to limit its consequences.

Senator BYRD. In nongovernmental tax-exempt bond field, I agree with you and agree with the Treasury Department that something needs to be done in that regard. It seems to me that it has gotten pretty much out of hand. Let me see if I have these figures right. You say that in 1970, 9 percent of all the tax-exempt bonds were in that area, but now it has gone up to, what is it, 41 percent?

Mr. LUBICK. Forty-one percent in the first 6 months of 1979, according to the Public Securities Association figures, but we think they may be understated because many of the very small issues are direct placements rather than going through an underwriting.

Senator BYRD. That is a very dramatic increase.

Mr. LUBICK. It is, and we think that is the core of the problem.

Senator BYRD. Does Treasury have recommendations in that regard?

Mr. LUBICK. Yes; we have made a number of recommendations from time to time which have been generally disregarded.

Senator BYRD. What is the maximum figure that industrial development bonds can be issued?

Mr. LUBICK. I beg your pardon?

Senator BYRD. Isn't there a maximum beyond which the industrial development bonds cannot go in dollars?

Mr. LUBICK. The small issue exemption which is to finance any type of industrial development is $10 million per issue, but if you go beyond that to some of the other purposes, such as the hospital bonds and the pollution control bonds, then there are no limits,

and the mortgage subsidy bonds for home mortgages, as you know, are the subject of some legislation considered in the House, and at the present time those can be issued without limit. Indeed, our forecast is that the revenue loss from continuation of the mortgage subsidy rules as they exist today would be $11 billion in 1984. So these mortagage-subsidy bonds are just growing and growing and mushrooming. The only control today is that as more and more tax-exempt bonds are issued, the interest rates rise, because the cost of issuing them goes up, as the market becomes saturated, and that is some check.

Senator CHAFEE. Mr. Lubick, whose definition for "nongovernmental" are you using? I mean, is housing nongovernmental?

Mr. LUBICK. Well, we have the feeling that low-income housing may very well be at least quasi-governmental, but when you go into providing——

Mr. CHAFEE. Hydroelectric power in Alaska.

Mr. LUBICK. Well, yes; that is one, but single family mortages for $100,000 condominiums, we think that is probably over the line by anyone's definition.

Mr. CHAFEE. Are football stadiums nongovernmental?

Mr. LUBICK. No; I would put football stadiums in the governmental. I think that is traditionally a governmental function. Some people have raised the question around here as to whether they should be authorized or not, but basically, Senator Chafee, there are about six or seven categories of permitted industrial development bonds. We think pollution control is in the nongovernmental area. Most of the others at least bear some relationship to historic State and local governmental——

Senator CHAFEE. I don't want to divert you. I am sure that next year we will spend a lot of time on this whole area. Thank you. I am sorry for interrupting.

Mr. LUBICK. If I might turn to the second bill, S. 1467, which involves a railroad depreciation. This bill would freeze the retirement-replacement-betterment method of depreciation as acceptable for tax purposes. Under the RRB method of depreciation, if I can call it that for short, the original cost of railroad track, for example, is capitalized, and no depreciation is claimed on the original cost. When it is retired, it is written off. When it is replaced, the taxpayer gets a complete writeoff in the year of replacement for his replacement costs less the fair market value of the replaced assets.

In our prepared statement we give an illustration of this method. Assume that rail has an original cost of $25 a ton, and a current value of $40 a ton. It is replaced by new rail of $150 a ton equal quality. The original cost of $25 remains capitalized. The replacement cost of $150 less the $40 realized on the scrap track or $110, is completely expensed in 1 year.

Now, this is a method of accounting that was devised about 100 years ago by State railroad commissions. The theory was that it was essentially a simpler method that arrived at the same result as ratable, for example, straight line depreciation. The theory is that in a mature industry like the railroads, replacements reach a stable amount every year. Therefore, you get the same writeoff whether you expense everything in 1 year or take, for example, one

twenty-fifth of the annual replacements and multiply it by 25 years. You are going to come out the same way.

The problem is that these conditions are no longer true in a period of inflation. The writeoffs get to be substantially more.

Now, so long as this method of accounting is permitted for ICC purposes, the Internal Revenue Service has indicated that it will accept it for tax purposes as well. The ICC is currently considering going off this method of accounting, and this bill would try to preserve this method of accounting only for tax purposes. We think that that is inappropriate for several reasons.

It is our understanding that the railroad industry has been concerned about the effect of switching off this method in that it would cost them significant additional revenues in the year of change. We would like to separate out two questions. We think the question of whether the railroads would be subject to a tax burden is a separate question from the question of whether the accounting method should be maintained. We have indicated in our statement a transition method which we would like to discuss with the railroad industry. This method will relieve them of any immediate tax burden from the switch, but at the same time it would enable us to move off this method of accounting if the ICC takes the railroads off of it. We see no particular reason for leaving a method of accounting for tax purposes that is regarded as unsound for ratemaking purposes for the ICC, as unsound for regulatory purposes for the SEC, and is not usable by the railroads in their own internal bookkeeping. Therefore, we think the solution we have suggested to the revenue loss would be appropriate.

Senator BYRD. You oppose that legislation?

Mr. LUBICK. We oppose the legislation, but we have invited the industry to come to talk with us about ways of working out a method of handling the revenue consequences of transition to a different accounting method.

Now, if I might talk briefly about the final bill, Mr. Chairman, S. 1078, which deals with tax provisions for artists. This bill contains three provisions which we oppose and a fourth provision which deals with carryover basis which we favor. I suggest in the light of the committee's recent action on carryover basis that we might defer consideration of this last provision until we see what the outcome of your proposal in that area is.

The first of the three other provisions which we oppose, would allow the estate of an artist to satisfy his estate tax liability by transferring works of art to the United States. The argument for this proposal is to permit liquidity in—estates. We think that, with the 1976 act, there are a number of provisions in the law now that deal with the liquidity problem. If the concern is the overvaluation of assets in the estate, the Service is currently working on a regulation project to take into account a recent case in the courts. This will give some relief to artists to make sure there is not going to be overvaluation. We think the idea of paying your taxes in kind is one that can't be confined to artists and is just not appropriate. If you have an asset that you have returned on your estate tax return, one might argue that the Government ought to have the option of buying that asset from you at the value you have returned it. We might pick up some very good bargains in that way,

because people would tend to report them at a low basis. However, we simply can't put the Government in the business of buying and selling assets in settlement of tax liabilities.

The second provision of the bill would provide a 30-percent credit against income tax for contributed literary, musical, or artistic compositions. Again, we are dealing with an ordinary income item. For example, if a physician contributes his services to a hospital, he can't take a deduction because he has never included anything in income for these personal services. It is the same with an artist who has done some painting or a composer who has composed a piece of music. If he gets a credit or deduction for contributions of this works, he is, in effect, getting compensation for his services. In 1969 the Congress provided, quite correctly, we think that you are limited in your deduction to the situation that would obtain if you sold the particular composition or artistic work, paid tax on it and contributed the after-tax amount.

Again, if we give a credit for this sort of thing, there is no particular reason to limit it to other types of in-kind contributions of services. In effect, you are subverting the appropriations process. You are allowing the artists to appropriate money through the tax credit for the purchase by the Government of art and for its transfer to others.

Senator BYRD. You are dealing only now with the Federal Government, are you?

Mr. LUBICK. Yes, Mr. Chairman.

Senator BYRD. An artist today can give a work of art to a museum or charity or what have you?

Mr. LUBICK. Under the bill, he could contribute it to any exempt museum, and he would get a credit of 30 percent. In effect, that means that the Government is purchasing the art for 30 percent and then directing it to that particular museum. He has never taken into income anything in respect to his services.

Senator BYRD. Can he not now do that?

Mr. LUBICK. He could contribute it today if he is the artist, but he is limited in his deduction to his actual out-of-pocket cost, the cost of paint and materials, which is very nominal.

Senator BYRD. You can't take the fair market value of——

Mr. LUBICK. That is true of the investor in art, because the art work is a capital asset, but an artist who has created it with his own personal services cannot do that. That is correct. It is the same as the physician contributing his services to work in the hospital.

Senator BYRD. Now, he could do that prior to 1969, as I recall.

Mr. LUBICK. Prior to 1969——

Senator BYRD. And that was changed in 1969?

Mr. LUBICK. He could do that, but it was changed. The 1969 act dealt with a situation where a person could be better off by contributing it than by selling it, because he would actually save more tax dollars by giving it away than he would realize by selling it and paying the tax. The 1969 act dealt with that rather serious tax abuse.

The third aspect of this bill deals with a change in the hobby loss rules. It proposes to change the presumption of hobby loss for artists from the present rule that 2 out of 5 years must be profitable to a rule of 2 out of 10 years. Again, we see no reason for a

special presumption with respect to artists. You could say the same is needed for farmers. It is simply a presumption. If an artist or a farmer can indeed show that a loss not a hobby loss but a genuine trade or business less, he is entitled to his deductions.

Those, in brief, are the positions on the other three pieces of legislation, Mr. Chairman.

Senator BYRD. Thank you very much.

[The prepared statement of Mr. Lubick follows:]

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STATEMENT OF
THE HONORABLE DONALD C. LUBICK
ASSISTANT SECRETARY OF THE TREASURY (TAX POLICY)
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

My testimony today relates to three bills: S. 1021, S. 1078 and S. 1467. I will begin with S. 1021, the bondholder taxable option proposal, introduced by Senator Danforth.

I. BONDHOLDER TAXABLE OPTION (S. 1021)

This innovative proposal would provide a 66 2/3 percent tax credit to the holders of tax-exempt bonds who elect to treat the income from the bonds and the amount of the credit as taxable income. This proposal would accomplish the same results as the taxable bond option proposal recommended by the Administration in 1978. It would promote tax equity, increase the efficiency of Federal tax subsidies to State and local government, and help to stabilize the tax-exempt bond market. Unfortunately, it would--as would our 1978 proposal--also provide greater economic and political incentives to expand the use of the tax-exempt market for nongovernmental purposes. In recent years, the amount of tax-exempt bonds issued for nongovernmental purposes has sharply increased. We believe that it is unwise to enact either a bondholder taxable option or a taxable bond option in this climate. If tighter limits on the use of tax exemption for nongovernmental purposes were imposed, particularly for pollution control facilities and single family housing, we would at once support the adoption of a taxable bond option, either as proposed in 1978 or in the form now proposed in S. 1021.

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Similarities Between S. 1021 and Taxable Bond Option

The taxable bond option ("TBO") would provide for a direct subsidy to a State or local government electing to issue taxable bonds in an amount equal to 40 percent of the interest due on the bonds. The bondholder taxable option of S. 1021 ("BTO"), on the other hand, would provide a 66 2/3 percent tax credit to the holders of tax-exempt bonds who elect to treat the interest and the amount of the credit as taxable. BTO would thus be an option for investors; TBO would be a choice available to State and local governments.

Both TBO and BTO would lower the cost of borrowing to State and local governments. Both proposals would lower the interest rate of tax-exempt bonds from approximately 70 percent to 60 percent of the interest rate on taxable bonds of comparable risk. This change in the relationship between tax-exempt and taxable interest rates will result from market forces. For example, under BTO, investors in marginal tax brackets of less than 40 percent would have an incentive to purchase tax-exempt bonds and claim the credit because it would provide them with a higher after-tax return than taxable bonds at current interest rates.

A taxpayer in the 30 percent marginal tax bracket could, for example, purchase $100 of tax-exempt bonds paying 7 percent interest. By electing BTO, the interest would be taxable. A tax credit of two-thirds of the interest would be available which also would be taxable. The credit would exceed the tax liability resulting from the increased income, increasing the after-tax return for a taxpayer in the 30 percent marginal tax bracket from $7 to $8.17.* If, on the other hand, the taxpayer had purchased a taxable bond for $100 paying 10 percent interest, he would be subject to $3 tax resulting in an after-tax return of $7, or 7 percent. Thus, the demand for tax-exempt bonds would increase, driving up the price of tax-exempt bonds and lowering the tax-exempt interest rates. The market would reach an equilibrium when the tax-exempt interest rate is 40 percent below taxable rates (such as a taxable rate of 10 percent and a tax-exempt

*The taxpayer's total taxable income would be $11.67 ($7 plus $4.67). At the 30 percent marginal tax bracket, his tax liability would be $3.50. He would, however, be entitled to a credit of $4.67, producing a net tax benefit of $1.17 or a total after-tax return of $8.17.

rate of 6 percent); at that point, investors in marginal tax brackets of less than 40 percent would receive the same after-tax return from holding tax-exempt State and local bonds and claiming the credit as from holding taxable corporate bonds.*

Under TBO, States and localities will initially find net interest costs on subsidized taxable bonds (60 percent of the taxable rate) lower than the net interest costs on tax-exempt bonds (approximately 70 percent of the taxable rate). As subsidized taxable bonds replace tax-exempt bonds, the supply of tax-exempt bonds will fall. The price of tax-exempt bonds will rise until tax-exempt interest rates fall to 40 percent below taxable rates. Therefore, TBO and BTO would have the same overall economic effects.

Both TBO and BTO would provide a more efficient subsidy to State and local governments than the current system. The current system is inefficient. Tax-exempt borrowers over the years have benefited from interest rates which on the average have been about 70 percent of taxable rates. Thus, the implicit subsidy of exemption to State and local governments is equivalent to a 30 percent interest rate reduction. Although the average subsidy is 30 percent, a reasonable estimate of the average marginal tax rate of all purchasers of tax-exempt bonds is about 42 percent. In other words, if municipal bond interest income were subject to tax, issuers of this debt would lose a subsidy of 30 percent of the taxable rate and the Treasury would gain revenues equal to about 42 percent of the taxable rate. This means that, with the present stock of tax-exempt debt outstanding, less than 75 percent of the Treasury revenue loss flows to State and local governments. Under both TBO and BTO, the incremental benefit to State and local governments in lower

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*The taxpayer in the 30 percent marginal tax bracket would thus receive $6 of interest from the tax-exempt bond and would be entitled to a tax credit of $4 (2/3 of $6). The additional tax, on the other hand, would be only $3 (30% x $10 taxable income comprised of $6 (interest) + $4 (taxable credit)). The $1 excess of the credit over the tax increases the return on the tax-exempt bond from $6 to $7, the after-tax return from a taxable bond.

BTO would require some system for allowing the IRS to verify that taxpayers claiming the tax credit have in fact received interest entitling them to the credit. The most effective system would be to require issuers to file information returns with the IRS as is presently required for interest on taxable bonds.

interest costs will exceed the increased budget cost to the Federal government, thereby increasing the efficiency of tax exemption as a subsidy. As described below, this improvement is derived from a reduction in the windfall gains to high bracket investors.

TBO and BTO, therefore, would also improve the equity of the tax system. Much of the inequity under current law stems from the high tax-exempt interest rate as compared with the taxable rate. An investor in the 50 percent tax bracket, for example, would be willing to buy tax-exempt bonds as long as the return was just above one-half of that on taxable instruments. Tax-exempt bonds thus have an implicit "tax" resulting from the acceptance by the investor of a lower return than that which is otherwise available. If municipal rates were in fact one-half of taxable rates, tax-exempt bonds would have an implicit tax to the investor in the 50 percent bracket of 50 percent; the implicit tax would equal his marginal tax bracket. As municipal rates rise to 60 percent, 65 percent and 70 percent of the taxable rate, this investor in the 50 percent marginal tax bracket finds that the after-tax return becomes increasingly above that required to induce him to invest. This extra return is purely a windfall gain. Thus, the higher the tax-exempt rate relative to the taxable rate, the greater the windfall gain. By lowering the interest rate on tax-exempt bonds from 70 percent to 60 percent of the taxable interest rate, both TBO and BTO would reduce this inequity by increasing the implicit tax to 40 percent.

Both TBO and BTO would broaden the market for State and local securities by making them potentially attractive to taxpayers in low brackets and to tax-exempt institutions. Under TBO, low bracket investors would be attracted to subsidized taxable bonds issued by State and local governments. Under BTO, low bracket investors would generally select the taxable option. By so broadening the market for State and local debt, both proposals would reduce the volatility of the tax-exempt bond market.

<u>Differences Between S. 1021 and Taxable Bond Option</u>

There are several significant differences between TBO and BTO. Under BTO, unlike TBO, all State and local borrowing would continue to be conducted by issuing tax-exempt bonds and therefore BTO would not alter existing arrangements for marketing State and local debt. Institutions currently involved in underwriting and marketing tax-exempt bonds will not be adversely affected by BTO because the volume of tax-exempt issues will not be reduced.

Under TBO, the subsidy to State and local governments would appear on the expenditure side of the budget. In contrast, BTO would be a tax expenditure; it would be

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recorded as a reduction in tax revenues. As such, BTO might appear to be less subject to review under Executive Branch and Congressional Budget Procedures.

Because of these two differences, States and localities may regard BTO more favorably than TBO. Although Treasury's advocacy of TBO was intended to help State and local governments by making an existing subsidy deeper, more stable, and more efficient, some organizations feared that TBO might be a first step toward elimination of tax-exemption. We have always viewed TBO as a supplement, not a substitute for tax-exemption. While accomplishing the same economic objectives as TBO, BTO may appear less suspect to States and localities because it does not directly affect the institutions that issue tax-exempt bonds and because, as a tax provision, it may appear less subject to future dilution than an expenditure program.

Reasons BTO or TBO Should Not Be Enacted At This Time

Notwithstanding the advantages of these proposals, the Administration does not support enacting either proposal at this time. Our principal concern is that a substantial portion of the increased subsidy would inure to the benefit of private persons and that the increased subsidy would provide further political and economic incentives to even further increase the amount of tax-exempt financing for nongovernmental purposes.

In recent years, the volume of tax-exempt bonds issued for nongovernmental purposes--principally for housing, private hospitals, pollution control and small issue industrial development bonds--has increased sharply as a share of the total tax-exempt market. There are indications that this trend is likely to increase. Just last week the Senate Finance Committee voted to significantly expand the exceptions to the industrial development bond provisions dealing with electric energy and solid waste disposal facilities.

A rough picture of the increased importance of the nongovernmental use of tax-exempt financing is provided by data compiled by the Public Securities Association. The PSA data subdivide new tax-exempt borrowing by purpose. Two of the categories are industrial aid (which includes pollution control bonds and all other industrial development bonds issued for corporations) and social welfare (which includes housing bonds and hospital bonds). These two categories--which include most tax-exempt borrowing for nongovernmental use--have increased, from 9 percent of all new tax-exempt borrowing (excluding refundings) in 1970, to 20 percent in 1972, 28 percent in 1976, 35 percent in 1977 and 41 percent in the first six months of 1979. In addition, there is evidence that PSA data underestimate the recent growth in small issue industrial development bonds because most small issues are direct placements which usually are not reported.

Congress is currently considering legislation to limit the use of tax-exempt bonds for home mortgages which have in part been responsible for this increase. However, this legislation, under consideration since last May, has not been enacted; nor has last year's Administration proposal to eliminate the use of tax-exempt bonds for pollution control facilities. In addition, we have no doubt that imaginative promoters are turning their attention to finding other legal devices to use tax exemption to finance nongovernmental activities. The increase in the subsidy under BTO would encourage this activity as well as making existing opportunities more attractive. It would aggravate the misallocation of limited capital resources which occurs when some industries can borrow at the tax-exempt rate while others cannot. Finally, it would insulate the tax-exempt market from the rise in interest rates which would normally accompany expansion of borrowing in the tax-exempt market. Thus, it may be some time before there is firm and effective legislation limiting tax exemption to governmental purposes or at least constraining the nongovernmental uses of tax-exempt borrowing to an acceptable level.

S. 1021 attempts to deal with the problem of tax exemption for nongovernmental purposes by not allowing the bondholder taxable option for interest received from tax-exempt industrial development bonds. Unfortunately, market forces would defeat the laudable intent of this provision. This provision would not affect the general level of tax-exempt interest rates. Its only effect would be to cause low bracket investors and tax-exempt institutions, who would seek to claim the credit, to concentrate on holdings of public purpose State and local bonds while high bracket investors, who would not claim the credit, would concentrate on holding tax-exempt industrial development bonds. Because the spread between tax-exempt and taxable interest rates would be equal to the subsidy rate provided by BTO, all tax-exempt borrowers, including users of the proceeds of industrial development bonds, would receive the same benefit from BTO.

Conclusion

Treasury reluctantly concludes that BTO should not be enacted at this time. The benefits that would flow to nongovernmental activities, and the encouragement given to expansion of nongovernmental uses of tax exemption, outweigh the benefit which would be derived by State and local governments in financing governmental facilities.

Treasury strongly supports tax-exempt State and local borrowing. We believe, however, that this tax exemption should not be used as a device to provide an indirect Federal subsidy to a wide range of nongovernmental activities, such as pollution control facilities and single family housing.

Treasury believes that the first legislative priority in the area of tax-exempt financing is to control the nongovernmental use of tax-exempt borrowing. Once this has been accomplished, we would support proposals such as S. 1021 or TBO which would contribute to tax equity and provide greater, more efficient Federal support for State and local governments.

II. THE "ARTISTS' TAX EQUITY ACT OF 1979" (S. 1078)

Section (2) of this bill would allow the estate of any artist to meet its liability for estate tax by transferring works of the artist's creation, included in the estate, to an arm of the United States government. The transferee would be required to certify the significance of the work and that it will be held for display to the public, but would not be required to reimburse the Treasury for the estate tax forgiven. Section (3) of the bill would allow a 30 percent credit against income tax liability, subject to certain dollar limitations, for artistic, literary or musical compositions contributed to a government or exempt organization by the individual whose personal efforts created the work. Section (4) would provide that an activity consisting of artistic, literary or musical creation is presumptively carried on for profit if the artist produced a profit in any 2 of 10 consecutive years rather than 2 out of 5 as under present law. Section (5) would provide that art works received by an artist's beneficiaries from the artist's estate would be treated as capital assets notwithstanding their having a carryover basis.

The Treasury is opposed to sections (2) through (4) of the bill. The change that would be achieved by section (5) is supported by Treasury and is included in H.R. 4694, the carryover basis "clean up" bill introduced by Congressman Fisher.

Payment of Estate Tax

Section (2) of the bill, which would allow a credit against tax liability for the full fair market value of art works contributed to the Federal government, is presumably motivated by a desire to alleviate liquidity problems perceived to be faced by artists' estates. The provision perhaps would be defended by its proponents on the ground that, if the Federal government places a value on an art work for estate tax purposes, it should be prepared to accept the work at that value in satisfaction of estate tax liability.

The Tax Reform Act of 1976 mitigated significantly the liquidity problems sometimes faced by authors' and artists' estates. Under that Act, payment of estate taxes may be deferred up to 10 years on a showing of "reasonable cause"--a standard more easily satisfied than the "undue hardship" test of prior law. In addition, professional authors and artists whose estates include significant portions of their literary or art works could qualify for the new "automatic" 15 year deferral of estate tax payment. It is our view that these provisions, together with the "automatic" 10 year deferral of estate tax permitted under prior law, afford adequate relief for illiquid estates.

The perceived need for additional liquidity relief, such as that provided by section (2) of the bill, stems from concern that the inventory of art works in an artist's estate will be overvalued, by being valued either at the sum of their "retail" prices rather than as inventory in the hands of a dealer, or at their undiscounted current value, disregarding the time needed to liquidate the inventory. In this context it is important to note that as a matter of practice the Internal Revenue Service has accepted the decision in Estate of David Smith v. Commissioner, 57 T.C. 650 (1972), aff'd on other grounds, 510 F.2d 479 (2d Cir. 1975), and has initiated a regulation project to consider the application of its current estate tax valuation regulations to artists' estates.

We are strongly opposed to creating a precedent that could significantly impair the efficiency of the government's revenue collecting function by substituting in-kind transfers for cash payments in satisfaction of tax liabilities. There is no logical basis on which a provision such as that contained in section (2) could be limited to works of an artist's creation. Nor do we think that artists should be afforded more favorable treatment with respect to their estate tax liabilities than other taxpayers.

This section does not, however, merely create a precedent that could significantly impair the efficiency of collection of Federal revenues. It also has the effect of subverting the appropriations process. It is the function of Congress to determine the purposes for which funds will be appropriated. Direct appropriations allow aid to be targeted much more carefully to specific groups of people and specific objectives. Direct appropriations also allow coordination among related programs. In contrast, this bill would permit an artist's executor to decide what works of art will be transferred to various governmental arms, to the extent of an artist's estate tax liability. Thus, an artist's executor would have the power to determine how government funds will be spent.

For the foregoing reasons the Treasury opposes section (2).

Charitable Contribution Credit

Section (3) of the bill would allow a 30 percent credit against income tax liability for property consisting of an artistic, literary or musical composition contributed by its creator to the government or an exempt organization. This credit would be in lieu of the charitable deduction. The bill also contains a series of provisions that have the effect of limiting the amount of the credit in any year to the greater of $2,500 or 50 percent of the taxpayer's liability for tax, and in no event may the credit exceed $10,500.

Prior to the Tax Reform Act of 1969, a taxpayer, including an artist, who contributed appreciated property to charity, was entitled to a charitable contribution deduction based on fair market value even though the appreciation was never subject to tax. In many cases, this enabled an individual to obtain a benefit through a charitable contribution that would exceed the after-tax proceeds from a sale. For example, assume an individual in a marginal tax bracket of 70 percent who owns property worth $100 that has a negligible cost. If the property were sold, the individual would owe $70 in tax and would retain $30. If the property were given to charity, the charitable deduction would reduce the donor's taxes by $70, resulting in a $40 increase in after-tax profit on a supposedly charitable transfer. Since this possibility was more evident in the case of property that would result in ordinary income if sold, Congress in 1969 modified the law primarily as to ordinary income property. Capital gain property was generally unaffected except in particular cases--for example, transfers to private foundations.

Works of art are treated as inventory in the hands of the artist and gain on their disposition by the artist is taxed as ordinary income. Thus, the 1969 Act affected the charitable deduction for contributions by artists of their work but not for contributions by investors in art. Under the Act, an artist's income tax deduction for works of the artist's creation contributed to a charity is generally limited to cost. Under this provision an artist donating art works to charity would be in the same position as if the works had been sold and the after-tax proceeds contributed to the charity.

We believe this approach is correct. It is also consistent with the treatment of other income producers. For example, a physician who works a half day in a hospital without pay does not get a charitable contribution deduction. The physician's income is unaffected, just as if he earned $100 for his services and donated a like amount to charity.

We recognize that S. 1078 attempts to meet some of our concerns by providing the artist with a tax credit rather than a deduction and by limiting the dollar amount of the credit. This would equalize the benefit to artists at all income levels and is intended to prevent any artist from obtaining a greater benefit from a charitable transfer than would be available from a sale. However, the latter would be achieved only if the deduction for charitable contributions could be limited to the actual fair market value that could be obtained by sale. The Commissioner's Art Advisory Panel cannot possibly evaluate all transfers for which taxpayers seek charitable deductions.

Moreover, a tax credit is in many ways similar to a direct appropriation. The government is offering 30 cents on the dollar for any art work the artist is willing to transfer to charity. However, a tax credit, unlike a direct payment, is not included in income. Moreover, other government programs to promote the arts already exist. If government aid to the arts is to be increased, it would be better to do so through existing or new programs subject to the appropriations process rather than through tax credits. The Treasury is therefore opposed to section (3) of the bill.

Activities Entered into for Profit

Section (4) of the bill would amend section 183 to extend from 5 to 10 years the period in which to determine whether an activity consisting of artistic, literary or musical creation is presumed to be carried on for profit under section 183(d). We can discern no legitimate reason for providing preferential treatment in this area to artistic, literary or musical activities. We see no justification for providing that if a writer's activities are profitable in 2 out of 10 years, the favorable presumption of section 183(d) is created while a farmer would be entitled to the favorable presumption only if his activities were profitable in 2 out of 5 years. It should also be kept in mind that section 183(d) merely creates a presumption; all relevant facts and circumstances are considered in determining whether a particular taxpayer is engaged in an activity for profit.

The Treasury therefore opposes section (4).

Capital Asset Status

Section (5) would provide that art works received by an artist's beneficiary from the artist's estate would be treated as capital assets notwithstanding their having a carryover basis. Such a provision should be enacted as part of any bill to clean up carryover basis, such as H.R. 4694 introduced by Mr. Fisher.

The Treasury therefore supports section (5).

III. METHODS OF DEPRECIATION - RAILROADS (S. 1467)

S. 1467 deals with methods of depreciation available to railroads. The bill would amend section 167 of the Internal Revenue Code to provide that the retirement-replacement-betterment ("RRB") method of accounting for depreciation is an acceptable method of depreciation for Federal income tax purposes.

Under the RRB method, the original costs of an asset are capitalized, and no ratable depreciation is taken. When the asset is retired, the original costs are written off. If, instead of being retired, the asset is replaced by an asset of similar quality, the original costs remain capitalized, and the costs of replacement (less the fair market value of the asset replaced) are expensed. In addition, a full investment tax credit is allowed, even though the cost is currently deducted. To the extent a "replacement" represents an asset of a better quality than the one being replaced, the costs of replacement, to that extent, are treated as a "betterment" and are capitalized. The method can be illustrated with the following example. Assume that rail with an original cost of $25 per ton (and a current fair market value of $40 per ton), is replaced by new rail of equal quality with a current cost of $150 per ton. The original cost of $25, on which no ratable depreciation has been taken, remains capitalized, and the replacement cost of $150, less the fair market value of the rail being replaced ($40), or $110, is deducted. If, however, the rail is replaced by rail of a better quality at a cost of $200 per ton, the increase in cost of $50 is a betterment and is capitalized.

The RRB method has historically been used by railroads for regulatory, financial and tax purposes, although we understand that five railroads use ratable depreciation for financial statement purposes. Its origin goes back about 100 years when a similar method was adopted by state railroad commissioners. Since the beginning of the income tax in 1913, the method has been used for tax purposes for roadway assets. However, in 1943 the Interstate Commerce Commission (ICC) ordered Class I railroads to change from the RRB method to straight-line depreciation for roadway assets (buildings, bridges, tunnels, etc.) other than roadbed or track. Such change was also made in 1943 for tax purposes with the Technical Amendments Act of 1958 resolving the method of adjustment on the change.

As stated by a number of courts, the RRB method is based on an accounting theory of equalization through the law of averages. The theory of the RRB method is that in a mature industry, such as railroads, annual retirements and replacements of property tend to become uniform in amount each year, and consequently, the deductions under the RRB method will approximate the results if straight-line depreciation were used. For example, if, on the average, a railroad replaces its track every 25 years and, therefore, on the average replaces one twenty-fifth a year, the deduction for depreciation will be the same, on average, under the RRB method and the straight-line method.

That the RRB method has been an acceptable method for tax purposes has been confirmed by numerous court decisions and the Internal Revenue Service's acquiescence in 1960. It is our understanding that the reason the railroad industry is now asking for legislation to codify the method is due to the fact that the ICC is currently reexamining its accounting rules for railroad track property, and the railroads fear that if the ICC changes the method of depreciation from RRB to straight-line, the IRS will similarly disallow RRB.

The railroads obviously are concerned that the denial of RRB depreciation will result in an increased tax burden on the industry. The concern arises in part because ratable depreciation based on the basis of existing book accounts under RRB (which could relate to property acquired many years ago) would likely be less than ratable depreciation based on the current cost of replacement property. However, two issues should be kept separate. First, we should ask ourselves whether it is sound policy to freeze the RRB method for tax purposes when it is no longer used for regulatory or financial purposes. Second, if a change in depreciation practices is warranted except for the increased tax burden that accompanies it, we should consider whether there are better or more logical ways to mitigate that burden.

Thus, we believe Congress should reexamine the RRB method. Although a practice has been accepted over a long period of time, it should be examined periodically to determine if it continues to be appropriate in light of changes in economic conditions and financial practices. Based on such a reexamination, the Treasury Department opposes the enactment of S. 1467 as introduced. The Treasury Department believes that RRB should be discontinued for tax purposes if the ICC disallows it. We can assure you, however, with the concurrence of Commissioner Kurtz, that the Internal Revenue

Service will not mandate any change in depreciation for track until an alternative has been developed and fully explored by this Subcommittee during the 96th Congress. We propose that this bill be revised to provide for an appropriate transition from the RRB method to ratable depreciation should the IRS require the change for tax purposes. The objective of such transitional rules should be the minimization of the revenue cost to the railroads of the change during a transition period.

We believe that the RRB method is not appropriate because 1) it is, in effect, indexing, 2) it is subject to various abuses, 3) if the ICC were no longer to allow it, its continuance would be administratively burdensome, and 4) it does not clearly reflect income.

First, as I previously stated, the courts have historically accepted the RRB method based on the theory that in a mature industry, annual depreciation and the cost of replacement will on average be identical. However, the initial court decisions that accepted the method dealt with taxable years prior to 1943. There is a major distinction between those years and today--namely, inflation. The "law of averages" theory works only in terms of constant dollars. That is, if one twenty-fifth of track is replaced each year, straight-line depreciation of the historical cost of the track in place will be the same as the amount currently spent on track, only if there has been no change in the cost of the track. However, if, for example, the cost of track in the current year is 75 percent greater than the average historical cost of the track in place, an immediate deduction for the cost of the current year's replacement will be 75 percent greater than the deduction based on straight-line depreciation of the track in place. Thus, in a period of inflation, RRB amounts to indexation of depreciation. Regardless of what one concludes about indexing depreciation generally, we submit that indexing depreciation only for a single industry or group of taxpayers cannot be justified.

The second reason for our opposition is that a number of existing or possible abuse situations have come to our attention regarding the use of the RRB method. The IRS is currently considering a situation where a railroad has been purchased at a price that was less than the book value of its gross assets. In this case, at the time of purchase a low amount was allocated to track. Since the taxpayer then elected to use the RRB method, the amount of the purchase price allocated to the track would not be relevant until the track was retired. This is unlike normal purchase situations

where the portion of the purchase price allocated to depreciable assets is relevant in determining the future depreciation deductions. When the RRB method is used, the future depreciation deductions are based on replacements, not the historical cost of track in place. In a separate situation, we understand that in a prospectus it is stated that the company acquiring the subject railroad would use the RRB method and could assign a zero basis to the railroad track. It is clear that in these situations, even assuming constant dollars, the deduction under the RRB method will be much greater than that under straight-line depreciation and is therefore inappropriate since the courts have based allowability of RRB on the theory that deductions under it equal the deductions under straight-line depreciation. Further, such abuse situations will be more difficult to detect if RRB is used solely for tax purposes and the allocations in question are not subject to review by the ICC or independent accountants.

Third, we believe that if the ICC changes the method of depreciating track for regulatory purposes, it would be less of an administrative burden for both taxpayers and the IRS if for tax purposes the method is also changed from the RRB method to a ratable method. Since 1913, the accounting for railroad track has been similar for the ICC and the IRS. At a minimum, a change to ratable depreciation by the ICC and not the IRS would require the keeping of two sets of books. No doubt there would be complaints of excessive paper work if the law imposed the additional burden. Reconciliations between records for ICC and IRS purposes would be difficult and it would certainly make IRS audits more complex and time-consuming. While reconciliation between ICC and IRS computations would still be required if both were to disallow the use of RRB, such reconciliation between straight-line depreciation and double declining balance depreciation would certainly be less of a burden than between straight-line depreciation and RRB. We believe it would be a step backward if you were to allow the continued use of the RRB method if the ICC were to change. In addition, we believe that a change from the RRB method to ratable depreciation would result in fewer tax disputes than now exist. For example, for all other taxpayers there is some natural tension between treating an item (such as repairs) as an ordinary and necessary business expense and treating it as a capital expenditure. While the benefit of the former is a current deduction, the benefit of the latter may be the availability of a 10 percent investment tax credit. When the RRB method is used, taxpayers naturally tend toward treating more items as "capital expenditures" because they obtain both a current deduction with respect to replacements as well as an investment tax credit. Other

existing issues often contested which are peculiar to RRB accounting involve whether an item is a replacement or a betterment and whether salvage value equals fair market value. Maintaining RRB for tax purposes would mean these difficult questions would be resolved only for tax purposes without consideration of their complementary effect for regulatory or financial purposes.

Fourth, we believe that the RRB method does not clearly reflect income. We understand this is the major reason for the ICC's reexamination. It is our understanding that it is common practice in the industry that in years of high revenue, railroads incur high capital expenses and replace higher than average amount of track, whereas in low revenue years railroads replace lower than average amount of track. Such practices are not uncommon in other industries. However, in high revenue years, railroads are able to increase capital expenditures and to immediately reduce their tax liability, while other taxpayers, consistent with the requirement to clearly reflect income, must spread the deductions over the years the assets are used. Thus, railroads have a clear advantage in timing their tax liability over other taxpayers who must use ratable depreciation. While the accounting profession allows the use of RRB as a generally accepted accounting principle, I would like to point out that one can assume that such allowability is based more on the method having been <u>generally accepted</u> over many years rather than that it clearly reflects income.

While we believe that it is no longer appropriate for railroads to use the RRB method, we are not unmindful of transitional problems which could, absent legislation, result in substantial immediate revenue cost to the railroad industry. We therefore propose that S. 1467 be revised to provide for appropriate transitional rules with the objective of minimizing the transitional cost. It seems reasonable to assume that the real question here is the tax burden of the industry and not the theoretical correctness of the RRB method.

A short-term tax increase can arise because in the past the RRB method has resulted in larger depreciation deductions than would have been allowed under ratable depreciation; for example, double declining balance. Normally, in such a situation the larger deductions in the past would be offset by lower deductions in the future. Thus, the taxpayer changing to the new method would not be entitled to as large future deductions for depreciation as a similarly situated taxpayer electing to use double declining balance from the beginning.

However, because of the very unusual circumstances of this case, we do not object to allowing the same deductions to a railroad switching from RRB as would have been allowed as if it had originally used ratable depreciation.

Toward that end, we propose the following as a general framework for transition. As of the beginning of the year of change, the book value of the track would be restated to reflect (a) the original cost of the track actually in place, and (b) the accumulated depreciation to such date that would have resulted had the straight-line method been used. It is our understanding that this is the method that would probably be used for book purposes if the ICC decides that the method should be changed. We would expect to work with the ICC to develop and agree on the detailed methodology to be used in making such restatement with the objective that the same restatement be applicable for both the ICC and for tax purposes. This restatement of the book value of the track assets would result in the allowance of a double deduction since the cost of most of the existing track (except betterments) has previously been deducted under the RRB method. The excess of the cost of the existing track (less accumulated straight-line depreciation) over the capitalized basis under RRB would be deducted again as part of ratable depreciation. A double deduction of this type is common when a method of accounting is changed. To avoid windfalls, section 481 of the Internal Revenue Code provides that the amount duplicated is to be taken into account as an adjustment to taxable income in the year of the change. Normally, to reduce distortions, such adjustment, which in this case would increase taxable income, is taken into account over a ten-year period. However, because of the very unusual circumstances involved, we propose that such adjustment not be taken into income at the time of the change, nor spread over a period of years, but that it be placed in a suspense account, and deferred until a later time; for example, when the taxpayer is no longer in the railroad business. This type of suspense account has been enacted in situations involving reserves for guaranteed debt obligations, accrued vacation pay, paperback and record returns, and discount coupons. In those situations the suspense account was used by Congress to allow the taxpayers to change to a more generous method of accounting without a resulting revenue loss to the Treasury due solely to double deductions in the period of transition. We believe it is appropriate to apply similar principles to the very unusual circumstances here.

With respect to future ratable depreciation, we propose that railroads be allowed the same method as other taxpayers. At present this is the use of the ADR (asset depreciation range) system including accelerated depreciation. Any difference in depreciation between ADR-double declining balance and RRB would be due to the effect of the current levels of inflation. Congress, as indicated by the earlier testimony this morning, will likely consider the possibility of liberalizing depreciation for taxpayers generally. Railroad depreciation practices should certainly be a part of this study. If depreciation is liberalized this may eliminate any revenue cost to the railroads from a change in method. If the effect of inflation is not otherwise mitigated by the adoption of changes in the depreciation system generally, we would consider the use of other benefits, such as additional first-year depreciation, to reduce the cost during the transition period to an acceptable level. Any such benefits would be phased out over the transition period.

We believe that these proposals are both generous and easy to administer. We presented these proposals on September 27 in testimony before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means. We have not as yet had an opportunity to discuss these proposals with representatives of the railroad industry. We believe, however, that with these proposals as a framework, the details could be developed into a legislative proposal to correspond to the similar objectives of the industry and the Treasury.

Senator BYRD. The next witnesses will be a panel of six: Mr. Herbert Liebenson, associate executive director, Small Business Legislative Counsel; Mr. Edwin S. Cohen, chairman, Taxation Committee, U.S. Chamber of Commerce; Mr. Dale Jorgenson, professor of economics, Harvard University; Mr. Ernest S. Christian, Jr., representing the Retail Tax Committee; Mr. Cliff Massa III, vice president, Taxation and Fiscal Policy Department, National Association of Manufacturers, and Mr. Ed Hartman, and Mr. Mark Weinberg, the tax counsel.

The committee will take a 1-minute recess.

[Whereupon, a brief recess was taken.]

Senator BYRD. Also present and available for questions is Mr. Gil Thurm of the National Association of Realtors.

Gentlemen, I understand you each have been notified of the time limitations. Each of you may proceed. Who will be the leadoff witness?

STATEMENTS OF WILLIAM E. HARDMAN, SMALL BUSINESS LEGISLATIVE COUNCIL; EDWIN S. COHEN, CHAIRMAN, TAXATION COMMITTEE, U.S. CHAMBER OF COMMERCE; DALE JORGENSON, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY; ERNEST S. CHRISTIAN, JR., RETAIL TAX COMMITTEE; CLIFF MASSA III, VICE PRESIDENT, TAXATION AND FISCAL POLICY DEPARTMENT, NATIONAL ASSOCIATION OF MANUFACTURERS; MARK WEINBERG, SPECIAL TAX COUNSEL FOR THE SMALL BUSINESS LEGISLATIVE COUNCIL; HERBERT LIEBENSON, ASSOCIATE EXECUTIVE DIRECTOR, SMALL BUSINESS LEGISLATIVE COUNCIL

Mr. HARDMAN. Mr. Chairman, my name is William E. Hardman. I am testifying in place of Mr. Liebenson. I am representing the Small Business Legislative Council and the National Tool, Die & Precision Machining Association. I am the executive vice president of the National Tool Die & Precision Machining Association, an association of 3,000 small businesses who manufacture tooling, dies, precision machine parts, molds, and special machines which are the keystone items of all manufacturing.

With me is Mr. Liebenson, vice president of governmental affairs of the National Small Business Association. NSBA represents over 50,000 small businesses in 1,000 of the 1,200 SIC codes in the United States. Mr. Liebenson is also associate director of the Small Business Legislative Council. The council that we are speaking for today is comprised of 72 trade associations who, with their affiliates, speak for more than 4 million small businessmen, and 46 of these associations have taken a position of support for the concept of depreciation reform and simplification.

The position and a list of those supporting it is attached to my statement.

Also sitting with us, on my right, is the special tax counsel for the Small Business Legislative Counsel, Mr. Mark Weinberg, who is with the firm of Arent, Fox, Kintner, Plotkin & Kahn.

I am grateful for the opportunity to share our thoughts and appreciation. This area is absolutely critical to the survival of small business in America. Basically, what is needed is legislation that will do two things. First, it should encourage business to increase capital investment and thus help close the gap between capital investment in the United States and foreign countries.

Second, since big business is steadily increasing its share of the Nation's economic activity, the legislation should attempt to reverse this disturbing trend toward economic concentration by providing enough stimulus to small business to enable it to regain a reasonable share of the American dream.

Nineteen years ago, small business manufacturers with under $10 million in assets accounted for 20 percent of the total business assets. Now they account for 10 percent. In the same period those U.S. corporations with over $1 billion in assets increased their assets from under 30 percent of total business to over 50 percent of total business assets. Imports into this country have increased dramatically during this period as well, so while the foreign competitors are doing well, and big U.S. corporations are doing well, small business in this country is in big trouble.

Many of our members got into the tool and die business after rising up through the ranks as apprentices. In the earlier days, a person who was willing to work hard could save a little money and start his own business with a reasonable chance of success. Today, 55 percent of the new businesses in the United States fail within the first 5 years.

We have many great toolmakers in the United States. A top toolmaker can easily earn over $30,000, and some gross $40,000, but with the cost of today's machine tool and today's property and buildings, he probably couldn't save enough to enter this business in his lifetime.

Today's American has to face these kinds of odds, odds that are getting worse each year. I am wondering how much longer the Horatio Alger concept of a free enterprise U.S. economy will last. How will minorities and women ever attain their share in American business? No businessman or any reasonable and knowledgeable person questions the need for legislation to encourage increased capital investment in this country. It is common knowledge that the rate of capital investment in this country is significantly below that of most of our industrialized trading competitors.

At the same time, productivity in the United States is showing smaller and smaller gains every year. The two problems of course, are interrelated. The weakest sector in terms of capital investment is in the small business community. The reasons are apparent. Small businesses are at a disadvantage in raising capital before they start. Being small, they can rarely generate enough capital through the issuance of stock or bonds as can their major corporate competitors.

The latter also have access to borrowed capital at the lowest available rates. While a major U.S. corporation can take its pick of money from banks, pension trusts, et cetera, the small competitor must beg and pray to get a loan at a higher rate at its local bank. It is not uncommon today to hear of 18- to 20-percent interest rates for small businesses. They don't have the bargaining power for negotiating capital purchases or negotiating financial arrangements.

Since small business is traditionally very competitive, they don't make sufficient profits to provide adequate investment revenue either. Many competitive disadvantages are major factors in the continuing concentration of economic power in the United States. It is revealed dramatically in effective corporate tax rates. In 1974, for example, taxes for manufacturing firms with over $1 billion in assets amounted to 11.5 percent of their net worth. For firms between $50,000 and $100,000 the effective rate was 30.1 percent, nearly three times the rate.

Unless this trend toward concentration is reversed, the economic power in this country will continue in its inexorable move to the major corporations. The healthy entrepreneurial experiences of our parents and grandparents will never again be experienced by our children and grandchildren. Clearly, the answer is to develop legislation that will counter the unfair competitive disadvantage small business now faces in raising capital.

We are not suggesting that big businesses in this country do not need additional incentives to increase their rate of capital. It

should not be denied that this should concern us. What we are saying is that presently the lowest rate of capital investment is in the small business in this country. Apart from the value of preserving this institution, the best way of increasing the rate of U.S. capital investment is to encourage a significant increase in investment by the small business community. It is not an insignificant fringe benefit that small firms produce 24 times the innovations of large firms per dollar and create two-thirds of all new jobs in our economy. This is according to Neal Smith, chairman of the Small Business Committee.

Senator BYRD. Thank you, Mr. Hardman.

Mr. Cohen.

Mr. COHEN. Thank you, Mr. Chairman. My name is Edwin S. Cohen. I am 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 appear today. I am a member of the law firm of Covington & Burling of Washington, D.C. I am accompanied today by Christine L. Vaughn, who is the director, and Kenneth D. Simonson, who is the tax economist, of the chamber's tax policy center.

The Chamber of Commerce of the United States is the world's largest business federation, comprised of more than 85,000 business firms, 2,600 chambers of commerce in the United States and abroad, and 1,280 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 chamber's 89,000 business and trade association members, we welcome this opportunity to express our support for S. 1435, the Capital Cost Recovery Act of 1979.

The U.S. 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 chamber believes that the present depreciation provisions should be replaced with an effective, equitable, and simple capital-cost-recovery system.

The chamber believes that S. 1435 will increase much needed capital investment. It will improve our lagging productivity. It will permit us to compete more effectively in the world markets. It will redress the significant understatement in present depreciation allowances that fail to reflect the marked increase in cost of replacement due to the ravages of inflation; and it will greatly simplify depreciation allowances to the great advantage of the Internal Revenue Service and business, and particularly so for small business.

Our Federal income tax system for many years has attempted to calculate depreciation allowances by permitting the cost of depreciable property to be written off over the estimated useful life of the property. When Mr. Christian, who is at the table with me, and I were at the Treasury in 1970 and 1971, we helped produce in 1971 the present asset depreciation range (ADR) regulations, which we

think were a marked improvement at the time, but we were working within the restriction of the existing law, which depended upon a forecast of useful life of the asset. It is inherently difficult to look backward at past history to try to forecast the future useful life of structures and equipment, bearing in mind the constant quickening pace of technology, the new emphasis on environmental requirements, increasing competition from foreign countries, the changes in availability of raw materials, and numerous other factors.

As the Secretary said this morning, "the past is not always the mirror of the future," and we think that is particularly so in trying to predict useful life. The chamber firmly believes it is time to amend the statute to abandon the attempt to estimate future useful life of assets and instead enact specific statutory lives to apply across the board to all industries, with a specified allowance in each taxable year in lieu of the complex system of annual allowances now in the code.

Moreover, Mr. Chairman, the existing depreciation system does not take into account the rapidly increasing costs of replacement of existing assets due to inflation. Indexing depreciation to allow for inflation would be complex, particularly for small business. The shorter lives provided in S. 1435 will offset the effects of inflation in a much simpler manner.

For these reasons, Mr. Chairman, among others, the national chamber urges the adoption of S. 1435.

Thank you, sir.

Senator BYRD. Thank you, Mr. Cohen.

Professor Jorgenson?

Mr. JORGENSON. Mr. Chairman, my name is Dale Jorgenson. I am a professor of economics at Harvard. My fields of professional specialization are investment and productivity. I have testified before the Joint Economic Committee and the Senate Budget Committee on the economic impact of investment incentives, and I have testified before this committee, the Senate Finance Committee, on the impact of taxes on energy production.

The purpose of my testimony today is to provide an economic evaluation of Senate bill 1435, the 10-5-3 proposal. For this purpose, I would like to compare 10-5-3 with the present law and with the first-year capital recovery system which is described in more detail in a paper by my Harvard colleague, Alan Auerbach, and myself, which I would like to submit for the record at this time.

Senator BYRD. It will be received.

Mr. JORGENSON. First, the present tax law, which is based on historical cost, has the important advantage that capital consumption allowances, like other business expenses, can be linked to the actual purchases of assets. However, a capital recovery system based on historical cost fails to preserve the necessary link between capital consumption allowances and economic depreciation when there is inflation in the prices of assets.

By contrast, the first-year capital recovery system would meet the problem of inflation directly by permitting taxpayers to deduct the present value of economic depreciation as an expense in arriving at income for tax purposes. Further, the deduction would be allowed in the year in which the asset is acquired. Hence the name, First Year System.

Now, it is very important, Mr. Chairman, to recognize that economic depreciation actually occurs in the years after the asset is originally acquired, so that expensing is not the same thing as cost recovery. Future economic depreciation must be discounted back to the present to arrive at the present value of economic depreciation.

For a factory, which is a relatively long-lived asset, a dollar's worth of investment might have depreciation with a present value of, say, 50 cents, whereas a short-lived asset like a pickup truck, the dollar's worth of investment might have depreciation worth in present value terms something like 75 cents.

The first-year capital recovery system would represent a vast simplification of the current tax law, since the whole capital recovery provision of the tax code could be described by one number for each of 30 classes of assets, say 10 types of structures and 20 types of equipment. Rather than choosing among a range of tax lifetimes and a number of alternative depreciation formulas as outlined by Secretary Miller, taxpayers would simply apply the first-year capital recovery allowance to their current purchases of depreciable plant and equipment. No records of past purchases would be required to substantiate capital consumption allowances.

Needless to say, this would be extremely advantageous for small businesses. It would essentially eliminate the whole public accounting function that is associated with maintaining records for capital recovery.

I would now like to direct your attention to table 3, where I present a comparison of the effective tax rates for each of five representative classes of assets under current tax law, under the 10-5-3 system, and under the first-year capital recovery system.

The most striking feature in these results for the 10-5-3 proposal is that the effective tax rates, which are the tax rates actually paid on the asset taking into account all the provisions of the tax law, would fall far below the statutory tax rates on corporate income of 46 percent.

However, the proposal has the very undesirable feature that for a moderate inflation rate, like 6 percent, which we have experienced relatively recently, the combination of the accelerated depreciation and the investment tax credit would produce negative tax rates for assets such as construction machinery and general industrial equipment.

In effect, the Government would pay taxpayers to hold these assets rather than taxing the income produced by the assets. This is the same point made by Secretary Miller in a different form. Needless to say, the result of the 10-5-3 system would be to increase rather than diminish the present misallocations of the capital stock due to inflation.

As a further basis for comparison between the first-year capital recovery system that I have described and the 10-5-3 system, my associate and I have simulated the U.S. economy with and without the first-year system. We have arrived at the following conclusions:

First, the cost of the first-year capital recovery system would be less than half that of the 10-5-3 proposal in terms of revenue losses. Let me say that contrary to what has been alleged here earlier, the revenue losses that are the basis for this estimate are nearly identical in the material presented by Secretary Miller,

prepared by the Treasury staff, and the simulations done by Alan Sinai for the Committee on Capital Formation.

The second feature of the first-year system is that it would provide 20 to 35 percent more stimulus than the 10-5-3 proposal; less cost, much more stimulus.

Finally, whereas the first-year capital recovery system reduces the bias toward equipment in the present law and away from structures, the 10-5-3 proposal worsens the bias. If you look at the effect of the stimulus to capital formation that results from the adoption of either one of these proposals, it turns out that the bias toward equipment and away from structures would be heightened under the 10-5-3 proposal.

I conclude that the 10-5-3 proposal, although it has the attractive features of stimulating capital formation and providing for more rapid capital recovery, fails on that critical point, that it does not deal directly with the problem of variation in inflation rates which our economy currently confronts.

The 10-5-3 proposal should be rejected by this committee and should be replaced by a proposal to stimulate capital formation and reduce the bias in present tax law based on a first-year capital recovery system that I have described.

Thank you.

Senator BYRD. How do you feel that 10-5-3 could be changed to get away from what you considered the disadvantages of 10-5-3?

Mr. JORGENSON. It is possible to repair 10-5-3 for the simple reason that, like current law, it is based on historical costs. Any system that is based on historical costs of the assets and distributing that cost over time, is going to have its effect attenuated by higher rates of inflation. It is going to yield additional benefits to taxpayers when rates of inflation diminish, as we certainly hope they will in the light of the initiatives taken in the Congress on fiscal policy with the Federal Reserve Board Governors on monetary policy.

As inflation rates diminish, a system like 10-5-3 will produce a bonanza of tax shelters. It will produce a bias toward equipment and away from structures that is better than the bias in the current law.

In short, Mr. Chairman, with historical costs, which is the basis for current tax law and also for the 10-5-3 proposal, it is simply impossible to deal with the problem at hand. The problem at hand is what to do about capital recovery in an inflationary environment.

The first-year capital recovery system is designed to meet that need directly. The way it meets it is to provide all of the capital consumption allowances in the year in which the asset is originally acquired.

In other words, we simply take the economic depreciation that is due on an asset—which varies with the lifetime of the asset. We discount it back to the present and we give it to the taxpayer as a deduction in the same year.

There is no possibility that the dollars that the taxpayer receives as a deduction can deteriorate in value as a result of inflation.

The first-year capital recovery system is essentially a solution to the problem of inflation. It provides greater stimulus to capital formation than the 10-5-3 proposal at less than half the cost.

Senator BYRD. You would expense everything in 1 year?

Mr. JORGENSON. Yes; in present value terms, that would be, for example, 50 cents on a dollar's worth of investments in a factory which is a long-lived asset, 75 cents on a dollar's worth of asset, like a short-lived asset.

The whole capital recovery scheme I am describing can be represented by 30 numbers—10 for structures, 20 for equipment.

You could eliminate pages and pages of the Internal Revenue Code and replace it by those 30 numbers.

The taxpayers would take those 30 numbers and simply apply them to their current expenditures on depreciable assets. They would then receive a deduction that would depend on the present value of a dollar's worth of depreciation multiplied by the number of dollars in the year in which they acquire the asset.

Then the Government and the taxpayer would be finished with the whole process. Capital recovery would have been achieved; capital formation would have been stimulated. The bias toward equipment and away from structures in the current system would be eliminated and we would essentially have a system in which we would get the maximum impact from the higher rate of capital formation that would result in terms of the things that really matter, namely, productivity growth and economic growth.

Senator BYRD. Mr. Cohen, would you care to comment on that?

Mr. COHEN. Mr. Chairman, I have a great respect for Dr. Jorgensen and I have listened to him many times. This is the first I have known of this proposal.

I see advantages in having the entire allowance in the first year. I am somewhat concerned about how the lives would be determined.

I said earlier that this is one of the basic problems of the existing system. In 1962, the lives were set by guidelines obtained largely from questionnaires filled out and sent in by companies as to the lives they were using in their tax returns, not the lives that actually existed or the lives that were agreed upon after the revenue agents had audited the returns. In 1971, we used those guidelines in providing the asset depreciation range, with a 20-percent leeway.

I think we have a problem. Instead of three classes of assets, I take it that under Professor Jorgenson's proposal we would have 30 classes, with someone having the responsibility of setting those lives. I do not know who will make that determination, or how it will be made.

Second, I am concerned about how one figures the discount rate. I assume that you have to make some interest rate assumption. I do not know who would fix that discount rate.

Mr. JORGENSON. May I comment on those points made by the preceding speaker?

Senator BYRD. Yes.

Mr. JORGENSON. The Treasury has recently completed a study that demonstrates that it is possible to dispense with the useful life concept as proposed by the advocates of 10-5-3 and replace it by a

concept in which the determination of depreciation is based directly on observations of asset prices.

After all, depreciation is simply the reduction in the value of an asset with age. What you have to do is observe the profile of asset prices directly, calculate those deductions and, as I say, discount them to the present.

It has been proved to be feasible to do exactly that. Treasury has demonstrated that that approach can be used to replace the present system of useful lives. Furthermore, the system can be summarized in terms, as I say, assumptions about the capital recovery provisions in present value terms that would be appropriate for 10 classes of structures and 20 classes of equipment.

We are talking about 30 numbers. The 10–5–3 system would, itself, require 18 numbers, the capital consumption provisions for each of those classes of assets. Therefore the proposal I have described is just as simple in the sense it can be described just as concisely.

Furthermore, it does not impose upon the taxpayer the necessity of keeping vintage capital accounts of this sort contemplated in the ADR system.

It gets rid of this burden on the taxpayer.

Former Secretary Cohen has asked the question, who would make the determination of what the capital recovery rates would be? The answer to that is very simple. It would be done as at present in the organization in the Treasury established by the ADR system called the Office of Industrial Economics. They have proved to be capable of doing the calculations that I have described. These calculations are the basis for the study I referred to carried out before the Treasury.

As far as discount rate is concerned, the fact is, over this past half-quarter century since the end of World War II, many measurements have been made of what the real rate of return is in this economy. It turns out to be essentialy unaffected by the rate of inflation.

The number that we would use is something like 4 percent. That number represents the after-tax rate of return. We would apply this rate to the capital recovery which is calculated from the asset prices, discount that back to the present and give it to the taxpayer in the form of a deduction.

It is a simple system. It would result in the elimination of enormous numbers of accounting records and reduce the administrative burden on the Treasury.

That is the important thing. Instead of having requiring the Treasury to administer this cumbersome ADR system, where they are supposed to be examining the records of the taxpayer to find out the useful lives actually are. We would replace this by a system of information based on the asset prices themselves. Simply discount depreciation back to the present, write the 30 numbers into the law, and give the Treasury the task of reporting back in 5 years to find out what asset prices are at that time.

That is something they can do. It would reduce their costs and it would essentially reduce the burden, both on the Treasury and the taxpayer.

Senator BYRD. Thank you.

STATEMENT OF MARK B. WEINBERG, SMALL BUSINESS LEGISLATIVE COUNCIL

Mr. WEINBERG. Mr. Chairman, in response to your earlier question about what sorts of modifications might be made to 10-5-3, to make it more productive for all segments of the business community, the Small Business Legislative Council wishes to propose the placement of limitations upon the amount of class 1 and class 2—which after amendment should include class 3—investment.

Our calculations indicate over 99 percent of the business enterprises in this country would be fully covered by the class 2 and class 3 benefits of this bill, if qualified investment in such assets were limited limited to $1 million per year.

Since this would definitely target the benefit of this proposal to small business enterprises, the Small Business Legislative Council has given this careful consideration and hopes your committee will do the same.

Senator BYRD. Thank you.

I thank each member of the panel for being with us this morning. Those witnesses who have not spoken, their statement will be published in the record.

[The prepared statements of the preceding panel follow:]

STATEMENT OF

WILLIAM E. HARDMAN

ON BEHALF OF

THE SMALL BUSINESS LEGISLATIVE COUNCIL

AND

NATIONAL TOOL, DIE & PRECISION MACHINING ASSOCIATION

Mr. Chairman and Members of the Committee:

Good morning. My name is William E. Hardman. I am Executive Vice President of National Tool, Die and Precision Machining Association, an association of 3,000 small businesses who manufacture tooling, dies, precision machined parts, molds and special machines. With me is Mr. Herb Liebenson, Vice President, Governmental Affairs with the National Small Business Association. NSBA represents over 50,0(small businesses in 1,000 of 1,200 S I C codes in the United States. Mr. Liebenson is also Associate Executive Director of the Small Business Legislative Council. The Council is comprised of 72 trade associations who, with their affiliates, speak for more than 4 million small businesses. 46 of these associations have taken a position that supports the concept of depreciation reform and simplification. The position and a list of those supporting it is attached to our testimony. Also sitting with us is the special tax counsel for the Small Business Legislative Council, Mark Weinberg, who will discuss technical aspects. Mr. Weinberg was formerly an attorney advisor with the Office of the Chief Counsel of the IRS and is now with the Washington Law Firm of Arent, Fox, Kintner, Plotkin and Kahn.

I am grateful for the opportunity to share our thoughts on depreciation. This area is absolutely critical to the survival of small business in America. Basically what is needed is legislation that will do two things. First, it should encourage business to increase capital investment and thus help close the gap between capital investment in the U. S. and foreign countries. Second, since big business is steadily increasing its share of the Nation's economic activity, the legislation should attempt to reverse the disturbing trend towards economic concentration by providing enough stimulus to small business to enable it to regain a reasonable share of the American dream.

Nineteen years ago, small business manufacturers with under $10 million n assets accounted for 20% of the total business assets. Now they account for 10%. In the same period those U. S. corporations with over $1 billion in assets increased their assets from under 30% of total business assets to over 50% of total business assets.[1] Imports into this country have increased dramatically during this period as well. So while the foreign competitors are doing well and big U. S. corporations are doing well, small business in this country is in trouble.

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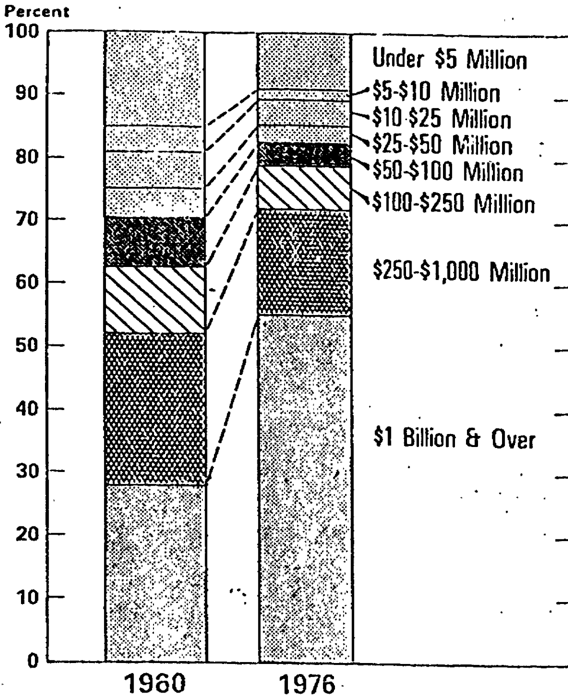
[1]Future of Small Business in America, Committee on Small Business, U. S. House of Representatives, November 9, 1978, page 44

Concentration of Total Assets for Manufacturing Corporations, 1960 and 1976



Many of our members got into the tool and die business after rising up through the ranks as apprentices. In earlier days a person who was willing to work hard could save a little money and start his own business with a reasonable chance of success. Today 55% of new businesses in the U. S. fail within the first five years.[*]

We have some great toolmakers in this industry. A top toolmaker can easily earn over $30,000, and some gross $40,000. But with the cost of today's machine tools and today's property and buildings, he probably couldn't save enough to enter this business in his lifetime. When today's American has to face these kind of odds, odds that are getting worse each year, how much longer do you think the Horatio Alger concept of a free enterprise United States economy will last? How will minorities and women ever attain their share in American business?

No businessman nor any reasonable and knowledgeable person questions the need for legislation to encourage increased capital investment in this country. It is common knowledge that the rate of capital investment in this country is significantly below that of most of our industrialized trading competitors. At the same time, productivity in the U. S. is showing smaller and smaller gains every year. The two problems, of course, are interrelated. The weakest sector in terms of capital investment is in the small business community.

[1]Future of Small Business in America, Committee on Small Business U. S. House of Representatives, November 9, 1978, page 44.

[2]Future of Small Business in America, Committee on Small Business U. S. House of Representatives, November 9, 1978, page 8.

The reasons are apparent. Small businesses are at a disadvantage in raising capital before they start. Being small they can rarely generate capital through the issuance of stock, or bonds, as can their major corporate competitors. The latter also have access to borrowed capital at the lowest available rates. While a major U. S. corporation can take its pick of money from banks, pension trusts, etc. its smaller competitor must plea and pray to get a loan at a higher rate from its local bank. It is not uncommon today to hear of 18-20% interest rates for small businesses. They don't have the bargaining power in negotiating capital purchases or in negotiating financial arrangements. Since small business is traditionally very competitive, they don't make sufficient profits to provide adequate investment revenue either.

The many competitive disadvantages are major factors in the continuing concentration of economic power in the U. S. It is revealed dramatically in effective corporate tax rates. In 1974 for example, taxes for manufacturing firms with over $1 billion in assets amounted to 11.5% of their net worth. For firms between $50,000 and $100,000, the effective rate was 30.1%, nearly three times the rate. Unless this trend towards concentration is reversed, the economic power in this country will continue its inexorable move to the major corporations. The healthy entrepreneurial experiences of our parents and grandparents will never again be experienced by our children or grandchildren.

CHART 2

RELATIVE TAX BURDENS, U. S. MANUFACTURING CORPORATIONS AND U. S. CORPORATIONS

Size of Business Receipts (x $1,000)	Taxes as a Percentage of Net Worth			
	All Manufacturing Corporations		All U.S. Corporations	
	1969	1974	1969	1974
50 - 100	18.3	30.1	10.5	13.3
100 - 500	14.8	23.5	12.4	16.7
500 - 1,000	15.4	21.3	12.6	16.2
1,000 - 5,000	16.6	19.9	12.6	15.0
10,000 - 50,000	14.7	16.9	10.2	11.8
50,000 - 100,000	13.7	13.6	8.9	9.4
over 1,000,000	11.8	11.5	11.6	10.4

SOURCE: U. S. Small Business Administration

Clearly, the answer is to develop legislation that will counter the unfair competitive disadvantage small business now faces in raising capital. We are not suggesting that the big businesses in this country do not need additional incentives to increase their rate of capital investment. They should not be denied additional incentives. What we are saying is that presently the lowest rate of capital investment is in the small businesses in this country. Apart from the value of preserving this institution, the best way of increasing the rate of U. S. capital investment is to encourage a significant increase in investment by the small business community. It is not an insignificant fringe benefit that small firms produce 24 times the innovations of large firms per dollar and create 2/3 of all new jobs in our economy, according to Neal Smith, Chairman of the House Small Business Committee.[1]

Gentlemen, we were initially very encouraged when we were approached by the U. S. Chamber of Commerce et al., earlier this year with a summary of a tax proposal later to be introduced as S 1435 and HR 4646. We were a little bit disturbed when we were asked to give our immediate support for a very brief summary without being provided a copy of the proposed language.

When we finally did get the language and evaluated it, we realized what was happening. To put it bluntly, the small business community was being taken for a ride on a piece of legislation authored by representatives of the major corporate powers in this country.

[1] quoted from a National Science Foundation study

Assuming all businesses increase investment at the same rate as a result of S 1435, one-tenth of one percent of the companies in the U. S. would get 60% of the benefits. All the small businesses in the U. S., 98.7% of the total companies, would receive less than 25%. But this is an optimistic assumption for small businesses never have had the access to capital that big business has enjoyed. More realistically, the nation's 4 million small businesses, 99% of all U.S. enterprises, would probably end up with less than 20% of the benefits. Maybe much less. (See chart, page 9).

Clearly this is unfair. It would be difficult to write a tax bill better designed to speed the extinction of small businesses. It would mean more expansion of big business into all facets of the small business community. The small shoe store owner, the independent grocer, and all the other independent retailers would find themselves surrounded by retail chains opened up or expanded as a result of S 1435. It would mean the same thing in our industry. Economic studies show that the independent tool and die shops can presently produce tooling for major clients cheaper than they can do it themselves.[1] But this bill would mean new captive tool shops in most major corporations, destroying our healthy and competitive small business industry.

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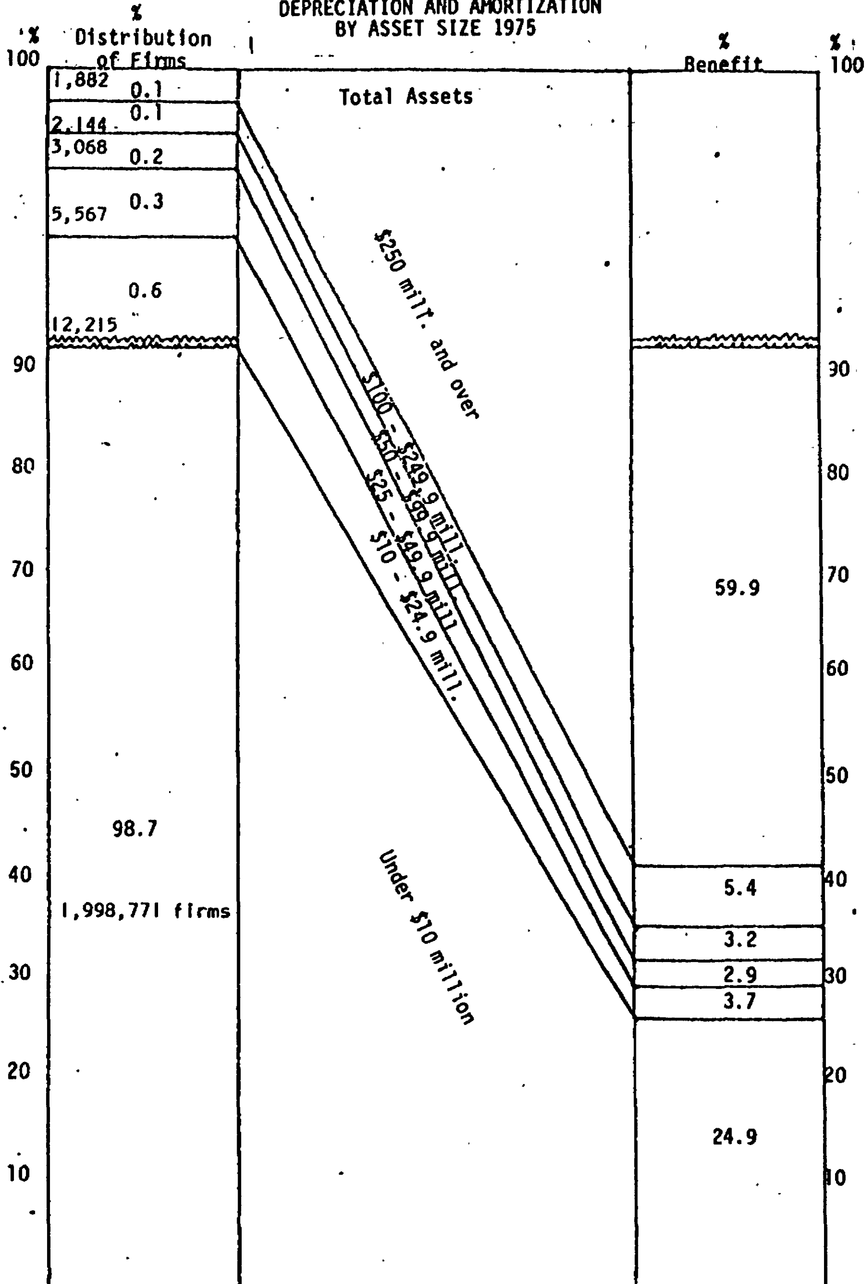
[1] The Tool and Die Industry Problems and Prospects, Michigan Business Reports, University of Michigan, 1975.


DEPRECIATION AND AMORTIZATION
BY ASSET SIZE 1975
%
Distribution of Firms
%
Benefit
%
100
90
80
70
60
50
40
30
20
10
1,882
0.1
2,144
0.1
3,068
0.2
5,567
0.3
0.6
12,215
98.7
1,998,771 firms
2,023,647
Total Assets
$250 mill. and over
$100 - $249.9 mill.
$50 - $99.9 mill.
$25 - $49.9 mill.
$10 - $24.9 mill.
Under $10 million
59.9
5.4
3.2
2.9
3.7
24.9
0.7% of firms receive 71.4% of benefits

Its costs are clearly too high anyway. Estimates abound but the most recent by the Library of Congress predicts a $75-85 billion revenue loss during the bills seventh year. We haven't seen all the figures but they could easily total $300 billion over seven years after phase in. On top of getting few of the benefits, small businesses would be hurt the most by the resulting inflation.

There is a solution that's fair to small business, fair to big business, and which would reduce the revenue loss to levels acceptable to the Congress and appropriate for the economy. The solution is to use ceilings or caps on the amounts of depreciation which can be taken annually. Amounts in excess would be depreciated under the current schedule. The caps could be adjusted to produce the revenue loss most appropriate to the economic and legislative environment at the time of enactment. Large and small companies would get the same benefits. Small companies would have to deal with one depreciation schedule only. The large companies would utilize the full benefits. They are sophisticated enough to deal with two depreciation schedules. Such an approach to the control of revenue costs is neither new nor unique. S 110, introduced by Senator Nelson, provides straight line depreciation over 36 months on business property and includes a $25,000 cap. It's a good bill and the revenue loss it would create would be modest. Such a proposal is the product of a realistic man and the Senator should be praised for his initiative.

We also suggest several other changes! The phase-in offered in S 1435 is similar and in many ways as complex as the A.D.R., a tax technique not often used by small business due to its complexity. This would make it difficult for small businesses to use the proposed benefits anyway. If the cost of S 1435 were reduced to a reasonable level, a phase-in would not be necessary.

Another simplification would be to use a four year accelerated depreciation schedule for all machinery, equipment, furnishings, autos and light trucks. This, combined with a 10% investment tax credit, would be simpler and provide improved benefits for all. It eliminates an additional schedule and one of two investment tax credit rates. Our "10-4" approach is fair to all and offers several other advantages as well. First of all, it would focus the help on the segment of American business that needs additional capital investment the most. Thus the increases in small business capital investment would greatly increase the average rate for the entire country. Secondly, the benefits would go to the segment of the business community which creates the jobs. A study done by the House Committee on Small Business even surprised us when the results showed small business creates 66 new jobs for every new job created by big business.[1] That's a 66 to 1 ratio. Despite their small share of the U. S. economic pie, small businesses still create 2/3 of all new jobs in the U. S.[2] And new jobs mean lower unemployment and more tax revenue.

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[1] Future of Small Business in America, Committee on Small Business, U. S. House of Representatives, November 9, 1978, p.8

[2] U. S. Department of Commerce.

Third, small business is the country's innovator. The National Science Foundation revealed that while 31 large firms spend an astounding 60% of all U. S. research expenditures, small firms produce 24 times more innovations per R & D dollar expended.[1] Those innovations mean new products for this country and/or greater productivity.

What is the cost of our suggestion? That is up to you. You can make them anything you want by setting the ceiling. Obviously, the costs would have to be much less than those of S 1435. Once there is some consensus of the true cost of that proposal, you can begin there. But take for example an assumption where the phased-in cost of S 1435 has a cost of $30 billion at the end of its phase-in, which probably is conservative. Let's say you allowed $1 million of depreciation under the accelerated schedule. Not many businesses under $10 million in assets invest $1 million per year. In 1975, firms of under $10 million in assets accounted for only 24.9% of total business assets although they comprise 98.7% of all U. S. businesses.

Since the depreciation is directly related to assets, you would be talking about reducing the cost of S 1435 by 3/4 to about $7.5 billion dollars. This figure is a much more realistic revenue loss for this committee, the rest of Congress and the Administration. You are giving 98.7% of the business community more benefits than they can use and the remaining 1.3% a very generous and beneficial incentive.

[1] National Science Foundation, as quoted by Congressman John J. LaFalce, October 12, 1979 (Release from House Committee on Small Business).

We think we are being realistic. We have made our suggestions before, going back to the week before the first bill was introduced. Our comments were well received by the House Small Business Subcommittee on Access to Equity Capital and Business Opportunities, chaired by Representative Henry J. Nowak of New York. It is our understanding that the Chairman is putting together a committee report which will investigate in depth the many problems small businesses have in the capital formation process and specifically with depreciation.

If Congress and organizations are truly interested in the future of small business in America, we think that it would be in everyone's interest to work out a solution amenable to all.

Thank you.

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October 19, 1979

The position paper -- Capital Investment Recovery -- is supported, as of this date, by 46 members of the Small Business Legislative Council:

American Association of Nurserymen
Washington, D.C.

American Textile Machinery Association
Washington, D.C.

Association of Independent Corrugated Converters
Washington, D.C.

Association of Physical Fitness Centers
Bethesda, Maryland

Automotive Warehouse Distributors Association
Kansas City, Missouri

Building Service Contractors Association
McLean, Virginia

Christian Booksellers Association
Colorado Springs, Colorado

Eastern Manufacturers & Importers Exhibit, Inc.
New York, New York

Direct Selling Association
Washington, D.C.

Electronic Representatives Association
Chicago, Illinois

International Business Association of Michigan
Kalamazoo, Michigan

Independent Business Association of Washington
Bellevue, Washington

Independent Sewing Machine Dealers of America, Inc.
Hilliard, Ohio

Institute of Certified Business Counselors
Lafayette, California

International Franchise Association
Washington, D.C.

Local and Short Haul Carriers National Conference
Washington, D.C.

Manufacturers Agents National Association
Irvine, California

Menswear Retailers of America
Washington, D.C.

National Association of Brick Distributors
McLean, Virginia

*Of the National Small Business Association

National Association of Floor
Covering Distributors
Chicago, Illinois

National Association of Plastics
Distributors
Jaffrey Center, New Hampshire

National Association of Plastic
Fabricators
Washington, D.C.

National Association of Retail Druggists
Washington, D.C.

National Beer Wholesalers Association
of America, Inc.
Falls Church, Virginia

National Burglar & Fire Alarm
Association
Washington, D.C.

National Candy Wholesalers
Association, Inc.
Washington, D.C.

National Coffee Service Association
Chicago, Illinois

National Concrete Masonry Association
Herndon, Virginia

National Electrical Contractors
Association, Inc.
Washington, D.C.

National Home Furnishings Association
Washington, D.C.

National Home Improvement Council
Washington, D.C.

National Independent Dairies Association
Washington, D.C.

National Office Machine Dealers
Association, Inc.
Zanesville, Ohio

National Office Products Association
Alexandria, Virginia

National Parking Association
Washington, D.C.

National Patent Council
Arlington, Virginia

National Pest Control Association
Vienna, Virginia

National Precast Concrete Association
Indianapolis, Indiana

National Small Business Association
Washington, D.C.

National Society of Public Accountants
Washington, D.C.

National Tire Dealers and Retreaders
Association
Washington, D.C.

National Tool, Die and Precision
Machining Association
Washington, D.C.

National Tour Brokers Association
Lexington, Kentucky

National Wine Distributors Association
Chicago, Illinois

Power & Communication Contractors
Association
Washington, D.C.

Sheet Metal & Air Conditioning
Contractors' National Association

CAPITAL INVESTMENT RECOVERY

Small business has seen its role in the U.S. economy dwindle for decades. Much of the reason for its decline lies in its inability to get the capital to be able to compete with large business in this country. The corporate giants, meanwhile, have access to the capital they need at the lowest available rates. They continue to increase their share of the Gross National Product at the expense of small business.

This competitive country must redirect its economic structure to return to the principles of private enterprise upon which it was founded. At the rate we are going there will soon be no small business in America. The American dream of starting one's own business and making it a success will be nothing more than a dream. No one man or woman will be able to come close to competing with the major corporations.

The U.S. Congress can help restore the American dream by passing legislation facilitating the recovery of capital. But it must be of genuine help for the small business and not a tool for big business to continue to take over and freeze out small business as it has been doing for years. The corporate giants, with their easy access to capital at the lowest rates, would use any legislation to accelerate expansion to the disadvantage of small business if there is not a ceiling on the benefits. The small retailer would get little joy from his newly won benefits if he found a major corporate chain was using them to open a store next door. This would happen without a ceiling. The small manufacturer would find the same thing. Whatever he was able to invest in new productive equipment would be more than matched by the well-heeled giant that had been running him out of business anyway. In some industries, major corporations who presently subcontract would find it a greater advantage to manufacture themselves should legislation without a ceiling be passed.

Any tax bill accelerating depreciation should provide a 10% investment tax credit for all equipment, machinery, and furnishings. It would allow them to be depreciated over four years. This type of capital investment could be depreciated as much as four or five times faster than presently allowed. These breaks would be targeted to small business by limiting to $1 million the amount of total investment in equipment, machinery and furnishings upon which accelerated depreciation would be allowed.

Buildings and fixtures would also be depreciated much faster. These types of investments could be written off in 10 years. This type of investment could be depreciated as much as six times faster than under present rules. This break would also be targeted to small business by limiting to $1 million per year the amount of investment in buildings and fixtures upon which accelerated depreciation would be allowed.

Over 97-1/2% of all U.S. companies would be able to use this legislation to full advantage. Most of the remaining 2-1/2% of companies, which account for 79% of the investment in this country, could use it up to the ceiling amounts. Thus this bill both would help small business and significantly reduce the revenue loss that would occur if there were no ceilings on benefits.

RESOLVED

Increased capital investment by small business is essential if this basic American institution is to survive and prosper. SBLC endorses legislation that will encourage increased capital investment by small businesses. The combined effect of more rapid depreciation and increased investment tax credit will assure small business a greater return on its investment in such capital, thereby making small business more profitable, and better able to compete in all markets.

STATEMENT
on
S.1435--"CAPITAL COST RECOVERY ACT OF 1979"
before the
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
of the
SENATE COMMITTEE ON FINANCE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
Edwin S. Cohen
October 22, 1979

My name is Edwin S. Cohen. I am 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 & Burling, of Washington, D.C., and I am accompanied today by Christine L. Vaughn, Director, and Kenneth D. Simonson, Tax Economist, of the Chamber's Tax Policy Center.

The Chamber of Commerce of the United States is the world's largest business federation, comprised of more than 85,000 business firms, 2,600 chambers of commerce in the United States and abroad, and 1,280 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 Chamber's 89,000 business and trade association members, we welcome this opportunity to express our support for S.1435, the "Capital Cost Recovery Act of 1979."

SUMMARY

The U.S. 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 Chamber believes that the present depreciation provisions should be replaced with an efficient, equitable and simple capital cost recovery system.

S.1435

The capital cost recovery system proposed in S.1435 has been designed to respond to the needs of the entire business community for depreciation reform, and if adopted, will encourage economic growth and modernization through increased capital investment and expanded employment opportunities.

The Capital Cost Recovery Act of 1979 will streamline and simplify the depreciation of buildings and equipment, by divorcing the recovery period for capital assets from the concept of useful lives and by assigning assets to three classes for depreciation over 10, 5, or 3 year periods. This "10-5-3" proposal will provide more rapid capital recovery, and will substanitally reduce the burden and expense of tax compliance by eliminating many complex provisions of existing law. Key features of S.1435 are discussed in an appendix to this statement.

THE NEED FOR DEPRECIATION REFORM

Liberalized depreciation will increase capital investment and improve productivity. In addition, adopting a capital cost recovery system will redress the significant understatement in present depreciation allowances relative to the cost of replacing capital assets that has resulted from inflation. Finally, simplifying present depreciation requirements will permit small businesses to make greater use of accelerated cost recovery.

Capital Formation Needs

The 1979 Economic Report of the President states that in the years ahead a strong rise in business fixed investment will be required to achieve sustained economic growth and a decline in unemployment. Substantial growth in our stock of capital will also be needed to expand our capacity to produce. Only by devoting a significant share of current production to replace, modernize, and expand the stock of capital in this country can we hope to achieve adequate growth in productivity.

But 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. From 1965 to 1973, this rate declined to 2.0 percent, and since 1973 productivity growth has averaged less than one percent per year. In 1979, productivity has actually fallen. 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 averages 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, 1966-1970	
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

More rapid capital cost recovery under the "10-5-3" system will raise the rate of return on investment in fixed assets and encourage more capital formation. With more capital in place, American workers will become more productive, raising the standard of living in this country and making American business more competitive in world markets.

The Concept of "Useful Lives"

Our federal income tax system for many years has attempted to calculate depreciation allowances for each taxpayer by permitting the cost or other basis of depreciable property to be written off over the estimated useful life of the property. This has necessitated a determination, at the time an asset is purchased or constructed, of the estimated useful life that it will have in the hands of the taxpayer. There is obviously no way to determine in advance the future length of life of buildings and equipment, and accordingly we have gone through various methods of estimating those lives.

At one time the Internal Revenue Service produced in Bulletin F a list of 10,000 types of assets with a life for each that was ordinarily acceptable to the Service, but Bulletin F soon became outmoded. Later, the Service in 1962 reduced the number of categories substantially, grouping assets by broad industry or by asset type, with "guideline lives" listed for each category. The determination of useful life, however, could still depend upon all the facts and circumstances of the particular case. In 1971 the Treasury and the Service amended the income tax regulations to institute an Asset Depreciation Range (ADR) system, which recognizes that the attempt to predict the future useful life of property is difficult and uncertain, and thus allows each taxpayer to choose a life that is within a range 20 percent higher or 20 percent lower than a guideline life. The ADR system represents a substantial improvement in depreciation, but one that is limited by the fact that it was designed as a regulation interpreting an existing statute that required depreciation to be measured by estimated useful life.

While ADR gives recognition to the obvious fact that future useful life is extremely difficult to predict, it cannot, without a change in the statute, eliminate the problems that necessarily flow from reliance on the useful life concept. Useful life has been estimated by trying to collect data as to past experience regarding the average length of time particular industries have used their assets and then assuming this experience will continue in the future. But changes in technology, in environmental requirements, in competition from foreign countries, in availability of raw materials and a myriad of other factors occur with an ever accelerating pace, making the experience of the 1960's and 1970's an unreliable base upon which to judge the future life of assets to be built or bought during the 1980's. The federal income tax should take into account the substantial possibility that useful lives in the future may, for a variety of reasons, be shorter than they have been in the past.

Effects of Inflation

Our existing depreciation rules permit write-off only of the actual cost of an asset, and do not take into account rapidly increasing costs of replacements. As plant and equipment wear out or become outmoded, they must be replaced by new assets that inevitably are more expensive because of the ravages of inflation. According to Department of Commerce estimates,

depreciation allowances for all fixed assets except residential structures were over $16 billion short of replacement costs in 1977, and $19 billion short in 1978. Private economists place the disparity 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 to corporations on existing plant and equipment by over $39 billion in 1977. While some have suggested that an "indexing" system be applied to depreciation to allow for inflation in replacement costs, indexing of depreciation involves numerous difficulties, notably complexity in calculation, and especially so for small business. Since depreciation is at best a rough approximation, a far simpler approach is to adopt shorter lives as a means of allowing for the factor of inflation.

The "10-5-3" approach of the pending bill has the advantage of eliminating the difficulties and controversies that have existed in the continuing effort to predict future useful life. Because in general S.1435 will shorten lives that are presently in use, it will automatically make allowances for the uncertainties that lie ahead in the 1980's and beyond. The "10-5-3" approach will take into account the risks that are inherent in the investment in plant and equipment so essential to our productivity and to jobs. It will make allowance for the increased cost of replacement of assets in an inflationary period. It will provide certainty as to the income tax treatment of such investments, and will put American industry in a better position to compete with industry in foreign countries, many of which now have more liberal depreciation allowances.

Needs of Small Business

Of prime importance, the "10-5-3" system would achieve a major simplification of depreciation calculations. This is a matter of great significance, especially to small business. Most small firms do not elect to use the ADR system, which they seem to find too complex to use. The ADR system contains over 100 guideline class lives for assets (excluding most real property), and imposes a number of formal accounting and reporting requirements.

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 afterward, depreciation reform is really an urgent necessity.

The Chamber concurs in Senator Nelson's assessment of the problems facing small business in the determination of depreciation. Adoption of a capital cost recovery system will make the accelerated methods and shorter recovery periods built into the "10-5-3" approach available to all taxpayers. This would redress the underdepreciation which presently occurs as a result of the inability of small firms to use ADR. Capital cost recovery will be simpler for small firms to use than present depreciation rules, even aside from ADR, because the new system substitutes three asset classes, each with a single recovery allowance, for the plethora of classes, accelerated and straight-line methods, and computation of salvage value required under present law.

CONCLUSION

We commend the members of this Subcommittee for their willingness to consider a major overhaul of our depreciation laws. The adoption of a capital cost recovery system such as that contained in S.1435 will stimulate capital formation, increase productivity, and simplify the operation of the system, especially for small business. We urge its prompt adoption.

APPENDIX

FEATURES OF S.1435

The proposed Capital Cost Recovery Act (CCRA) will streamline and simplify the depreciation of buildings and equipment. It will provide more rapid capital recovery, and will substantially reduce the burden and expense of tax compliance by eliminating many complex provisions of existing law.

CCRA divorces the recovery period for capital assets from the concept of useful lives. Key features of this proposal are discussed below.

Classes of Assets

The capital cost recovery allowance which taxpayers would be entitled to deduct each year varies among three classes of investment:

- Class I - Investments in buildings and their structural components would be written off over 10 years.
- Class II - Investments in tangible property other than that in Class I or Class III would have a 5 year write-off. Equipment and machinery would be included in this class.
- Class III - Up to $100,000 per year of investments in automobiles, taxis, and light-duty trucks would have a 3-year write-off.

Coverage

The system would be mandatory for investment in assets eligible for CCRA treatment. Intangible assets, residential rental property, and land would not be covered. Taxpayers could elect to exclude (1) property subject to special amortization provisions, such as pollution control facilities; (2) property depreciated using special methods not expressed in terms of years, such as unit-of-production and retirement-replacement methods; and (3) leasehold improvements properly depreciated over the term of the lease.

Amount of Allowance

Each year, taxpayers could elect to deduct all or any portion of the following capital cost recovery allowances on their investments. These have been calculated using accelerated method principles and a half-year convention.

Capital Cost Recovery Table

Ownership Year	Class of Investment I	II	III
1	10%	20%	33%
2	18%	32%	45%
3	16%	24%	22%
4	14%	16%	
5	12%	8%	
6	10%		
7	8%		
8	6%		
9	4%		
10	2%		
	100%	100%	100%

The percentages shown are taken against the original amount of investment.

Instead of maintaining complex depreciation schedules, taxpayers would be able to quickly determine their capital cost recovery allowances by referring to the table.

Carryover

The amount of any unused capital cost recovery allowance could be carried forward and deducted in future years, at the taxpayer's discretion.

Investment Tax Credit (ITC)

Class II (5-year) property which qualifies for the credit under current law would receive a full 10 percent investment tax credit, and Class III (3-year) assets would get a 6 percent credit. Only those Class I (10-year) assets eligible for the credit under existing law would receive a 10 percent ITC.

To the extent the property is not held for at least one year after it is placed in service, the entire ITC would be recaptured. For Class III property, two-thirds of the credit would be recaptured for property held less than two years, with one-third recaptured for property held less than the full three years. For Class I and II property, the recapture schedule would be as follows:

Property Held Less Than:	Percentage ITC Recaptured:
2 years	80%
3 years	60%
4 years	40%
5 years	20%
Over 5 years	0%

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Modified Placed-In-Service Rule

Under CCRA, an investment would qualify both for the capital cost recovery allowance and the ITC at the earlier of (1) the date on which the taxpayer actually makes a payment to acquire the property; or (2) the date on which the property is placed in service.

This treatment will benefit taxpayers purchasing long lead-time property, since the allowance and the ITC would no longer be delayed until the property is placed in service, but instead would be available in the year in which funds were expended to acquire the property.

For self-constructed property, a taxpayer could use the allowance and the credit for the taxable year in which funds are properly chargeable to the taxpayer's capital account.

Used Property

The CCRA would eliminate the distinction between new and used property for purposes of the capital cost recovery allowance. The $100,000 limitation on used equipment for ITC purposes would be retained.

Salvage Value

Salvage value would be ignored in all CCRA computations, and salvage would be accounted for only when realized. The treatment of both salvage value and used property under CCRA would be of substantial benefit to small business by removing an area of complexity that exists under present law.

THE FIRST YEAR CAPITAL RECOVERY SYSTEM

by

Alan J. Auerbach and Dale W. Jorgenson*

The purpose of this paper is to present a new approach to capital recovery under U.S. tax law. This approach is based on recovery of capital consumption during the year an asset is acquired. Accordingly, we have described our proposal as the First Year Capital Recovery System or, more simply, the First Year System. In presenting the proposal we begin with a review of principles for designing a system of capital recovery. We then describe the First Year System. We compare this System with three alternatives -- present tax law, a modification of present law proposed under the "Tax Restructuring Act of 1979," and the Conable-Jones or "10-5-3" system for capital recovery. We conclude by discussing the implementation of the First Year System.

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1. Statement of the Problem.

The objective of a system for capital recovery is to permit taxpayers to recover capital consumption as a cost of doing business. This objective has been recognized as important from the beginning of income taxation in the United States. Under current law taxpayers are permitted to deduct depreciation as an expense in arriving at income for tax purposes. Taxpayers are also allowed to reduce their tax liability by means of an investment tax credit based on purchases of equipment.

As tax rates at corporate and personal levels have increased, provisions for capital recovery under the tax code have become increasingly significant for economic policy. These provisions have an important impact in stimulating or retarding capital formation. They also affect the allocation of capital among different types of assets and have an important role in linking capital formation to productivity growth.

An ideal system for capital recovery would enable taxpayers to recover economic depreciation on each asset they hold. Economic depreciation is the decline in the value of an asset with age. Depreciation can be measured by simply looking at the profile of asset prices corresponding to assets of different ages at a given point of time. An ideal system of capital recovery would permit taxpayers to deduct the decline in the value of all their assets with age in arriving at taxable income.

Although it is a very straightforward matter to describe an ideal system for capital recovery, such a system is difficult to implement.

Normally, business expenses under the tax code are linked to actual purchases of goods and services. The approach to capital recovery embodied in U.S. tax law is based on the historical cost of an asset. This cost is allocated over the useful life of the asset in accord with accounting formulas.

In the absence of inflation an approach to capital recovery based on historical cost has many advantages. Perhaps the most important advantage is that capital consumption allowances, like other business expenses, can be linked to actual purchases of assets. However, a capital recovery system based on historical cost fails to provide the necessary link between capital consumption allowances and economic depreciation when there is inflation in the prices of assets.

With inflation the profile of prices corresponding to assets of different ages rises over time due to increases in the prices of newly produced assets. Even capital consumption allowances that accurately reflect the profile of asset prices when the asset is originally acquired rapidly fall behind economic depreciation as inflation takes place. As a consequence, capital formation is substantially retarded. In addition, the allocation of capital among different assets is distorted by the differential impact of inflation on assets with different useful lives.

Since 1973 the U.S. economy has experienced rates of inflation that far exceed those of any peacetime period in U.S. history. Capital formation has stagnated and economic growth has slowed measurably. A very important source of the slowdown in capital formation has been the increasing divergence between economic depreciation and capital consumption

allowances for tax purposes. The contribution of capital to productivity growth has been further diminished by growing misallocations of capital due to distortions in capital recovery allowances under the tax system.

In considering economic policies to stimulate U.S. economic growth top priority should be given to the design of a new system for capital recovery. Such a system should bring capital consumption allowances into line with economic depreciation in order to stimulate capital formation. It should also enhance the impact of capital formation on economic growth through insuring the efficient allocation of capital.

2. The First Year Capital Recovery System.

Our proposal for a new system for capital recovery under U.S. tax law is to permit taxpayers to deduct the present value of economic depreciation as an expense in arriving at income for tax purposes. The deduction would be allowed in the year an asset is acquired. Accordingly, we refer to our system for capital recovery as the First Year Capital Recovery System.

Like the present system for capital recovery, the First Year Capital Recovery System is based on actual purchases of depreciable plant and equipment. However, to avoid the deterioration in the value of capital consumption allowances with inflation, the present value of economic depreciation is allowed as a deduction in the same year that the asset is acquired. As a consequence, the capital consumption allowances are unaffected by inflation or by variations in the rate at which inflation takes place.

It is important to recognize that economic depreciation actually occurs in the years after the asset is originally acquired. Future economic depreciation must be discounted back to the present to arrive at a present value of economic depreciation. For example, the present value of one dollar's worth of investment in a long-lived asset such as a manufacturing plant might be fifty cents, while the present value of one dollar's worth of investment in a short-lived asset such as a pick-up truck might be seventy-five cents.

Under the First Year Capital Recovery System capital consumption allowances would be described by a schedule of present values of economic depreciation for one dollar's worth of investment in each class of assets. We would propose to use about thirty classes of assets -- perhaps ten types of structures and twenty types of equipment. The whole capital recovery system could then be described in terms of thirty numbers, giving the first-year capital recovery allowances for all classes of assets.

The First Year Capital Recovery System would represent a vast simplification of current tax law. Rather than choosing among a range of asset lifetimes and a number of alternative depreciation formulas for tax purposes, taxpayers would simply apply the first-year capital recovery allowance to their purchases of depreciable plant and equipment. No records of past purchases would be required to substantiate capital consumption allowances taken in a given year.

Many assets are sold by taxpayers before the end of the useful life of the assets. It is important to provide for capital recovery on used assets in order to insure that the existing capital stock is efficiently allocated. Under existing tax law the purchase price for an asset is reduced by the capital consumption allowances in arriving at a basis for resale. If the actual proceeds from a sale exceed this basis, the taxpayer is subject to tax on the difference.

Under the First Year Capital Recovery System purchasers of used assets would be permitted to deduct the present value of economic depreciation on the asset in the year the asset is acquired. Sellers of used assets would be subject to ordinary income tax on the same amount; this amount would always be less than the sales price of the asset. If purchasers and sellers have the same marginal tax rates, there would be no effect on government revenue resulting from transactions in used assets.

3. Alternative Capital Recovery Systems.

The system for capital recovery embodied in current tax law is the result of extended efforts to deal with the problem of inflation in the value of assets. In 1954 a system of capital consumption allowances was adopted that permitted taxpayers to use accelerated formulas for allocating capital recovery over the useful lifetime of an asset. Accelerated depreciation was adopted in response to the rapid inflation in prices of assets during the Second World War and the Korean War.

Between 1954 and 1962 lifetimes used in calculating capital consumption allowances were gradually reduced. In 1962 a new set of guideline lifetimes was adopted for tax purposes. These guideline lifetimes represented a further acceleration in capital recovery. In addition, an investment tax credit for purchases of equipment was adopted in 1962. The combination of the guideline lifetimes and the investment tax credit resulted in a dramatic stimulus to capital formation. Business fixed investment rose by forty percent over the four years from 1962 to 1966.

In the original legislation providing for the investment tax credit, the credit was linked to capital recovery by reducing the basis for calculating capital consumption allowances by the amount of the credit. This feature of the investment tax credit, the so-called Long Amendment, was repealed in 1964. As inflation rates began to rise in the late 1960's pressure began to build to adjust lifetimes for tax purposes to levels below the guidelines of 1962. In 1971 the Asset Depreciation Range System was adopted, permitting taxpayers to reduce lifetimes by as much as twenty percent.

We can summarize these developments by saying that the current system has developed through successive liberalization of depreciation formulas and lifetimes for tax purposes and through the introduction of the investment tax credit. These changes in the capital recovery provisions of the tax code have been motivated by the need to bring capital consumption allowances into line with economic depreciation. However, double-digit inflation in the early 1970's has undercut the effectiveness of the earlier reforms, so that revision of the capital recovery provisions of the tax code is again under serious consideration.

The most widely discussed current proposal for reform of capital recovery is the Conable-Jones bill, which embodies the "10-5-3" system of capital recovery. Under this bill structures would be written off in ten years, long-lived equipment would be written off in five years, and short-lived equipment would be written off in three years. The present investment tax credit for equipment would be retained. The Conable-Jones bill would simultaneously simplify and liberalize the capital recovery provisions of the current law.

Under the "Tax Restructuring Act of 1979" the statutory rate of the corporate income tax would be reduced to thirty-six percent from the current level of forty-six percent. Under a revised form of the Asset Depreciation Range System, taxpayers would be permitted to reduce lifetimes by as much as forty percent below the guideline levels of 1962. Finally, the full investment tax credit would apply to assets with tax

times by as much as forty percent below the guideline levels of 1962. Finally, the full investment tax credit would apply to assets with tax lifetimes greater than five years, rather than greater than seven years under current law. Sixty percent of the investment tax credit would apply to assets with tax lifetimes greater than three but less than five years. Under current law two-thirds of the investment tax credit can be applied to assets with lifetimes for tax purposes equal to five or six years and one-third can be applied for assets with lifetimes equal to three or four years.

To compare the First Year Capital Recovery System with existing law, with the Conable-Jones bill, and with the "Tax Restructuring Act of 1979," we have compared the impact of these systems on five representative classes of assets. The asset classes are described in detail in Table 1. For each asset we have given the economic lifetime employed by the Bureau of Economic Analysis in estimating capital consumption allowances in the U.S. National Income and Product Accounts, the tax lifetime embodied in current law, and the economic depreciation rate as calculated in a comprehensive study for the Department of the Treasury by Charles Hulten and Frank Wykoff. We also give the proportion of nonresidential fixed investment in 1974 for each asset class. Together these five assets accounted for about a third of investment in that year.

To analyze the impact of changes in capital recovery provisions of the tax law over the postwar period, we have calculated the effective tax rate for each class of assets in Table 1. Effective tax rates represent that fraction of each project's gross income which goes toward corporate taxes. Since such rates may vary from year to year, our figure represents the average tax rate faced by a new asset over its lifetime. To calculate an effective tax rate we first calculate the gross rate of return that a particular investment would have if the corporate tax rate were zero and there were no investment tax credit. We then calculate the net rate of return, taking account of corporate taxes and adjusting for depreciation deductions and the investment tax credit. We subtract the net rate of return from the gross rate of return and divide this difference by the gross rate to find the proportion of the gross return paid in taxes.

To assess the impact of the tax law prevailing in each year from 1952 to 1979 on capital recovery we present effective tax rates for all five classes of assets for each year in Table 2. For purposes of comparison we also give the statutory rate on corporate income in each year. Under an ideal system for capital recovery the effective tax rates would be equal to the statutory rates for all assets. The first conclusion to

TABLE 1:

ASSETS AND THEIR CHARACTERISTICS

Asset Class	Type	Economic Lifetime[1]	Tax Lifetime[2]	Economic Depreciation Rate[3]	Percentage of 1974 Investment
Construction Machinery (CM)	Equipment	9.0	5.5 (7.0*)	.172	2.8
General Industrial Equipment (GIE)	Equipment	14.0	8.6	.122	4.4
Trucks, Buses and Trailers (TBT)	Equipment	6.8	5.5. (7.0*)	.254	9.0
Industrial Buildings (IB)	Structures	27.0	23.8	.036	5.2
Commercial Buildings (CB)	Structures	36.0	31.8	.025	11.0

Notes:

1. Economic Lifetimes are lives used in estimating capital consumption allowances in the U.S. National Income and Product Accounts.

2. Tax Lifetimes equal guideline lives for structures and eighty percent of guideline lives for equipment, as permitted under current law (*except where a lengthening of tax lifetime is preferred to obtain a full investment tax credit).

3. Economic Depreciation Rates are annual rates of decline in asset value with age, as estimated by Hulten and Wykoff.

TABLE 2:

EFFECTIVE TAX RATES SINCE 1952

Year	Statutory Tax Rate	CM	GIE	TBT	IB	CB
1952	.52	.57	.59	.65	.51	.51
1953	.52	.57	.59	.65	.51	.51
1954	.52	.58	.60	.66	.52	.52
1955	.52	.58	.60	.66	.52	.52
1956	.52	.54	.57	.62	.49	.49
1957	.52	.54	.57	.62	.49	.49
1958	.52	.54	.57	.62	.50	.50
1959	.52	.55	.58	.63	.50	.50
1960	.52	.56	.58	.63	.51	.50
1961	.52	.54	.57	.62	.50	.50
1962	.52	.41	.43	.49	.49	.49
1963	.52	.40	.43	.49	.49	.49
1964	.52	.31	.34	.38	.48	.48
1965	.48	.26	.29	.34	.45	.45
1966	.48	.35	.38	.43	.46	.46
1967	.48	.37	.40	.45	.47	.47
1968	.48	.35	.38	.43	.48	.48
1969	.48	.53	.56	.61	.52	.51
1970	.48	.43	.44	.51	.53	.52
1971	.48	.35	.37	.42	.53	.52
1972	.48	.35	.37	.43	.53	.52
1973	.48	.39	.40	.47	.54	.53
1974	.48	.43	.44	.51	.55	.54
1975	.48	.33	.36	.40	.56	.54
1976	.48	.34	.37	.42	.56	.54
1977	.48	.37	.39	.45	.56	.55
1978	.48	.36	.39	.44	.56	.55
1979	.46	.32	.35	.39	.54	.53

Note: Assumes real discount rate to be four percent and relevant inflation rate to be unweighted five-year moving average of past inflation rates.

be drawn from Table 2 is that effective tax rates have varied widely among assets and over time, depending on the provisions of the tax code and the rate of inflation.

Before 1954 effective tax rates for structures were in line with the statutory rate on corporate income of fifty-two percent. However, effective tax rates for equipment far exceeded the statutory rates. While effective tax rates for both structures and equipment were reduced by the adoption of accelerated depreciation in 1954, effective tax rates for equipment remained above statutory rates until the adoption of the guideline lifetimes and the investment tax credit in 1962. With the repeal of the Long Amendment in 1964 there was a further reduction in the effective tax rates on equipment to levels well below the statutory rate.

As the pace of inflation quickened during the late 1960's the effective tax rates on equipment rose gradually; repeal of the investment tax credit in 1969 raised effective tax rates to levels comparable to those that had prevailed before 1962. Similarly, inflation and restriction of accelerated depreciation on structures to the 150 percent declining method after 1966 resulted in increases in the effective tax rates for structures to levels that exceeded those that prevailed before 1954. For equipment reinstitution of the investment tax credit in 1970, adoption of the Asset Depreciation Range system in 1971, and the increase in the rate of the credit from seven to ten percent resulted in effective tax rates well below the statutory rate, even in the face of double-digit inflation in 1973 and again in 1979.

In Table 3 we present a comparison of effective tax rates for each of the five classes of assets listed in Table 1 for the current tax law, the Conable-Jones system, and the First Year Capital Recovery System. For the first two systems the effective tax rates depend on the rate of inflation, so that we have calculated effective tax rates for inflation rates, denoted Π in Table 3, of six and twelve percent. The effective tax rate under the First Year Capital Recovery System is equal to the statutory rate and is unaffected by the rate of inflation.

The current tax law imposes a greater tax burden on structures than equipment; under this law inflation results in a heavier tax burden on all assets. Since incentives to purchase equipment are greater than incentives to purchase structures under current law, the allocation of the capital stock is biased toward equipment. More output could be produced from the existing capital stock by shifting its composition away from equipment and toward structures.

The most striking feature of the Conable-Jones proposal is that effective tax rates are reduced substantially for all assets; in fact, under either six or twelve percent rates of inflation the effective tax rates under the Conable-Jones bill fall below the statutory rate of forty-six percent. However, the Conable-Jones proposal has the undesirable feature that for a moderate inflation rate, like six percent, the combined effect of greatly accelerated depreciation and the

TABLE 3:

EFFECTIVE TAX RATES UNDER CURRENT AND ALTERNATIVE SYSTEMS OF CAPITAL RECOVERY

	Current System		Conable-Jones		Tax Restructuring		
Asset Class	Π = .06	Π = .12	Π = .06	Π = .12	Π = .06	Π = .12	First Year
Construction Machinery (CM)	.06	.34	-.23	.16	-.44	-.06	.46
General Industrial Equipment (GIE)	.16	.36	-.17	.13	-.16	.07	.46
Trucks, Busses and Trailers (TBT)	.09	.42	.22	.45	-.72	-.09	.46
Industrial Buildings (IB)	.49	.53	.36	.43	.33	.43	.46
Commercial Buildings (CB)	.48	.51	.32	.39	.38	.41	.46

Notes:

1. The inflation rate is denoted Π. The real discount rate is assumed to be four percent.

2. "Current System" assumes adoption of the double-declining balance method (equipment) or 150 percent declining balance method (structures), with optimal switchover to straight-line, plus a ten percent investment tax credit on equipment.

3. "Conable-Jones" assumes tax lives of 5 years (equipment) or 10 years (structures) plus a ten percent investment tax credit on equipment.

4. "Tax Restructuring" assumes a statutory tax rate of thirty-six percent and adoption of the double-declining balance method (equipment) with shorter lifetimes and 150 percent declining balance method (structures), with optimal switchover to straight-line, plus a ten percent investment tax credit on equipment.

5. "First Year" allows firms a one-time deduction, equal to the present value of depreciation allowances.

and the investment tax credit will produce negative tax rates for construction machinery and general industrial equipment. In effect, the government would pay taxpayers to hold these assets rather than taxing income produced by the assets.

Another important effect of the Conable-Jones proposal is that it would widen rather than narrow the substantial differentials in effective tax rates among classes of assets under present law. In addition, the rates would be made more rather than less sensitive to variations in the rate of inflation. Both of these impacts of the Conable-Jones proposal would result in greater gaps between capital consumption allowances and economic depreciation than under present law. The result would be to increase the present misallocations of the capital stock.

Like the Conable-Jones Bill, the "Tax Restructuring Act of 1979" would reduce effective tax rates for all assets, however, it would not result in effective tax rates for all assets below the statutory rate of thirty-six percent. The combined effect of more rapid depreciation, a more generous investment tax credit, and a reduction in the statutory tax rate will produce negative tax rates for construction machiner and trucks, buses, and trailers even with double-digit inflation at the rate of twelve percent. Under a more moderate inflation rate of six percent these provisions would result in negative effective tax rates for general industrial equipment.

Again like the Conable-Jones Bill, the "Tax Restructuring Act of 1979" would widen rather than narrow the differentials in effective tax rates for equipment would plummet with the government actually paying taxpayers to hold trucks, buses, and trailers at the healthy rate of seventy-two percent per year at a rate of inflation of six percent. Effective tax rates on structures would remain positive and higher than statutory rates under either six or twelve percent inflation rates. The consequence of the resulting gaps between capital consumption allowances and economic depreciation would be to increase the present misallocations of the capital stock.

Our overall conclusion is that the present system for capital consumption results in very sizeable distortions of economic depreciation. The size of the distortions depends on the rate of inflation, so that inflation undercuts incentives for capital formation and results in serious misallocations of the capital stock. These misallocations blunt the impact of capital formation in contributing to higher productivity and to economic growth.

The Conable-Jones proposal would provide a substantial stimulus to capital formation. However, much of the impact of the higher rate of capital formation would be dissipated through misallocations of the resulting capital stock. This misallocation would be much more serious than under the existing tax law, resulting in subsidies rather than

taxes on some types of assets under moderate rates of inflation. These subsidies would grow dramatically under low rates of inflation.

The "Tax Restructuring Act of 1979" would, like the Conable-Jones Bill, provide a substantial stimulus to capital formation. Again like the Conable-Jones proposal, much of the impact of higher capital formation would be dissipated by misallocation of the resulting capital stock. The misallocation would be much greater than under existing tax law and even more serious than under the Conable-Jones Bill. In effect, taxpayers would be subsidized to hold equipment and would be taxed only on their holdings of structures under moderate rates of inflation.

The First Year Capital Recovery System is a direct attack on the problem confronting tax policy makers, namely, to design a system of capital recovery that can cope with high, moderate, and low rates of inflation without the distortions resulting from the current system. While the First Year System would provide substantial stimulus to capital formation, it would also contribute to improving the allocation of capital. The System would enhance rather than dissipate the impact of a higher rate of capital formation on productivity and economic growth.

4. Implementation.

With the current emphasis on reducing the Federal deficit as a means of combating inflation, a very important issue in tax reform is the impact of any proposed change on the budget. To assess the macroeconomic impact of adoption on the First Year Capital Recovery System and the impact of this System on Federal revenue, we have simulated the U.S. economy under the assumption that the System is adopted for tax years beginning in 1980. We have assumed that the Federal Reserve will not adjust monetary policy to accomodate a revenue loss, so that any shortfall will result in the creation of additional government debt.

Even if the First Year Capital Recovery System is permitted for tax years beginning in 1980, time will be required for taxpayers to adopt the new System. On the basis of the patterns of adoption observed following the liberalization of depreciation formulas in 1954, we have assumed that the new System will be implemented gradually over several quarters. Finally, we have assumed that whether or not the new System is implemented, the windfall profits tax will be adopted in 1980 and there will be a rollback of the payroll tax in 1981.

The results of our simulation of the U.S. economy from 1980 to 1984 with and without adoption of the First Year Capital Recovery System are presented in Table 4. In these simulations we have employed the Data Resources Incorporated (DRI) Quarterly Econometric Model of the U.S. Economy. In Table 4 the Base Line simulation, denoted B in Table 4,

TABLE 4:

IMPACT OF THE FIRST YEAR CAPITAL RECOVERY SYSTEM

	80:1	80:2	80:3	80:4	81:1	81:2	81:3	81:4	82:1	82:2
--- GNP72: Real Gross National Product										
A	1410.4	1411.9	1427.9	1447.0	1467.5	1488.2	1509.5	1526.9	1536.3	1541.5
B	1411.1	1414.3	1424.9	1438.6	1453.7	1467.1	1481.9	1494.4	1499.6	1502.2
D	-0.7	-2.4	2.9	8.4	13.9	21.1	27.6	32.5	36.6	39.2
%	-0.0	-0.2	0.2	0.6	1.0	1.4	1.9	2.2	2.4	2.6
--- IPDENR72: Real Investment in Producers Durable Equipment										
A	98.3	97.9	99.1	100.6	102.3	104.0	106.0	108.3	109.0	109.6
B	98.8	98.4	98.8	99.5	100.4	101.2	102.3	103.5	103.0	102.1
D	-0.5	-0.5	0.3	1.0	1.9	2.7	3.7	4.8	6.0	7.5
%	-0.5	-0.5	0.3	1.0	1.9	2.7	3.6	4.6	5.8	7.3
--- ICNR72: Real Investment in Nonresidential Structures										
A	46.7	46.7	47.3	48.3	49.8	51.5	53.4	55.1	56.4	57.2
B	46.7	46.3	46.4	46.6	47.1	47.5	48.0	48.4	48.6	48.4
D	-0.0	0.4	0.9	1.6	2.7	4.0	5.4	6.7	7.8	8.8
%	-0.0	0.9	1.9	3.5	5.7	8.5	11.2	13.8	16.1	18.2
--- IFIXR72: Real Investment in Residential Structures										
A	51.9	51.6	53.8	57.3	61.3	65.2	68.2	69.9	70.2	69.5
B	52.0	51.7	52.9	55.0	57.2	59.2	60.6	61.3	60.9	60.2
D	-0.1	-0.1	0.9	2.3	4.1	6.0	7.6	8.6	9.4	9.3
%	-0.2	-0.2	1.7	4.2	7.1	10.1	12.5	14.1	15.4	15.5
--- RU : Unemployment Rate										
A	6.8	7.1	7.2	7.2	7.0	6.8	6.6	6.4	6.2	6.2
B	6.8	7.1	7.2	7.3	7.2	7.2	7.1	7.0	7.0	7.0
D	0.0	0.0	-0.0	-0.1	-0.2	-0.3	-0.5	-0.6	-0.7	-0.8
%	0.1	0.4	-0.1	-1.1	-2.5	-4.4	-6.5	-8.6	-10.3	-11.6
--- RPGNP : Rate of Growth, GNP Deflator										
A	8.4	8.4	8.4	9.2	8.8	9.1	9.2	9.7	8.7	8.3
B	8.4	8.4	8.5	9.1	8.7	8.7	8.6	9.0	7.9	7.6
D	0.0	0.0	-0.2	0.1	0.1	0.4	0.6	0.7	0.8	0.7
%	0.1	0.0	-1.8	0.8	1.5	4.6	6.8	8.0	10.0	9.4
--- DEFGF : Federal Deficit										
A	-40.9	-45.9	-50.7	-47.4	-36.9	-27.5	-24.5	-18.5	-17.2	-22.0
B	-33.7	-36.1	-41.4	-39.0	-30.3	-24.3	-24.7	-21.2	-21.9	-27.8
D	-7.2	-9.8	-9.2	-8.4	-6.6	-3.2	0.2	2.7	4.7	5.8
%	21.3	27.1	22.3	21.6	21.6	13.1	-0.7	-12.5	-21.6	-21.0

TABLE 4 (CONCLUDED)

	82:3	82:4	83:1	83:2	83:3	83:4	84:1	84:2	84:3	84:4
--- GNP72: Real Gross National Product										
A	1550.0	1557.5	1568.5	1583.1	1600.8	1621.2	1644.4	1668.4	1692.6	1716.2
B	1510.3	1519.4	1533.0	1550.4	1570.5	1592.3	1615.7	1638.7	1660.8	1681.1
D	39.6	38.1	35.5	32.7	30.3	28.9	28.7	29.7	31.8	35.1
%	2.6	2.5	2.3	2.1	1.9	1.8	1.8	1.8	1.9	2.1
--- IPDENR72: Real Investment in Producers Durable Equipment										
A	109.7	110.0	111.4	113.2	115.5	118.4	121.9	125.6	129.6	133.3
B	101.4	101.2	102.4	104.1	106.2	109.0	112.1	115.5	118.8	121.8
D	8.3	8.8	9.0	9.2	9.3	9.5	9.8	10.2	10.7	11.5
%	8.2	8.7	8.8	8.8	8.8	8.7	8.7	8.8	9.0	9.4
--- ICNR72: Real Investment in Nonresidential Structures										
A	57.9	58.4	59.0	59.7	60.4	61.4	62.4	63.7	65.1	66.5
B	48.2	48.0	48.1	48.3	48.8	49.5	50.4	51.5	52.7	53.9
D	9.7	10.4	10.9	11.4	11.7	11.9	12.0	12.2	12.4	12.6
%	20.1	21.6	22.7	23.5	23.9	24.0	23.9	23.7	23.5	23.3
--- IFIXR72: Real Investment in Residential Structures										
A	68.8	68.7	69.2	70.4	72.2	74.6	77.2	79.9	82.1	83.9
B	60.1	61.3	63.3	66.0	69.0	72.0	74.8	77.2	78.9	80.0
D	8.7	7.4	5.9	4.4	3.3	2.6	2.4	2.7	3.2	3.9
%	14.4	12.1	9.4	6.7	4.8	3.6	3.3	3.5	4.0	4.9
--- RU: Unemployment Rate										
A	6.2	6.3	6.3	6.3	6.3	6.2	6.0	5.8	5.5	5.3
B	7.1	7.2	7.2	7.1	7.0	6.8	6.6	6.3	6.1	5.8
D	-0.9	-0.9	-0.9	-0.8	-0.7	-0.7	-0.6	-0.6	-0.6	-0.6
%	-12.3	-12.4	-12.0	-11.3	-10.5	-9.8	-9.3	-9.1	-9.2	-9.7
--- RPGNP: Rate of Growth, GNP Deflator										
A	8.1	8.5	7.8	7.7	7.7	8.3	7.8	7.8	7.8	8.4
B	7.5	8.0	7.3	7.3	7.3	8.0	7.4	7.4	7.4	8.0
D	0.6	0.5	0.4	0.4	0.3	0.3	0.3	0.4	0.4	0.4
%	8.6	6.6	6.1	5.1	4.6	4.0	4.6	4.9	5.3	5.0
--- DEFGF: Federal Deficit										
A	-26.0	-34.6	-34.8	-37.1	-36.7	-38.0	-27.7	-21.6	-14.5	-12.4
B	-30.8	-36.4	-32.4	-30.0	-24.7	-21.6	-7.9	0.8	9.5	12.4
D	4.9	1.8	-2.4	-7.1	-12.0	-16.4	-19.9	-22.4	-24.0	-24.8
%	-15.8	-5.0	7.5	23.8	48.5	76.0	253.0	****	-253.3	-199.6

Notes:

1. A: Simulation with adoption of the First Year Capital Recovery System, based on TRENDLONG 09 79.
2. B: Simulation without adoption of the First Year Capital Recovery System, based on TRENDLONG 09 79
3. D: A-B.
4. %: D/B * 100.

is the projected development of the U.S. economy without the First Year Capital Recovery System. The Alternative simulation, denoted A in Table 4, assumes that the new System is adopted. The difference between the two simulations, denoted D, provides measures of the impact of the new System. This difference is also given in percentage terms, denoted %.

The First Year Capital Recovery System provides a very substantial stimulus to capital formation. Within four years after the adoption of the new System, real investment in equipment has increased by 11.5 billion dollars and real investment in nonresidential structures has increased by 12.6 billion dollars. The greater relative stimulus to investment in structures is the result of removing the distortions between capital consumption allowances and economic depreciation that exist under current law. Although there is no specific incentive to owner-occupied housing, investment in residential structures increases moderately. In percentage terms the overall impact of the incentives provided by the First Year System on capital spending is slightly less than half the impact of the incentives adopted in 1962.

With substantial unemployment in prospect for 1980 and 1981, the stimulus to investment provided by the First Year Capital Recovery System results in an increase in real gross national product of almost forty billion dollars by the third quarter of 1982. The unemployment rate in 1982 is reduced by almost a percentage point from levels over seven percent that would prevail in the absence of stimulus to capital formation. The increase in the rate of inflation, as measured by the deflator of gross national product, would reach a

peak of 0.8 percent per year in early 1982 and would decline rapidly through the end of the period covered by our simulations.

The estimated revenue loss from adoption of the First Year Capital Recovery System would be about 8.6 billion dollars in 1980 and only 1.6 billion dollars in 1981. By 1982 the new System would provide sufficient stimulus to generate a positive impact on revenue of 4.3 billion. The revenue loss would gradually rise to 9.5 billion in 1983 and 22.8 billion in 1984 as a strong recovery of capital spending from the recession of 1980 and 1981 takes place. The revenue loss from the new System would decline in later years after the recovery in capital spending is completed. The total revenue loss over the first five years of adoption of the First Year System would total 38.3 billion.

Our overall conclusion is that adoption of the First Year Capital Recovery System would provide a very sizeable stimulus to capital formation at the cost of a modest revenue loss to the Federal government. It would also contribute to the reallocation of the capital stock away from equipment and toward structures in order to rectify the misallocation of capital that has resulted from current tax law. By enhancing the efficiency of the use of capital, the First Year System would assure that additional capital formation would have the maximum possible impact on productivity and economic growth.

We next consider administrative issues that would arise in implementing the First Year Capital Recovery System. First, the Treasury would have responsibility for measuring economic depreciation as a basis

for the first year a capital consumption allowance for each class of assets as at present. The Treasury study by Charles Hulten and Frank Wykoff already mentioned above has demonstrated the feasibility of measuring economic depreciation from data on asset prices. Conceptually, this approach is alternative but equivalent to the engineering approach to cost recovery used by the Treasury for almost half a century and embodied in the legislation enacting the Asset Depreciation Range System.

Almost ten years of experience with the Asset Depreciation Range System has revealed the impracticality of the engineering approach to cost recovery. An original objective of the ADR System was to develop the necessary information from taxpayers' records. This has imposed a reporting burden on taxpayers that has made it infeasible for all but the largest businesses to maintain the records required for the ADR System. This reporting burden can be eliminated by adoption of the First Year Capital Recovery System. The Treasury would be given responsibility for collecting information on asset prices so that the first year capital consumption allowances could be periodically revised to reflect economic depreciation accurately.

The results of Hulten and Wykoff indicate that a system for capital recovery can be designed that will cover structures and equipment by a uniform method. Like the present system, this method would be based on a system of asset classes, but the classes would be much less numerous than those used in the ADR system. The declining balance method for estimating economic depreciation would be used for all assets. The rate of decline of the price of assets with age would be estimated for

each class of assets on the basis of the methods developed by Hulten and Wykoff. A system for calculating capital consumption allowances for financial reporting purposes could be based on empirical estimates of the depreciation rate for each class of assets.

The declining balance method has very important advantages in simplifying accounting systems for financial reporting. Rather than requiring a system of vintage accounts, as in the ADR System, the method would require each taxpayer to maintain a single account for each asset class. Capital recovery would be a constant fraction of the undepreciated balance remaining from all previous expenditures on assets in that class. If, in addition, some kind of revaluation is required for financial reporting purposes, the undepreciated balance in each account can be revalued at the end of each accounting period, based on the change in the acquisition prices of new assets during that period. These prices are reported annually in the U.S. National Income and Product Accounts.

Our overall conclusion is that the First Year Capital Recovery System could be administered within the present framework established by the Department of the Treasury. Moreover, the reporting requirements imposed on taxpayers would be drastically reduced. The First Year Capital Recovery System would be uniform for structures and equipment. For financial reporting purposes capital consumption allowances could be ascertained without a cumbersome system of vintage accounts. Revaluation of assets for financial reporting would be facilitated by adoption of a uniform system based on the declining balance method of depreciation for all assets.

An issue that frequently arises in the context of economic analysis of systems for capital recovery is whether an adjustment to income should be made to account for the fact that inflation diminishes the value of outstanding corporate debt. There are really two issues here. One deals with the appropriate treatment of the decline in value of long-term debt issued at low interest rates before high current inflation rates were anticipated. The second deals with the fact that firms which borrow currently at high nominal, but low real interest rates, may deduct the entire amount of their nominal interest cost, even if the real cost is negative to begin with.

The first gain is a real one. Firms currently paying interest on debt issued at five percent have gotten a once-and-for-all gain at the expense of the lenders. However, this windfall gain has already occurred. Further such gains will occur only if inflation again rises above expectations. Losses resulting from lower than expected rates of inflation are just as likely. Therefore, while the future may bring gains or losses to borrowers due to unexpected fluctuations in the inflation rate, there is no bias inherent in this process and no adjustment is called for.

The gain from being able to deduct high nominal interest payments when real interest costs are low is, on the other hand, a continuing gain. However, it should not be considered in the absence of the concommitant impact on holders of the debt. Just as firms can deduct all

interest payments, bond-holders must pay taxes on all such income, even if it represents a real loss in purchasing power because of inflation. If high inflation is anticipated, lenders will take account of this in determining the interest rate at which they will lend.

A simple example should clarify this point. Suppose lenders require a real, after-tax return of two percent and that both lenders and borrowers face a 50 percent marginal tax rate. With zero inflation, lenders will require a four percent interest rate to earn two percent, while firms will bear a real, after-tax interest cost of two percent. Suppose the inflation rate increases to four percent. If anticipated by lenders and borrowers, this will cause the interest rate to rise. To get a two percent return after taxes and inflation, lenders will require a twelve percent nominal interest rate. After taxes and inflation, firms will still face a real borrowing cost of two percent. Neither side gains in this example, where both sides have the same tax rate.

Of course, the situation is more complicated if tax rates are different, and borrowers will gain from inflation if their tax rate is higher, by the magnitude of the tax rate differential. However, this gain, if indeed a gain at all, will be small compared to the loss on the erosion of depreciation deductions under the current system, both because it relates not to the firm's tax rate but only the difference between its tax rate and those of those from which it borrows, and also because only a fraction of all investment is financed with debt.

A third effect of inflation is to increase the tax burden of the firm's stockholders. Since capital gains taxes are assessed on nominal gains, owners of a firm's shares may have to pay substantial taxes on selling stock which has gone up little, if at all, in real terms. While this effect is also small relative to the impact of inflation on depreciation allowances, it tends to offset any gain resulting from the deductibility of nominal interest. We conclude that while depreciation allowances are not the only area in which the tax system may require adjustment, it is legitimate to attack this problem separately.

One final concern is whether the establishment of large deductions in the first year of investment will encourage the creation of tax shelters where high-bracket taxpayers purchase assets to take the deductions and lease them to low-bracket entities which use the assets in production. In fact, the new system would, if anything, discourage the establishment of such leasing schemes. While high-bracket buyers would certainly get a bigger deduction in the first year, they would lose all subsequent deductions, a trade-off similar to that faced by prospective low-bracket purchasers as well.

It is reasonable to assume that high-bracket individuals possess a lower discount rate than others do, precisely because thev must pay a higher rate of tax on capital income. In this case, the conversion of all future deductions to one in the present will be perceived as more generous by low-bracket investors (those with the higher discount rate) and encourages the purchase of assets by them directly.

We conclude that reform of the system for capital recovery under U.S. tax law can be separated from other adjustments to income to deal with the impact of inflation. Gains in inflation from increasing tax deductions for interest payments are largely offset by losses resulting from taxation of capital gains due to inflation. There is no need to complicate the implementation of a new system for capital recovery by making other adjustments to the tax law at the same time. Finally, the First Year Capital Recovery System would make tax shelters involving capital recovery less rather than more attractive. We conclude that the First Year System would very greatly reduce the administrative burden imposed on taxpayers and on the tax authorities under the current system for capital recovery.

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REMARKS OF
MARK B. WEINBERG
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT
MANAGEMENT OF THE SENATE FINANCE COMMITTEE

Good morning. As Mr. Hardman indicated, my name is Mark Weinberg. I am an attorney practicing in Washington, D.C. with the firm of Arent, Fox, Kintner, Plotkin & Kahn, and am here today on behalf of the Small Business Legislative Council to make a few brief technical observations about the capital recovery legislation now pending before the Congress.

There is much in S. 1435 that small business interests can support. Abandonment of the useful life concept could substantially simplify the tax law and permit faster capital recovery through depreciation. This would, in turn, spur productivity. Yet the manner in which S. 1435 seeks to achieve these goals is certain to produce inequities for small businesses; these prevent the Small Business Legislative Council from supporting this bill. To see how S. 1435 would impact upon small businesses, we need only consult recent records regarding the benefit conferred by present depreciation rules.

*Of the National Small Business Association

For 1976, the most recent year for which Treasury Department figures are available, over 1 3/4 million corporations claimed depreciation deductions totalling over 93 billion dollars. Of this total, over 55 billion dollars or sixty percent (60%) of the deductions were taken by firms with total assets of over 250 million dollars ($250,000,000). Yet these 1951 business giants are only one tenth of one percent (.1%) of the business corporations in this country. Meanwhile, the 1,702,772 firms with assets of less than 10 million dollars made up over 98.5% of the corporations in this country and derived less than 25% of the depreciation deductions under the present system. Since S. 1435 as presently written would merely accelerate present depreciation deductions, it would at best allocate less than 25 percent of the bill's benefit to the small firms which make up 98.5 percent of American businesses. Since this acceleration would, under S. 1435, be proportionately greater for longer lived assets like buildings which are traditionally held more by large businesses than small, the bill might further shrink the small business community's share of tax incentives.

A second inequity stems from the way this bill deals with the problem of revenue loss. To reduce its cost to more acceptable levels, S. 1435 phases-in its provisions. Aside from the usual complexity associated with transitional rules, S. 1435 places an added burden on small businesses by requiring them to, in effect, use the Class Life Asset Depreciation Range System during the transitional period. Small businesses have historically not

elected to use the ADR system, while a great percentage of those who have are large firms. S. 1435 would force small businesses to classify all of their section 1245 depreciable assets under the ADR system during the transitional period, a process that could prove costly and, to say the least, confusing.

Further needless complexity is added by the presence of Class III in the bill. Depreciating an asset over three years instead of five would normally speed up capital recovery. When the cost of this shortened recovery period is a 40 percent reduction in the Investment Tax Credit (from 10% to 6%), however, the value of the shortened period depends upon the tax rate of the asset's owner. In this case, taxpayers in a 25% marginal tax bracket (for example, all corporations with taxable income of $50,000 or less), would recover more capital in the first year by having these assets in Class II instead of Class III. See Exhibit A attached to these remarks. It is ironic that this provision is cited by some as an example of the bill's concern for small businesses. Suffice it to say, the added complexity of a third asset class, combined with this adverse impact on small businesses suggest it should be deleted from the bill.

Other aspects of the bill favorable primarily to large concerns include the option to defer depreciation deductions to future years and the very presence of Class I assets.

Yet, with a few modifications S. 1435 could be both equitable and beneficial to the entire business community. Removal of the transitional rules and Class III would significantly simplify the bill. Further shortening the recovery period for Class II assets to 4 years would further accelerate the bill's benefits to the economy. Costs could be cut by limiting the amount of capital investment in any given year that will be subject to rapid depreciation. Placing these limits so as to accord equal benefit to businesses large and small would make the bill more equitable. For example, the average American business corporation with total assets of between $75,000 and $100,000 made a capital investment in Class II assets of $8,000 in 1976; those with total assets between $750,000 and $1,000,000 invested an average of $39,000 in Class II assets; and firms with total assets of $7,500,000 to $10,000,000 averaged $241,000 of Class II investment. A limit of $1,000,000 per year on Class II investment would permit over 99% of the corporations making such investments to obtain all the benefits to be conferred under the present bill, while significantly reducing costs.

The Small Business Legislative Council stands ready, as it has from the beginning, to meet with Congressional and business representatives to suggest specific improvements in this bill that are protective of small business interests.

Mr. Chairman, should you or other members of the Committee have any questions, I will be glad to answer them at this time.

EXHIBIT A

APPLICATION OF CLASSES
II & III TO TAXPAYERS
IN DIFFERENT BRACKETS

TAXPAYER IN 25% BRACKET	CLASS II	CLASS III
Asset Cost	$10,000	$10,000
First Year Depreciation Tax Savings	500	825
ITC	1,000	600
Total Tax Reduction	$ 1,500	$ 1,425

TAXPAYER IN 46% BRACKET	CLASS II	CLASS III
Asset Cost	$10,000	$10,000
First Year Depreciation Tax Savings	720	1,518
ITC	1,000	600
Total Tax Reduction	$ 1,720	$ 2,118

NATIONAL ASSOCIATION OF REALTORS
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Jack Carlson, Executive Vice President

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STATEMENT OF GIL THURM

VICE PRESIDENT AND LEGISLATIVE COUNSEL, GOVERNMENT AFFAIRS

ON BEHALF OF THE NATIONAL ASSOCIATION OF REALTORS®

ON S. 1435

REGARDING THE CAPITAL COST RECOVERY ACT OF 1979

BEFORE THE SENATE FINANCE SUBCOMMITTEE ON

TAXATION AND DEBT MANAGEMENT

OCTOBER 22, 1979

The NATIONAL ASSOCIATION OF REALTORS® is comprised of more than 1,780 local boards of REALTORS® located in every state of the Union, the District of Columbia, and Puerto Rico. Combined membership of these boards is over 726,000 persons actively engaged in sales, brokerage, management, counseling, and appraisal of residential, commercial, industrial, recreational and farm real estate. The activities of the Association's membership involve all aspects of the real estate industry, such as mortgage banking, home building, and commercial and residential real estate development, including development, construction and sales of condominiums. The Association has the largest membership of any association in the United States concerned with all facets of the real estate industry. Principal officers are: Donald I. Hovde, President, Madison, Wisconsin; Ralph Pritchard, President-Elect, Oak Brook, Illinois; and Jack Carlson, Executive Vice President. Headquarters of the Association are at 430 North Michigan Avenue, Chicago, Illinois 60611. The Washington office is located at 925 15th Street, N.W., Washington, D.C. 20005. Telephone 202/637-6800.

Mr. Chairman and members of the Committee:

My name is Gil Thurm. I am Vice President and Legislative Counsel, Government Affairs division of the NATIONAL ASSOCIATION OF REALTORS®. I am accompanied today by John Ams, who is the Director of Tax Programs in the Government Affairs division of the Association.

The NATIONAL ASSOCIATION OF REALTORS®, with over 726,000 members, is the largest trade association in the United States. Our membership is involved with all facets of the real estate industry -- residential, commercial, industrial and farm real estate.

We appreciate the opportunity to express our views on S. 1435, The Capital Cost Recovery Act of 1979. We are pleased to offer our comments in support of the general concepts concerning certain depreciation rule changes in the bill, introduced by Senators Nelson, Bentsen, Packwood and Chafee. The bill, though in need of certain changes regarding real estate, is a commendable step in the appropriate direction.

DEPRECIATION

Revision of some of the depreciation laws in the Internal Revenue Code is long overdue. The "useful life" concept has been shown to be problematic for a number of reasons, including inconsistent IRS audit practices, rising interest rates, and the high rate of inflation we have experienced over the years. Double-digit inflation has been especially harmful to capital formation because new buildings and equipment double or triple in cost by the time that businesses are able to recover their investment in older buildings and equipment.

Depreciation revision is desirable to eliminate the needless complexity of the present system and to allow taxpayers a reasonable measure of certainty in this area. At present, certainty may never

be achieved, even after numerous depreciation audits with the Internal Revenue Service and the expenditure of time and money required by litigation.

Residential Real Estate

We are concerned, however, that S. 1435 would have serious adverse effects on the housing needs of this country because, as presently drafted, the bill would not extend depreciation revision to residential rental real estate. We urge this Committee to eliminate this discriminatory exclusion.

As the members of this Committee know, there is a serious shortage of rental housing in this country. In fact, as Table 1 in the Appendix to this statement shows, the vacancy rate in apartment buildings is estimated at a record low level of 4.9% and is expected to go even lower. This vacancy rate is important because it indicates that apartments available for rent are becoming increasingly hard to find. At a time when record high interest rates and single family housing prices are forcing families to postpone the purchase of a house and to continue to rent, legislation that would further decrease the number of available rental housing units is most unfortunate.

In fact, rather than discriminate against the construction of residential rental property, this legislation should actively promote more construction of such property. According to the Bureau of the Census, the net number of households in the United States will increase by more than 1,800,000 during this year. The estimates are set forth in Table 2 in the Appendix. Each of these new households, usually a young family in the rental housing market, will need a dwelling unit and, as Table 3 indicates, the number of new rental dwelling units available has been and will continue to be only a fraction of the demand for such units and will contribute to the present housing shortage.

Consequently, S. 1435 should be amended to provide a stimulus to the construction of residential rental property by extending depreciation revision to such property.

It is also important to extend depreciation revision to residential rental property because, unlike other types of property, rental buildings are subject to rent controls and other factors that are not present with respect to other investments. As a result, investment in residential rental property is generally less profitable than other investments. A recognition of this fact is that the rate of construction of new residential rental property has been declining. In fact, construction of nonsubsidized rental units during 1979 is expected to be only 258,000 units, the same level as 1977, even though the number of new households in need of living space is 1,832,000, approximately seven (7) times this number. Should S. 1435 be enacted in its present form, the bill would further erode the incentive to invest in residential rental property.

In fact, there is little doubt that this bill would provide a <u>disincentive</u> to invest in residential rental property. When faced with an investment decision, it is obvious that the typical investor would choose to invest in property subject to the depreciation method envisioned in S. 1435 than to invest in an apartment building subject to a depreciation system that some members of this Committee have conceded is "unfair and unrealistic."

Although we agree that it is important to provide incentives to increase productivity and economic growth through faster recovery of capital, it is no less important to provide incentives to supply adequate housing for the people of this country. It is not adequate to address depreciation revision with respect to some buildings and not to

others when all types of buildings are competing for the same investment dollar. Accordingly, we urge this Committee to include residential rental property in the scope of the bill under consideration.

Depreciation Recaputure

We also urge this Committee to retain the present tax rule regarding the recapture of depreciation on real property (Code Section 1250). S. 1435 changes the present important rule by requiring all depreciation on the sale of real property to be recaptured as ordinary income instead of being taxed at favorable capital gains rates.

The NATIONAL ASSOCIATION OF REALTORS® is concerned that this proposed change in the recapture rules would have serious consequences for the real estate industry. It is apparent, for example, that unlike personal property, a building is sold together with the land on which it stands and that land is a non-depreciable asset. Given the present high value of land, it is entirely probable that most of the gain on the sale of a building and land may be attributable to a rise solely in the value of the land and not the building. The proposed recapture rules in S. 1435 as presently drafted would assume that all of the gain on a sale is attributable solely to the building, and would ignore any rise in land values. Therefore, to the extent that the gain is actually a reflection of the rising price of land, S. 1435 would transform what should be capital gain into ordinary income.

The proposed change in the depreciation recapture rule would also unjustly discriminate against taxpayers, mostly small businesspeople who choose to do business as individual proprietors or in a partnership. The marginal tax rates on ordinary income for such individuals go up to 70%, compared with the highest corporate tax rate of 46%. Under the recapture rule envisioned in S. 1435, an individual or partner who realizes a gain on the sale of real property may therefore have to pay

up to 70% of that gain to the IRS as tax, whereas a corporation need only pay 46%, a savings of more than one third of the total tax.

This proposed change in the recaputre rules would also discourage potential investors from investing in real property since available funds would be placed in investments that are not subject to this onerous provision. We estimate that a builder, developer, or investor in the real estate industry holds a given piece of real property for an average term of eight years before it is sold. If, upon such sale, up to 70% of the gain is confiscated as tax, why would the reasonable investor choose to invest in real property since the yield would obviously be higher on almost any other type of investment?

Accordingly, we strongly urge this Committee to amend S. 1435 to delete this harsh and discriminatory provision and to retain the present rules concerning depreciation recapture for real property.

Although we have serious reservations concerning certain provisions in S. 1435, we strongly support depreciation revision and increased capital formation and we would be pleased to provide any assistance to the Committee to achieve these admirable goals.

TAX INCENTIVES FOR SAVERS

We would also like to take this opportunity to express the Association's support for tax incentives for individual savers. Although this issue is not included in the current draft of S. 1435, we feel it is especially appropriate that such a consideration be addressed during the Committee's effort to effectively revise capital formation policy.

A variety of tax incentive measures are currently under consideration in both the House and Senate, and for good reason. Under existing conditions, private businesses and industry are held back from borrowing for investment and expansion purposes, due to high interest rates and and a lack of available funding.

As a result, we have the lowest rate of capital investment among the major industrial powers. The United States presently invests only 17 percent of its gross national product in capital, whereas West Germany and Japan invest 25 and 35 percent respectively. Our savings performance also ranks among the poorest - only 4.5 percent of gross income is currently invested in savings accounts.

Several types of incentives have been suggested. REALTORS® favor an approach which would allow taxpayers to exclude from gross income a portion of the interest earned from savings accounts in thrift institutions. The fiscal implications of such an incentive would obviously vary with the size of the exclusion. However, it has been estimated that accelerated savings spurred by such a measure would ultimately result in a net increase to the Treasury, due to the subsequent dramatic economic expansion that would result, evidenced by higher levels of output and personal income.

An interest exclusion would raise the after-tax return on savings, thus making saving a significantly more attractive alternative than it is now. We urge the Committee's support of such an exclusion. A tax incentive for savers constitutes an important step forward in the revision of a tax system which, as currently structured, restricts the investment necessary for the nation's industrial growth, production, employment and trade.

INVESTMENT INTEREST

In an effort to further increase the ability of investors and businesspeople to form capital, we would like to direct the attention of the Committee to another provision of the Code that seriously impairs capital formation activities and unjustly discriminates against

the small businessperson. This provision is the limitation on interest deductions on investment indebtedness (Code Section 163(d)).

Specifically, the limitation on investment interest provision provides that an individual is denied a deduction of more than $10,000 plus the amount of any net investment income in the case of investment indebtedness. In practical terms during this time of 15% interest rates, an individual can borrow no more than $67,000 for investment purposes without facing this discriminatory ban on the allowance of any further deduction. It is discriminatory because no such limitation is imposed on corporate taxpayers. It is unfair because the wealthy investor may in fact have no limit because of other investment income. This provision seriously impairs the capital formation activities of the small businessperson. We urge this Committee to correct this obvious inequity and vote to repeal this limitation.

We thank the Committee for the opportunity to present our views on these important matters. We will be happy to answer any questions the Committee may have.

APPENDIX A-1

TABLE 1

MULTI-FAMILY DWELLING UNIT VACANCY RATE*

YEAR	ANNUALIZED VACANCY RATE
1970	5.3%
1971	5.5%
1972	5.6%
1973	5.8%
1974	6.2%
1975	6.0%
1976	5.6%
1977	5.2%
1978	5.0%
1979 (est.)	4.9%
1980 (est.)	4.7%

*Source: Department of Commerce, Bureau of the Census

APPENDIX A-2

TABLE 2

NET YEARLY INCREASE IN HOUSEHOLD FORMATION*

YEAR	NET INCREASE
1970	$1,187,000
1971	1,377,000
1972	1,898,000
1973	1,575,000
1974	1,608,000
1975	1,261,000
1976	1,747,000
1977	1,275,000
1978	1,888,000
1979 (est.)	1,832,000
1980 (est.)	1,851,000

*Source: Department of Commerce, Bureau of the Census

APPENDIX A-3

TABLE 3

MULTI-FAMILY HOUSING STARTS PER YEAR*

YEAR	NUMBER OF UNITS STARTED
1970	535,900
1971	780,900
1972	906,200
1973	795,000
1974	381,000
1975	204,300
1976	289,200
1977	414,400
1978	462,000
1979 (est.)	425,000
1980 (est.)	425,000

*Source: Department of Commerce, Bureau of the Census

TESTIMONY OF

CLIFF MASSA III

ON BEHALF OF

THE NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

"Capital Recovery Allowances"

October 22, 1979

Cliff Massa III -- Vice President, Taxation and Fiscal Policy Department,
National Association of Manufacturers

The National Association of Manufacturers appreciates the opportunity to present its views to this Subcommittee on S. 1435, "The Capital Cost Recovery Act of 1979." The NAM very strongly supports the major restructuring of federal tax depreciation policy which is presented in this bill. The twin benefits of reducing a significant obstacle to productive investment and of greatly simplifying tax compliance will be wholeheartedly welcomed by American industry, particularly the small and growing manufacturers which cannot fully utilize the existing acceleration techniques. We encourage the Subcommittee to focus attention on these major economic and administrative benefits of the capital recovery allowance concept.

Manufacturers inherently are more capital intensive than our friends in the distribution, service and commercial sectors of the

economy. Significant investments in a building, machinery and equipment are necessary to provide our members' employees with the means to produce the goods which the consumer needs and wants. Because the purchase of capital assets is so important, the tax treatment accorded to these investments ranks as a primary tax policy issue for manufacturers. In fact, the capital recovery allowance bill is our top tax legislative priority.

Under the current tax law, the cost of buying a piece of machinery can be recovered by deducting it from income over a period of years which is based on someone's judgment of what constitutes the "useful life" of that asset. This system is called depreciation because it attempts to equate the tax deduction with the falling or depreciating economic value of the asset.

Extensive debates take place over whether this matching of taxable and economic income is desirable -- or even reasonably possible given the differences among scholarly studies on economic depreciation. In our view, the debate is of academic interest only. "Useful life" depreciation has outlived its own usefulness and should be given a decent burial. It has created two very serious problems -- (1) a drag on productive investment by industry in new and modern plant and equipment and (2) an indefensibly complex structure which wastes both taxpayer and IRS time and money in useless arguments about depreciable lives and methods of computing deductions.

Drastic depreciation reform has been needed for many years. NAM's official policy language, as adopted by our Board of Directors, has long called for much shorter depreciation periods. In 1970, our

Board revised that policy to recommend specifically that a simplified and rapid system of capital recovery allowances be enacted. As developed in S. 1435, this concept is supported by a wide range of organizations and companies of all sizes from all sectors of the economy in all areas of the country. NAM is very pleased to be supporting this bill, and we have been encouraging our members to do the same.

It is certain that there are a number of features of this bill which do not quite attain the ideal which many of us would like to reach. It is equally certain that there are a number of provisions which are of much less importance to manufacturers than to other types of business enterprises, and the opposite is also true. Briefly put, no one group is likely to find 100% of its objectives met by the bill.

However, NAM very strongly supports this bill because it provides a generally applicable system for use by both large and small firms, by manufacturers and retailers and service companies, by all areas of the country. The legislative process can be expected to generate a number of proposed revisions. During this process, we urge the Congress to focus on the major issues of broad based faster recovery and simplification and not to give undue attention to lesser concerns.

We are very gratified to see the increasingly broad based support for this approach. However, we regret that it has taken the appearance of longterm economic problems to provide at least some of the impetus for this support. It is our hope that the following discussion of these problems can contribute to an awareness of the need for basic depreciation reform.

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THE CURRENT ECONOMIC SITUATION

The anti-inflation fight is the number one priority for our economy -- and rightly so. The steadily rising cost-of-living must be contained and then stopped. This will be a long and unpleasant task because inflation's roots have grown deep through years of neglect or outright nurturing by government action. Restraint in federal spending and a balanced budget are appropriate longterm approaches to this serious problem.

However, there is concern over a major recession during this period of change. The government's traditional remedy for a sluggish economy has been to pump up the demand for goods and services through tax cuts and increased federal spending which have poured money into the economy. But many in the Congress and the Administration -- as well as the consuming public -- now believe that such actions have been a primary cause of inflation. When the federal government has poured more and more dollars into the economy, consumers' demand for goods and services has strained industry's ability to supply, thus pushing prices higher.

Some observers argue that this traditional remedy is the only appropriate approach to a sluggish economy. But if federal spending habits need to be restrained to reduce inflationary pressures, is there a way to promote real economic growth while also fighting inflation?

<u>Absolutely</u>! Now is the time to focus on improving our economy's ability to <u>supply</u> the goods and services which consumers want to buy. Removing obstacles to investment in new and more modern plant and equipment would enable American industry to improve productivity to

offer real wage increases and to provide more jobs while improving our competitiveness in world markets. It's time to encourage greater, more efficient productive capacity, even as the fight against inflation is being waged. The two objectives are not incompatible; in fact, they are very much related.

While inflation is the number one problem for the country, other economic problems -- sagging productivity, sluggish industrial production, low levels of capital investment -- are also evident. They have developed over a long period and, like inflation, they will need many years to correct. The statistics are dull, dry and lifeless, but they are signs of serious problems which need attention now.

Productivity Gains

In simple terms, productivity is the measure of output per unit of time worked. Increased productivity means that one unit of labor (e.g., 1 man hour) produced more output this year than it did last year. It is these productivity gains which generate real wage increases, as opposed to those which merely keep pace with inflation, because labor is generating more output in the same period of time.

Regrettably, American productivity gains have been slipping. TABLE 1 shows the annual productivity changes from 1959 through 1978. During the first ten years, there were eight years with gains of 2% or more. There were only three such years during the last ten, and two years showed productivity losses.

TABLE 1 -- CHANGES IN PRODUCTIVITY

(% changes from preceding period, seasonally adjusted, for the non-farm 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

Reports for the second quarter of 1979 are even more alarming. For non-farm businesses, the change from the first quarter of 1979 to the second quarter was -4.3%.

This sagging growth rate indicates more severe problems ahead for both the worker's paycheck and the cost of goods and services. While overall U.S. productivity remains ahead of our industrial competitors, the declining rate of growth is weakening that lead and could wipe it out completely. The American worker requires continuing investment in more efficient and technologically advanced plant and equipment if

productivity gains are to return to sustained higher levels. With the increasing costs of energy, this need for new investment will become even greater.

Industrial Production

Another sad statistic is the comparison of growth in U.S. industrial production to that of the rest of the world during the last several years. Our capacity to supply goods has not been growing as fast as most of our industrialized competitors. Of the major industrialized free world nations, only the U.K. has lagged behind us in production growth rate since 1967.

TABLE 2 -- GROWTH IN INDUSTRIAL PRODUCTION

(1967 = 100)

Year	Japan	Canada	West Germany	France	United States	United Kingdom
1967	100.0	100.0	100.0	100.0	100.0	100.0
1968	115.2	106.4	109.2	104.0	106.3	106.8
1969	133.4	113.7	123.1	114.0	107.4	110.3
1970	151.7	115.3	131.1	120.0	107.8	110.9
1971	155.8	121.5	133.6	129.0	109.6	110.6
1972	167.2	130.7	138.7	135.0	119.7	113.2
1973	190.5	143.0	147.7	145.0	129.8	123.0
1974	183.1	147.5	145.1	148.0	129.3	120.0
1975	163.9	139.6	137.1	139.0	117.8	114.3
1976	182.0	146.7	149.1	149.0	129.8	117.4
1977	189.5	152.6	152.7	152.0	137.1	123.1
1978	201.1	160.8	155.8	154.7	144.9	126.8

Source: Economic Report of the President, 1979
Foreign Industrial Production: December 1978, Department of Commerce

Total Productive Investment

Sad as the productivity and production statistics are, they should not be too surprising. An economy cannot realize significant steady increases in these areas if it has not been investing in the new plant and equipment which generate those increases. For many years, government spending and tax policies have encouraged high levels of consumption while inhibiting the savings and investment needed to develop the capacity to supply efficiently the consumer's demands. Meanwhile, our industrialized foreign competitors have encouraged higher levels of investment. TABLE 3 shows the relative rates of investment in non-residential business assets among the U.S. and our major foreign competitors. In this comparison, the U.S. is behind even the U.K. in the percentage of our gross domestic product which is devoted to productive investment.

TABLE 3 -- REAL NON-RESIDENTIAL FIXED INVESTMENT AS A PERCENT OF REAL GROSS DOMESTIC PRODUCT, 1966-1976

Country	% of gross domestic product
Japan	26.4
West Germany	17.4
Canada	17.2
France (1970-1975)	16.7
United Kingdom	14.9
United States	13.5

Source: Economic Report of the President, 1979, Organization for Economic Cooperation and Development

A Change is Needed

To attack these problems, a fundamental longterm change in our economic thinking is needed. While reducing government policies which generate inflation, governmental barriers to savings and investment

must also be eliminated or reduced. Long years of counterproductive tax policy and regulatory excess have actually discouraged new investment in and by American industry. Now, we are paying the price with aging productive capacity, sagging productivity and faltering competitiveness in world markets.

It is time to focus on America's capacity to produce in modern and efficient industrial plants. The NAM agrees with the President's Council of Economic Advisors 1979 Annual report which noted:

> Private investment during the coming years will play two important roles in shaping economic developments. A strong rise in business fixed investment will be required to achieve sustained economic growth and declining unemployment. Substantial growth in the capital stock will also be needed to expand our capacity to produce. Only by devoting a significant share of current production to replace, modernize and expand the capital stock can we hope to maintain adequate growth in productivity.
>
> Economic Report of the President, 1979

CAPITAL RECOVERY POLICY

Recognizing the need to generate more investment is a major step, but it is not enough. Definite actions must be taken.

Federal tax policy now contains a strong bias against savings and investment. For example, the high corporate tax rate is a severe penalty on income generated by business. This is followed by the double tax applied to corporate income paid as dividends to shareholders, at rates ranging up to 70%. Capital gains taxes are applied to both real gains and inflation gains on investments.

However, while all of these problems need attention, depreciation reform appears to offer the best legislative promise. Earlier this year, the Joint Economic Committee issued its first unanimous report in 20 years. The Committee voiced a growing congressional sentiment by stating:

> Some of the tax changes in the Revenue Act of Act of 1978 will stimulate investment. But these are not sufficient. We believe that per dollar of revenue loss, liberalization of depreciation allowances would be the most effective stimulant.
>
> The 1979 Joint Economic Report

The fundamental problem with the current depreciation system is that it ties deductions to long "useful lives", thus raising the cost of capital either by increasing the interest cost of borrowing to finance investment or by foregoing the return on a new investment during the long recovery period. Long lives also tie up investment dollars which should be reinvested more quickly to keep pace with new technology and to expand capacity. This is particularly troublesome to manufacturers with average depreciable lives of about nine years on machinery and about forty years on buildings. This bad situation is made even worse by inflation which erodes the value of the invested dollars recovered over long depreciation periods.

Another major problem for taxpayers is the myriad of rules, formulas and regulations with which they must comply under present depreciation concepts. Disputes with IRS agents over lives and calculations of deductions are the major controversies for business taxpayers.

The time spent arguing with IRS about depreciation is wasteful. The Class Life System and the Asset Depreciation Range (ADR) reforms, instituted under the Revenue Act of 1971, have improved the available rate of recovery for major firms. However, the recordkeeping problems under these changes are significant. As a result, few firms have been able to use ADR, although a major protion of all productive assets are covered by it.

The Capital Recovery Allowance System

The best approach to depreciation reform is to scrap the useful life concept. In its place, Congress should enact a capital recovery allowance system, as proposed in S.1435.

Write-off periods. Capital recovery allowances would allow the taxpayer to recover capital investments over very short periods of time. The allowances would not be related to useful lives. Recovery periods would be divided into a limited number of categories for different groups of assets.

Asset Group	Recovery period
buildings (except residential rentals)	10 years
machinery and equipment	5 years
autos and light trucks (up to $100,000 of annual purchases)	3 years

With no disputes over useful lives, an enormous administrative burden would be lifted from both the taxpayer and the IRS, and a major source of audit controversy would be ended.

Percentage deductions. Instead of having to choose among several accounting techniques and make a series of calculations, the taxpayer

would utilize a deduction schedule for each asset group, based on the existing accelerated deduction techniques and the half-year convention (*i.e.*, the assumption that all assets purchased throughout the year were in fact purchased at mid-year). The schedules would tell the taxpayer what the maximum deduction for each year would be.

	Categories		
Year	3 years (autos, trucks)	5 years (machinery and equipment)	10 years (sturctures)
1	33%	20%	10%
2	45	32	18
3	22	24	16
4		16	14
5		8	12
6			10
7			8
8			6
9			4
10			2

The taxpayer could take up to the maximum deduction each year or carry forward any portion of it. The unused portion would be added to the next year's maximum and the same discretion would apply.

Other features:

-- The investment credit would be 10% for the five year category and 6% for the three year category, subject to recapture of 2% per year for earlier dispositions;
-- No salvage values would be deducted from the depreciable basis;
-- The system would become applicable as costs are paid, if that is earlier than the year an asset is placed in service;and
-- There would be no distinction between new and used property for capital recovery purposes.

ECONOMIC BENEFITS

Present Value

It is readily apparent that capital recovery allowances are larger in the early years than the deductions for most assets under current law. But will this necessarily make capital investments more attractive than under present depreciation since the same amount of dollars eventually is deducted under either system (except for salvage values)?

The answer is "yes" for several reasons. The major factor is the favorable effect on the cost of physical capital, i.e., plant and equipment. Because capital costs are recovered through depreciation deductions spread out over a period of time, the resulting cash flow must be discounted to reflect the lost income due to the interest cost paid for the use of the money or to foregone interest earnings on new investments. The discounted stream of depreciation deductions, multiplied by the statutory tax rate, results in the present value of the tax benefits.

Obviously, if a company recovers its capital costs more quickly, the present value is higher, and the deductions are more valuable. Thus, the cost of capital drops and the rate of return rises. A related, although secondary, factor is that faster cash flow can lessen debt financing, which would further decrease the cost of capital.

TABLE 5 compares the discounted cash flows from depreciation deductions under current techniques to the value of deductions under the proposed five year capital recovery allowance category.

TABLE 5 -- DISCOUNTED CASH FLOWS

($100,000 asset; 10 year life with one-half year convention but no salvage value for Current Law Techniques; 46% corporate rate and 9% interest for a 4.9% after tax discount rate)

Year	Current Law Techniques: Straight line	Current Law Techniques: Double declining balance	Current Law Techniques: Sum-of-the-years-digits	Capital Recovery Allowances
1	$ 2192.56	$ 4385.13	$ 3986.52	$ 8979.99
2	4180.29	7524.53	7220.62	13696.85
3	3985.03	5738.44	6158.86	9792.78
4	3798.88	4376.31	5180.16	6223.58
5	3621.43	3337.51	4279.80	2966.43
6	3452.27	3545.01	3452.27	--
7	3291.01	1941.17	2692.71	--
8	3137.28	1480.40	1996.57	--
9	2990.74	1129.00	1359.29	--
10	2851.04	861.01	777.48	--
11	1358.93	656.63	247.05	--
Present Value	*34,858.46	*33,975.14	*37,351.33	41,669.63

*These three figures would be lower if normal salvage values had been used.

Note: The double declining balance method does not fully depreciate an asset. Also, firms generally use a combination of depreciation methods so that the present value of a typical technique would be closer to $38,000 for a $100,000 asset. However, the required use of salvage values would reduce all of the current law figures since fewer dollars could be deducted.

There is a considerable body of economic research that testifies to the fact that the dominant factor determining investment behavior is the cost of capital. Therefore, any decrease in the cost of a capital asset will lead to increased investment in that specific asset. Clearly, the cost of capital under the capital recovery allowance system is lower than under current law because of higher present values of the tax benefits. It can be expected that large increases in

investment in physical capital will occur following the enactment of the system. A snowball effect can develop as new projects are initiated and their capital costs are recovered and reinvested, leading to large increases in the economy's stock of capital.

ECONOMIC EFFECTS

The Analysis of Tax Impact Model, developed with NAM sponsorship by the economic consulting firm of Norman B. Ture, Inc., estimates that the system would induce major increases in capital investment, which would also increase total tax deductions. TABLE 6 summarizes the areas of impact as determined by the model in June. The Ture firm currently is updating this analysis to take into account the five year phase-in period in S. 1435.

TABLE 6 -- INDUCED CHANGES IN DEPRECIABLE INVESTMENT AND TAX DEDUCTIONS*

(billions of constant 1979 dollars)

	1980	1982	1984	1989
Increased depreciable investment	$34	$51	$69	$31
machinery and equipment	20	31	40	20
structures	14	21	29	11
Increased recovery deductions	43	80	105	82
due to the system applied to expected investment under present law	38	63	76	62
due to the system applied to increased investment stimulated by the system	5	17	29	20

*All estimates reflect increases above what would otherwise occur under current law.

Source: Norman B. Ture, Inc., June 1979.

The Model estimates the differences between what would otherwise be expected to occur under present law and what could be anticipated following a change. It should also be noted that the Model's output does not forecast economic developments. Rather, it is based on a general trend over a long period of years. Therefore, the output must be read as an indication of the direction and order of magnitude of the economic impact of the proposed system.

The snowball effect of the system on capital stock is readily noticeable. This increase in the existing stock of physical capital will create a multitude of economic benefits in terms of output, employment and real wages. The Model also estimates significant beneficial impact from such a system on employment, real wages and output over a period of years as noted in TABLE 7.

TABLE 7 -- GENERAL ECONOMIC EFFECTS*

Changes in:	1980	1982	1984	1989
Employment (thousands of full-time employees)	240	340	440	490
Annual Wage Rate (1979 dollars)	$190	$260	$350	$400
Total GNP (billions of 1979 dollars)	31	48	67	82
Business Sector GNP (billions of 1979 dollars)	25	36	50	62

*All estimates reflect increases above what would otherwise occur under present law.

Source: Norman B. Ture, Inc., June 1979.

CONCLUSION

The current interest in major depreciation reform presents a legislative opportunity which should not be allowed to pass unused. We strongly urge you to support S. 1435 actively and to urge your colleagues to do the same. If this simplified rapid capital recovery system is enacted, it will greatly reduce the complexity of federal tax law for business and encourage needed longterm increases in investment in productive plant and equipment. These are both worthy objectives, and the NAM wholeheartedly supports them.

STATEMENT
OF
ERNEST S. CHRISTIAN, JR.
BEFORE THE
SENATE COMMITTEE ON FINANCE
SUBCOMMITTEE ON TAXATION AND DEBT
MANAGEMENT GENERALLY

October 22, 1979

On Behalf Of The American Retail Federation; The National Retail Merchants Association And The Following Companies: Allied Stores Corporation; Associated Dry Goods Corporation; Carter Hawley Hale Stores, Inc.; Dayton Hudson Corporation; Federated Department Stores; K-Mart Corporation; R. H. Macy and Company, Inc.; The May Department Stores; Montgomery Ward & Company; J. C. Penney Company, Inc.; and Sears, Roebuck and Company

SUMMARY OF STATEMENT

1. The Capital Cost Recovery Act of 1979, S. 1435, is a distinguished and historic legislative initiative.

2. The retail sector of the economy strongly endorses S. 1435 which is the key to increased capital investment, productivity and growth in our economy.

3. S. 1435 would take the final step forward in the evolution toward a capital cost recovery system and away from a "useful life" system of depreciation.

4. Enactment of S. 1435 would have a dramatic effect in increasing the level of fixed capital investment and economic growth, but S. 1435 is not a radical departure from the present depreciation system. The guideline system of depreciation adopted in 1962 and the Asset Depreciation Range System adopted in 1971, long ago substantially departed from outmoded concepts of "useful life" depreciation. Useful life depreciation never was, and never could be, anything more than a rough, often inaccurate, and generally arbitrary prediction of facts and circumstances far out into the future.

STATEMENT
OF
ERNEST S. CHRISTIAN, JR.
BEFORE THE
SENATE COMMITTEE ON FINANCE
SUBCOMMITTEE ON TAXATION AND DEBT
MANAGEMENT GENERALLY

October 22, 1979

On Behalf Of The American Retail Federation; The National Retail Merchants Association And The Following Companies: Allied Stores Corporation; Associated Dry Goods Corporation; Carter Hawley Hale Stores, Inc.; Dayton Hudson Corporation; Federated Department Stores; K-Mart Corporation; R. H. Macy and Company, Inc.; The May Department Stores; Montgomery Ward & Company; J. C. Penney Company, Inc.; and Sears, Roebuck and Company

Introduction

Enactment of the Capital Cost Recovery Act of 1979, S. 1435, would be a major step forward in eliminating impediments to capital investment and improved productivity that are imposed by our present income tax system. S. 1435 is a distinguished and historic legislative initiative in a number of respects. First, by establishing statutorily prescribed cost recovery periods of 10, 5, and 3 years, S. 1435 would break the link between tax depreciation and the physical "useful lives" of business assets -- a

limitation in present law which has long both unduly complicated depreciation and frustrated attempts to provide appropriate cost recovery allowances in the face of escalating inflation and other factors which have made "useful life" depreciation allowances inadequate. Second, S. 1435 would vastly simplify our present complex depreciation system of about 130 separate classes of assets and depreciation lives. Third, by providing uniform capital recovery periods of 10, 5, and 3 years for nearly all business assets, including buildings as well as movable equipment, S. 1435 would achieve a substantial degree of desirable neutrality in the impact of the tax system on capital investment decisions.

The retail sector strongly endorses S. 1435 as the key to greater capital investment, increased efficiency and enhanced productivity in our economy.

Historical Perspective

S. 1435 correctly can be viewed as the culmination of a 10 to 20 year process of gradually moving away from a useful life system of depreciation closely tied to the actual physical life of each particular item of a business' fixed capital investment. Inexorably, the movement has been toward a capital cost recovery system which prescribes by statute reasonably uniform rates of capital recovery for all business assets. A cost recovery

system recognizes that the actual physical life of any particular asset is not necessarily an adequate measure of the economic life cycle of an asset. Such a system also recognizes that other factors, including the overall impact of the tax system itself, justifies allowing business firms to recover more rapidly the costs of their fixed capital investment.

The process of moving toward a capital cost recovery system began in 1962, when the Treasury adopted the so-called "guideline" system of depreciation which was published as Revenue Procedure 62-21. The Treasury grouped depreciable assets into approximately 100 classes according to the type of business in which used. Treasury assigned to each class a "guideline" life which taxpayers were permitted to use in depreciating all the assets in that class without regard to the physical life of any particular asset. Some of the assets in each class had physical lives longer than the guideline and some had physical lives shorter than the guideline. However, because of the strictures of the so-called useful life limitation on depreciation, which the Treasury was unwilling or unable completely to abandon, the Treasury included what was called a "reserve ratio" test intended to determine over a long period of time whether a particular taxpayer's actual replacement practices roughly corresponded to the guideline life and

justified the continued use by the taxpayer of the guideline life.

Because the guideline lives for equipment were significantly shorter than the depreciable lives otherwise in use by many taxpayers, and because the results of the "reserve ratio" test would not show up until a number of years in the future, guideline depreciation resulted in a significant increase in the rate of capital cost recovery for 1962 and for a number of years thereafter. Guideline depreciation was introduced, along with the investment tax credit, to provide a stimulus to capital investment and to counter a serious lag in productivity and economic growth.

The next significant step toward a capital cost recovery system was taken nearly a decade later when we were again faced with similar concerns about the levels of fixed capital investment and economic growth. The Asset Depreciation Range System was introduced in 1971 to replace the by then insufficient guideline system. The "reserve ratio" test, established with the 1962 guidelines, was by 1970 beginning to have the effect of limiting depreciation. It held out the possibility that depreciable lives would actually be lengthened at a time when it was desired to shorten depreciable lives in order to provide an incentive to capital investment. Also, the President's Task Force on

Business Taxation had a short time earlier recommended adoption of a capital cost recovery system involving a major reduction in depreciable lives. The Task Force report had also compared the depreciation system in the United States with capital cost recovery systems used by our principal trading partners where the real cost of capital -- after taking taxes into account -- was less than in the United States. This report, and other comparisons of the relative cost of capital, came at a time when we were facing a severe balance of payments problem in relation to these same principal trading partners.

The Asset Depreciation Range System was promulgated in early 1971 through Treasury regulations and was enacted into law in December of 1971 as part of the Revenue Act of 1971, which also reinstated the investment tax credit. Basically, the ADR system did two things. First, it shortened the guideline life for each class of equipment, but not for buildings, by a uniform 20 percent. Second, it eliminated the "reserve ratio" test, so that taxpayers would be able to use the newly-shortened guideline lives as a matter of right without having to meet a useful life requirement. The ADR system went on, primarily by means of lengthy Treasury regulations, to provide a significantly revised, largely self-

contained, set of rules for the retirement of assets, for the determination and significance of salvage values, for the use of vintage accounts, etc. These operating rules by implication substantially departed from the "useful life" concept and are in a more refined form substantially reflected in S. 1435.

Although the ADR system moved a long way toward a capital cost recovery system and must be considered the direct ancestor of S. 1435, it did not totally eliminate the useful life concept nor did it provide an adequate mechanism for continuing to adjust the guideline lives as circumstances change. In fact, in now critical respects the ADR system institutionalized a type of useful life concept in only a somewhat different form by establishing a special office in the Treasury -- the Office of Industrial Economics. OIE was charged with the responsibility of collecting data about retirement and replacement practices of business firms using the ADR system, with monitoring the application of the classes and class lives under the ADR system, and with revising those classes and class lives from time to time.

In the eight years since the ADR system was enacted, the OIE has refined the class descriptions and established some new classes. It has in a few instances also made changes in the basic guideline lives for some

classes. However, OIE's mandate from Congress and its ability to alter the class lives is limited. Basically, OIE is limited to an aggregate or industry-wide useful life concept, perhaps tempered to some extent by the concept of economic depreciation. OIE also is limited to maintaining a rough proportionality between the multiplicity of short-lived and long-lived asset classes as originally established in 1962 and modified in 1971.

Thus, despite the fact that the ADR system was a major step toward capital cost recovery, and despite the fact that the Office of Industrial Economics has for many years been under the progressive leadership of Mr. Karl Ruhe, who is one of the leading experts on depreciation, further statutory change, in the form of S. 1435, is necessary in order for the ADR system finally to evolve into a true capital cost recovery system.

A major difference between the ADR system and a capital cost recovery system, such as S. 1435, relates to the multiplicity of classes and lives under ADR. S. 1435 has only three classes of assets and their recovery rates are based on 10 years, 5 years, and 3 years. ADR has about 130 classes of assets and provides widely varying recovery rates of from 2 years to 40 years. This disparity in treatment -- largely based on outmoded physical useful

life concepts -- results in widely varying after-tax costs of fixed capital investment in different sectors of the economy and among otherwise similarly situated business firms. Such lack of uniform treatment and the failure to look upon the depreciable assets of any business firm merely as a pool of dollars invested in the assets necessary to produce goods and services without regard to the particular mix of assets or their physical characteristics, is contrary to the concepts of capital cost recovery. A related difference is the failure of the ADR system to apply to buildings. While in theory the basic framework of the ADR system applies to buildings as well as to equipment, the 20-percent reduction in guideline lives introduced in 1971 does not apply to buildings. S. 1435 would apply a 10-year capital cost recovery period to buildings.

Another major difference which reflects a defect in the ADR system is complexity vs. simplicity. S. 1435 is relatively simple in its operation. On the other hand, the ADR system is not in its structure a simple mechanism, even though it did successfully eliminate much of the administrative controversies associated with useful life depreciation as applied in audits on a taxpayer-by-taxpayer basis. Many smaller business firms do not use the ADR system.

Some sources indicate that while the greatest portion of total business assets are depreciated under the ADR system, the majority of taxpayers do not use ADR. The complexity of the ADR system is due to a number of causes. First, there is the multiplicity of classes and lives implicit in the remaining vestiges of useful life depreciation still present in ADR. Second, and closely related, are the data reporting requirements which although now simplified have been a problem for many taxpayers. Third, there are complexities arising out of the attempt to engraft upon the former outmoded depreciation rules a substantially new system, without facing up to the adoption of a capital cost recovery system and starting afresh as would S. 1435. Lastly, the ADR system and the regulations published thereunder were the first major attempt at a version of a self-contained capital cost recovery system. Much has been learned since then, and that experience is to a substantial extent reflected in the simplified techniques in S. 1435.

Underlying Concepts Of S. 1435 In A Current Context

Viewed in a current context, against the background of the development of cost recovery concepts over the last two decades, S. 1435 is the next logical step.

It has now been nearly a decade since any meaningful change has been made in depreciation, but within that time much else has changed. The rate of inflation has continued to rise and interest rates are approaching and surpassing all-time highs. New technologies are coming on stream throughout the world. Competition in world markets is more intense. Large new capital investments to accommodate to changed energy circumstances and to comply with governmental regulations are being required of nearly all business firms. Predictably, business fixed capital investment and productivity are lagging -- a matter of major national concern.

It is irrational to look at the impact of the tax system on a piecemeal basis -- to consider depreciation or capital cost recovery in isolation independent of the overall impact of the tax system on savings, investment and productivity. The total burden of tax must be considered. Not only have many other countries adopted capital cost recovery systems, many have also made, or are in the process of making, major structural changes in their tax systems which substantially reduce the overall tax burden on productive capital investment. Many countries have integrated their corporate and shareholder taxes. Many

countries provide substantial tax incentives for personal savings. In contrast, in the United States we still impose a double level of tax on earnings realized in corporate form. Also, with a few limited exceptions related to retirement plans, we fully tax personal savings. The result is that savings must be accumulated out of after-tax, not pre-tax, income.

There have in recent years been some reductions in business taxation, but they have not even offset the corrosive effects of inflation on a business firm's ability to make and replace fixed capital investments. There have also been some reductions in personal taxation, but these reductions have only offset the tax increases from bracket-progression as a result of inflation. The overall impact of the tax system is still to impose a relatively high burden of tax on savings and on business capital investment. Within that framework, the importance of adequate capital cost recovery allowances is greatly magnified.

The effects of inflation -- not just inflation that may be expected to occur in the future but inflation which has already occurred -- would alone be sufficient to warrant the increase in the rate of capital recovery that would be provided by S. 1435. The effects of continuing high rates of inflation on a business firm's ability to

replace its fixed capital investment are so devastating that the Securities and Exchange Commission has already moved to require some disclosure in financial reports. The accounting profession is moving in the direction of requiring that the effects of inflation on fixed capital investment be shown in financial reports to shareholders. Serious proposals have been made to provide for price level basis adjustment depreciation for Federal income tax purposes. Under such proposals, a taxpayer's deduction for depreciation would not merely be related to the original cost of the asset but would be related to the increased cost of replacing that asset as measured by annual increases in the Consumer Price Index or some similar index. Such proposals for indexing depreciation have, however, generally been resisted, in part because of their complexity and in part because of a general reluctance to give statutory recognition to the spectre of inflation continuing on a long-term basis into the future. Many of these concerns about indexing depreciation are real and there is not general agreement on exactly how the adjustment for price level changes should best be taken into account. Moreover, merely indexing depreciation for inflation which might increase capital recovery allowances as inflation increased, but which would decrease capital recovery allowances as price levels declined, would not address on a permanent basis the

underlying long-term need for an improved capital recovery system.

The impact on business firms of depreciation or capital cost recovery allowances is primarily a cash flow effect. At the very heart of our tax system -- when we undertake to measure the impact of taxes on any business firm -- lies the distinction between an expenditure which for tax purposes can be expensed in the year made and an expenditure which for tax purposes must be capitalized in the year made. If an outlay of $100 can be expensed, the tax system is neutral as to that expenditure. The firm needs only $100 to be able to make that expenditure which, in effect, is made out of pre-tax earnings. But if the $100 outlay must be capitalized, a corporate taxpayer subject to a 46 percent tax rate must have $195 in order to make the $100 expenditure. In effect, the business firm must make the expenditure out of after-tax earnings.

The business firm which makes the capitalized expenditure may in the future through annual depreciation deductions recover the cost of the capitalized outlay. Because those deductions are postponed, it is as if the firm had prepaid tax which will be refunded in installments over a future time period. Having made that pre-payment, the total cash flow cost to the firm directly relates to the interest or discount rate, and the number of years over which

the depreciation deductions are spread. By definition, the longer the depreciation life or capital cost recovery period for any particular outlay for a capital asset, the greater is the cash flow cost to the firm at any given rate of interest. It is also obvious that the longer the depreciation life or capital cost recovery period, the greater is the chance that any predicted future income stream from the investment may be inaccurate and the greater is the risk to the firm undertaking to make that capital outlay.

In theory, if there were a perfectly stable and completely predictable economic environment, if interest rates and price levels remained constant, if there were no new technologies or other changes, and if the various short and long depreciation lives under the present system accurately reflected the future income stream and relative economic values of all assets in the multiplicity of ADR classes, the present depreciation system, and the long recovery periods which it entails, might be justified. But such theoretical predictability and accuracy does not exist. Moreover, it would be difficult to suggest that any new or updated study of "useful lives," or any mere tinkering with the present ADR system, could ever achieve it. It must be understood that "useful life" never has been and never could be anything more than a rough estimate or

prediction of circumstances in the future; and the longer into the future that prediction extends, the greater the inaccuracy.

The capital cost recovery system provided by S. 1435 directly addresses the need for improvement in the present system. First, S. 1435 would accomplish a significant reduction in the tax liabilities of firms which make productive capital investments, which in turn would provide substantial additional cash flow, and provide a powerful incentive for new investment. This change -- viewed in the larger context of our overall tax system -- would partially offset the present relatively heavy burden of tax imposed on savings and investment. Second, by shortening the number of years over which capital investments are to be recovered, S. 1435 would in a simple, straightforward manner substantially eliminate the need for complex indexing or price level basis adjustment depreciation. Third, by narrowing -- into some reasonably predictable period of 5 to 10 years -- the period for capital recovery for all assets, S. 1435 would eliminate much of the present distortions and disparities in after-tax costs associated with the present 15, 20, 25, or even 40-year recovery periods where productivity and value can, in fact, not be predicted for that long a period with much accuracy. Having in mind the national purpose of increased capital

investment and productivity, to the extent that S. 1435 would allow more rapid capital cost recovery for any particular investment than might be justified by a theoretically pure income measurement based on "useful life," S. 1435 would err on the side of liberality.

While enactment of S. 1435 could be expected to have a dramatic effect on capital investment, it is not a radical departure from the present system as it has evolved over the last 20 years. S. 1435 is in fact merely the logical next step. We do not now have anything even approaching a pure useful life system of depreciation. We long ago, quite logically and out of necessity, departed from that. What we have in the ADR system is nearly a cost recovery system, but one which has been twisted and tortured to maintain the facade of useful life and one which is, therefore, incapable of further adjusting to the need for improved capital recovery. S. 1435 would resolve that impasse and, in doing so, contribute substantially to capital investment and economic growth.

Senator BYRD. The next panel consists of Mr. Daniel Boorstin, Librarian of Congress; Mr. Robert Wade; Mr. Dana Fradon, cartoonist, New Yorker, Cartoonist Guild, the Council for Creative Artists and the Authors League of America; Mr. Cleve Gray, artist, Cornwall Bridge, Conn.; and Mr. Norman Tanis, director of university libraries, California State University at Northridge, representing the American Library Association.

Senator Javits is interested in this legislation and he will be here shortly, but I think we might as well proceed.

Who would like to start off?

STATEMENT OF DANIEL J. BOORSTIN, LIBRARIAN OF CONGRESS

Mr. BOORSTIN. I appreciate the opportunity to appear here today to support S. 1078, a bill to amend the Internal Revenue Code of 1954 to provide for taxation of artists' income and estates.

For many years, the Library of Congress, as well as other research institutions in the United States, has actively solicited gifts

of personal papers, music, rare books, prints and photographs, and other historically valuable material. The preeminence of the Library of Congress collections in these areas is largely due to our ability to solicit and receive such gifts. The donors have been able to deduct the fair market value of the gift made as a charitable contribution.

One category of donors has, however, since the enactment of the Tax Reform Act of 1969, been unable to claim such a deduction as a charitable contribution. These are the creators of literary, scientific, and artistic material.

Living authors, poets, musicians, scientists, and artists who wish to donate the results of their creative efforts to a library or a museum are ineligible for a deduction. Yet, at the same time an owner of a work of art or manuscript created by someone other than himself can take advantage of the charitable contributions deduction.

The inequity has had a devastating effect on the ability of libraries and museums to receive and preserve important collections for future generations. Before 1969, the Library of Congress Music Division was annually receiving from 35 living composers the original manuscripts of their work. From 1963 to 1970, 1,200 manuscripts were added to the collections and since that time we have received a scant 30. Composers have ceased making donations to the Library of Congress or have put the material on deposit without a deed of gift. But we find it hard to justify using public funds to arrange and classify materials without assurance that they will remain in the national collection.

The Library of Congress Manuscript Division was receiving manuscript collections totaling nearly 200,000 manuscripts a year before 1969. Although bequests and donations of other material have occurred, the Library of Congress has received only one major gift of self-created material of a living author since 1969.

The number of gifts of original works of art to the Prints and Photographs Division of the Library by living artists, photographers, and cartoonists has dwindled since the 1969 Tax Reform Act. Three New Yorker artists have stopped donating their drawings and cartoons as a direct result of the 1969 act.

The consequences of the reduced level of acquisitions will have a disastrous effect on scholarship, on the study and appreciation of American civilization. Creators disperse their collections by selling them on the open market—mostly to individual collectors. Thus, the material ceases to be available for research in public institutions.

Even more alarming, these materials are usually stored where they suffer rapid deterioration and are subject to risks of fire, flood, and theft. They are lost forever.

I am aware of your committee's concern about abuse of charitable deductions. S. 1078, the bill before you, addresses this problem in a most sensible way. Many of us would, of course, like to see the restoration of the 100-percent fair market value provision. But we applaud the provisions in S. 1078 which will partially restore the charitable deduction. We hope and expect that it will stimulate donations.

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It has been widely felt our unfortunate situation today was a result of Congress well-motivated effort to prevent abuses of the charitable contributions provisions by public officials who were donating materials that had been created at taxpayers' expense.

S. 1078 specifically prohibits this practice. At the same time, it recognizes that it is in the public interest that material of artistic, musical, and literary significance should be donated to public institutions.

Our Nation thrives on our heritage. Positive action by the Congress such as enactment of S. 1078 will remind us that we all have a share in that heritage and we all are nourished by it. To garner the works of artists, musicians, and authors by enacting S. 1078 will help us preserve a precious part of us.

Appended to my statement is a list of manuscripts that have been sold on the open market and the prices paid. I would appreciate it if this could be made a part of the record.

[The material referred to follows:]

Sales as Listed in *American Book Prices Current* -- Examples
1970--1978

Marc Connelly	
typescript working draft, *Green Pastures*	$6,500
Zane Grey	
typescripts of novels	1,900-$3,000
autograph manuscripts	
41 leaves	350
436 leaves	1,700
498 leaves	2,000
Jerome Kern	
autograph transcript (music)	150, 90, 80, 400
Anne Morrow Lindbergh	
autograph manuscript poem 1 p.	130
Clifford Odets	
typescript play *The Big Knife*	170
John O'Hara	
2 autograph letters and 20 letters signed	1,500
Archibald MacLeish	
corrected proof, *Conquistador*	550
Arthur Miller	
typescript rehearsal version, *All My Sons*, signed	200
Marianne Moore	
corrected typescript and galleys for *Puss in Boots*	1,100
Katherine Anne Porter	
typescript article	725
typescript short story	725
12 signed letters	750
William Saroyan	
signed letter	95
Arnold Schoenberg	
autograph music 2 p.	225
autograph transcript (music)	375

John Steinbeck	
archive of material from <u>Winter of Our Discontent</u>	$5,000
Igor Stravinsky	
autograph music 16 p.	1,900
autograph transcript (music)	160, 225, 170, 140
autograph letter	850
Ethel Waters	
93 autograph letters	675
Thornton Wilder	
40 p. typescript manuscript, original working draft of <u>Bridge of San Luis Rey</u>	3,500
17 autograph letters	575
Tennessee Williams	
typescript signed 1 p.	100
William Carlos Williams	
signed letter	275

Mr. BOORSTIN. I strongly urge the enactment of S. 1078.
Senator BYRD. Thank you.
I yield to Senator Javits.

STATEMENT OF HON. JACOB JAVITS, A U.S. SENATOR FROM THE STATE OF NEW YORK

Senator JAVITS. First, may I thank you very much for holding the hearings? It has been an indispensable element of bringing up this issue. May I thank the panel, Mr. Boorstin, and especially welcome a friend and New Yorker, Mr. Fradon, a member of the Cartoonist Guild, and Mr. Gray of Connecticut, Mr. Wade from the National Endowment, and Mr. Tanis from the American Library Association.

I would state, Mr. Chairman, that the bill was dictated, as far as I was concerned, by a seeming inability to give the necessary attention to the artists' problems when we passed what I thought was a highly desirable law in 1969 which dealt with the problem of gifts generically, and resulted not necessarily by design, but in effect in a very serious discrimination against artists, so much so that we had one artist—I do not know if it has been testified to—who destroyed his works because he could not afford to pay the tax. I think that was Bentsen, was it not?

Also, I have an artist friend, the greatest in the world, Jasper Johns, who has a big problem about that, too. He has a great collection of his work, of inestimable value to our country and is really thinking about how to invest it because of the impact of the estate tax situation on him and the ability, because he is a large earner, to make gifts now.

I know I heard the last few words of Mr. Boorstin relating to the utilization of the manuscripts, what manuscripts are worth, et cetera, and how they are denied to the libraries. We have that problem with the New York public libraries. Senator Long had the problem, Mr. Chairman, I might say, concerning precisely how to handle the situation. I do not think he was nearly as much opposed to the fact that there was a problem which needed remedy, but apparently found the way to do it very difficult.

I hope, Mr. Chairman, that under your direction, and if you are impressed with the case, that it may be possible to find a way which would be helpful.

My own feeling is that we have to save our artistic heritage in the national interest. It seems to me we ought to be able to define a way to do it and I think that would probably be the essential question before you.

Thank you. I just wanted to introduce the panel and thank them, and thank the Chair.

Senator BYRD. I am delighted to have you, Senator Javits. I think this does raise a very important point. I would hope that something could be worked out.

I remember when this matter came up before the committee in 1969, there were problems in the minds of many members of the committee in regard to it. I think it is well worthwhile, Senator Javits, that you should have raised this again at this point.

It may be, as these discussions go on, we can work out something that would be satisfactory to the Treasury in protecting its concerns and also attack the problem that this bill seeks to reach.

Thank you very much.

The next witness.

STATEMENT OF NORMAN E. TANIS, DIRECTOR OF UNIVERSITY LIBRARIES, CALIFORNIA STATE UNIVERSITY AT NORTHRIDGE

Mr. TANIS. My name is Norman E. Tanis. I am director of university libraries at California State University at Northridge and a member of the University Museum Committee of the same institution. I am also the past president of the Association of College and Research Libraries, a division of the American Library Association representing research and special libraries and libraries in institutions of postsecondary education.

I appreciate this opportunity to speak in support of S. 1078, the Artists Tax Equity Act of 1979. The American Library Association views a tax incentive for contributions of creators 'works as vital to the preservation of our cultural heritage and the ability of libraries to provide students and scholars with valuable research materials. Through a system of tax credits such as that offered in the Artists Tax Equity Act of 1979, libraries will once again benefit from the donation of literary artistic and musical works.

I am the author of two studies, one in 1974 and the other in 1979, on the effects of the 1969 law on libraries and I would like to tell you just a couple of examples of what libraries have told me around the country about the effect of the 1969 amendment.

"The Act of 1969 has reduced to zero the donation of significant literary manuscripts." This is from an eastern university.

"The Tax Reform Act of 1969 has eliminated completely, with minor exceptions, the program of our Conservatory Library collection of manuscripts of living composers and musicians for its Archives for the Institute of the Study of American Music." This is from a midwestern university.

"There is no question that it has had a negative and inhibiting influence. Some active donors have simply stopped making donation of important documentation waiting for an advantageous time in the future when there will be a change in the law, or a propi-

tious turn in the market." This is from a major midwestern university.

"Most adverse. We have received a fairly large quantity of author's manuscripts since the passage of the act but only on deposit, with one significant exception. All authors have expressed a desire to give us their manuscripts but cited the act as making it financially impossible for them to do so." This is from a midwestern university.

"The Act has had a significantly deleterious effect upon this Library's acquisiton of scholarly materials that would otherwise have come our way." This is from a large scholarly university.

"I can say without equivocation that it was a disastrous blow to our efforts to collect and preserve manuscripts of creative writers." This is from an eastern college.

"The Tax Reform Act indeed has had a serious and deleterious effect upon donations to special collections at the university. Our efforts to acquire donations for the manuscript division and the university archives have met with continued frustration." This is from an eastern college.

"I know of one collection that had come to us on loan and which subsequently was sold to another institution. We should have received this collectoin as a gift had tax deduction been available." This is from a major Virginia university.

And the list goes on and on. Specific instances of manuscript collection losses directly attributable to lack of tax incentives are easily enumerated. However, the number of valuable collections lost to libraries because tax relief was unavailable to the originators will never be fully known.

There have been some who contend that libraries and research institutions have not been harmed by the present tax structure and point to continued donations of prominent authors and composers. Indeed, some collections have been received, but it is extremely important to point out that many such collections have not been donated, but rather have been placed on deposit.

This practice of placing collections on deposit, that is to loan collections under conditions set by contract, is detrimental to both libraries and the scholars who use them. It is detrimental because many libraries cannot afford the professional time and money involved in the cataloging and maintaining of a collection which may later be withdrawn, and more importantly, because use restrictions placed on such collections by their donors may severely hamper the scholarly research the collection is meant to support.

But perhaps the most important question is what becomes of those collections that are not donated to nonprofit institutions or even placed on deposit. Such collections may be sold piecemeal to dealers or private collectors, often making scholarly access difficult and costly, if not virtually impossible.

We do not know how many valuable literary and art collections were purchased to be housed abroad, thereby widely scattering the works of well-known literary and art figures. Or, such collections may also be sold to the nonprofit institutions which previously would have acquired them through donations.

The result of the latter practice of manuscript purchasing by institutions has been that at times the more appropriate location

for a collection, for example, a State historical archive, has been ignored and instead location is determined by the highest bidder. It also places an increasing burden on already dwindling book budgets.

In summary, the results of our survey indicate the following:

One, the libraries most affected by the Tax Reform Act are those which collect contemporary literature, art, and music. Collections have experienced a definite decline traceable to the present tax structure.

Two, the Tax Reform Act has also increased the practice of accepting gifts on deposit, a costly practice for libraries with a severely limited benefit to scholars and researchers.

The tax reform has definitely limited bibliographic and physical accessibility of manuscript collections through reduced donations and in cases where donations have been accepted on deposit through restricted use policies required by donors.

In addition, illogical locations and divided collections, as well as the separation of collections from closely related materials, have posed considerable problems for researchers.

The purchase of some manuscript collections places a greater burden on library book budgets. If these collections were available through donation, more money would be available for general acquisitions.

The loss of valuable archival materials is indeterminable. Specific instances of manuscript collection losses directly attributable to lack of tax incentives have been cited. However, the number of authors, artists, and composers who may have come forward with donations had the Tax Reform Act not been in effect will never be fully known.

The cultural contributions of our most prominent authors, composers, and artists and the records of our precious historical heritage are being scattered. And, a traceable archive of their achievements which have been instrumental to the growth of our society and which will lay the foundation for growth in the future, is imperiled.

We strongly support S. 1078 and feel that the tax credits offered in this legislation will provide the necessary incentive for authors, artists, and composers to donate their works to nonprofit institutions where they may be properly maintained and saved for future generations.

I appreciate the opportunity to appear before the subcommittee on behalf of the American Library Association, a nonprofit educational organization whose 35,000 members are dedicated to the improvement of library service for all the American people.

In closing, I would like to call your attention to a resolution on literary, musical and artistic donations to libraries adopted by the Council of the American Library Association at its Dallas conference in June 1979.

Senator Byrd. Two questions at this point.

How does the legislation under consideration—how is the value determined and how are abuses controlled?

Mr. Tanis. Mr. Chairman, when a donor gets a manuscript he has to have an independent evaluation which he files with the IRS and the comptrollers at the IRS can appeal this evaluation and

send in their own evaluation, or submit it to a panel of their own choice.

If the donor is unsatisfied with this type of thing, I understand there is a tax court the donor can appeal the case to, so there is due process for both sides.

Senator BYRD. Thank you.

[The attachment to the statement of Norman Tanis follows:]

RESOLUTION ON LITERARY, MUSICAL, AND ARTISTIC DONATIONS TO LIBRARIES

WHEREAS prior to the Tax Reform Act of 1969 (PL 91-172), an author or artist who donated his or her literary, musical or artistic compositions or papers to a library or museum could take a tax deduction equal to the fair market value of the items at the time of the contribution, and

WHEREAS since 1969 such deductions have been limited to the cost of the materials used to produce the composition, and

WHEREAS since 1969 donations of manuscripts and papers from authors and other figures to libraries have been severely reduced, and

WHEREAS libraries, in their present precarious financial condition, are rarely able to compete successfully for manuscripts on the open market, and

WHEREAS an entire generation of literary papers may be lost to future scholars through lack of an incentive to donate them to libraries, and

WHEREAS restoration of the tax deduction would contribute to the equitable tax treatment of authors and artists and would increase public access to and preservation of the nation's literary and artistic legacy;

THEREFORE BE IT RESOLVED, that the American Library Association go on record in support of legislative measures which would help restore a tax incentive for authors and artists to donate their creative works to libraries and museums, and

BE IT FURTHER RESOLVED, that the American Library Association supports the restoration of the pre-1969 tax deduction equal to the fair market value of literary, musical or artistic compositions or papers at the time donated by the creator to a library or museum.

Adopted by the Council of the
American Library Association
Dallas, Texas, June 28, 1979

Senator BYRD. Who is the next witness?

STATEMENT OF CLEVE GRAY, ARTIST, CORNWALL BRIDGE, CONN.

Mr. GRAY. Mr. Chairman, my name is Cleve Gray from Connecticut. I am an artist and I am a commissioner on the Connecticut Commission for the Arts which last week voted unanimously to support Senator Javits' bill and to convey you that message, I also have a list of national visual art groups that support the Senator's bill.

The Graphic Artists Guild, the Society of Illustrators, the Society of Photographer & Artist Representatives, the American Society of Magazine Photographers, the Association of American Editorial Cartoonists, the Foundation for the Community of Artists, the Cartoonists Guild, and I am sure there will be many, many other groups which, as time goes on, will support the Senator's bill.

As it stands now, the estate tax law punishes the contemporary artist very severely, and I will speak personally about that aspect of it.

I have practiced my trade for 40 years. I have shown nationally for 30 years in museums and galleries. I have had a modest success.

But it took me 20 years before I could begin to own my costs.

I really have nothing to show beyond the work that exists now in the museums of this country, but a large accumulation of work in my studio.

I have a wife and two sons who, as a result of this accumulation of works, would be devastated by the estate tax laws as it stands today.

The reason for this is that the practice of art is unlike that of any other profession. Some of the basic characteristics of that practice are one, the rapid accumulation of work in the artist's studio he cannot sell at his rate of production.

No. 2, the method of appraisal of full and fair market value is unique because each work of art is a unique work and has to find a unique buyer. It is all but impossible to say that one work of art equals another work of art.

Art galleries will attest to the difficulty in selling individual works of art.

This has caused, No. 3, the great difficulty of marketing it. There is no marketplace for art, such as there is for stocks and bonds, such as there is for jewelry internationally, which is priced by size, or quality, or color.

Four, art works, although they generally increase in the life of a contemporary artist, decrease after he dies. It is far more common for a work of art to decrease in value than it is to rise in value after he dies, for many years after the death of an artist.

We hear, of course, about the famous artists whose works increase, but that is not the case for the average artist, by any means.

The fifth problem is caused by the carryover basis rules, the loss of capital gains aspects.

The sixth by the fact that heirs cannot deduct for their contributions to museums.

I, in the last year, painted 275 works. The art galleries which represent me sold 7 percent of the work I produced. I am left with about 250 works produced in a year.

It is easy for you to see then that when I die I will leave thousands of works in my studio. This is a source of terrible discouragement and has resulted in mass destruction by many artists, as Senator Javits has mentioned.

I, myself, am destroying my work because of this problem.

Finally, sir, I would like to conclude by saying that in the last 25 years, the United States has been an international cultural leader because of the fact that the tax law had helped stimulate the arts by contributions to museums throughout the world and because of the fact that the National Endowment for the Arts has given psychological and material help to the artist, which has been of tremendous value.

This has produced millions of dollars in commerce throughout the Nation as a peripheral result of interest in the arts and it has given our country international prestige for cultural vitality.

I pray, sir, that this will not be lost.

Senator BYRD. Thank you.

[The prepared statement of Mr. Gray follows:]

Before the
Subcommittee on Taxation & Debt Management
Committee on Finance
United States Senate

October 22, 1979 Statement by Cleve Gray / Hearings on S1078 / Washington, D.C.

My name is Cleve Gray. I am an artist. I live and work in Warren, Connecticut and I am a Commissioner on the Connecticut Commission for the Arts. The Connecticut Comission for the Arts has recently decided to unanimously endorse S1078, The Artists Tax Equity Act of 1979.

I am here to testify in behalf of Senator Javits bill S1078, especially concerning those sections dealing with the estate tax laws as it effects artists.

Of course I must speak to you from personal experience. I am a moderately successful artist; at the age of 61 I have been exhibiting throughout the country for the past thirty years; yet it took me many years before I could begin to pay my expenses. I have a wife and two sons, who when I die, will be financially devastated by the estate tax law as it stands today in this country.

But I must state at the onset that I speak for EVERY artist, those who are poor as well as those who have a modicum of success, for they are the ones who today suffer most from the present law. I have no concern with the few very rich artists; they are able to sell out their work; that is why they are rich. Their inventory at death is comparatively small. But the huge majority of artists are selling at moderate prices in moderate quantity with a very high rate of production. That leaves an enormous quantity of work in the estate.

At the heart of the problem with art is the question of Valuation. The artist's manner of working and producing art is unrelated to any other professional activity. At the present, art works are appraised for estate purposes at full or fair market value, this value being derived from past sales of what appears to be "equal" works- the assumption being that art works can withh fairness be so equated. In fact they cannot; for each work of art is unique and has to find a unique buyer. This fact is intrinsic to their value. Artists and art galleries will testify to the complications, the time, and the effort expended attempting to sell each individual work at a satisfactory price.

The difficulties caused by the problem of marketing art works are compounded by the fact that virtually no artists are able to sell their work at their rate of production. An enormous inventory builds up in a lifetime. For a productive artist it can amount to thousands of works. In my case, for example, in 1978 I painted approximately 275 works; the gallery sold well, yet sales amounted to only 7% of my production. An active contemporary artist can therefore at death leave a few thousand items. Appraised at full and fair market value, the estate will run into millions of dollars. Heirs would find it impossible to pay such a tax.

Contrary to popular belief, works of art do not necessarily rise in value after the artist's death. Without the force of the artits' personality, it is far more typical for sales and prices to descend. Artists who commanded good prices during their lifetime more often than not, are forgotten after death. There are countless examples of such decreased values, whereas the reverse, increased values, is comparatively rare.

Works of contemporary art cannot easily be liquidated. No ready market like that for stocks and bonds exists. Nor can they be compared to furniture or jewelry which traditionally have accepted international values set by weight, color, quantity, species, etc. The enforced liquidation of an artist's estate, unless it was very small, would unquestionably destroy the value of the property for years to come.

The few concessions that IRS makes to artists' estates do not adequately lessen the serious problems I speak of or the many others I haven't mentioned. One of these is the length of time it takes an artist to build a reputation so that he can earn enough money to pay his espenses. S1078 is an important help in this area, extending the amount of time that an artist has to make a profit from five to ten years. There are many young and beginning new artists who will experience some relief and encouragement from this provision of the bill.

I can only mention a few more of the many serious difficulties discouraging American artists which Senator Javits' bill attempts to correct. There is the fact that heirs, like the artist during his life, are unable to gain tax relief from charitable contributions of the work. It is incomprehensible to the artist that his work is valued for tax purposes at the cost of materials when he donates it to tax exempt institutions, but when his estate is appraised it assumes full market value.

With all the above problems of valuation in mind (and there are still others) we now have to face the carryover basis rules: If heirs have by some miracle been able to pay the estate tax, and if they have found a buyer for an individual work, that sale is subject to income tax on the entire sale price. No longer does a capital gains tax apply on the gain over the appraised value. The heirs are back in the position of the artists while alive, paying full weight income tax; infact, they are worse off, as the 50% maximum tax on earned income does not apply, and they can pay up to 70%.

Using myself as an example and speaking moderately, if I leave an estate of 2,000 works averaging $2,000.each, the size of my estate is evident. On each work my heirs would pay roughly $500.in estate tax. When they are fortunate and sell a work, the gallery deducts its commission, say 25% - another $500. The heirs pay income tax on $1,500 - perhaps another $500. Then come state and local taxes. A few hundred dollars are left. But the heirs can't keep that, for it will have to go to pay off the estate tax on the remaining unsold works. In truth, the estate tax and carryover basis are, for artists, practically confiscatory.

American artists are only beginning to absorb the dreadful implications of the new aspects of the estate tax law. They are terrified. The normal editing which any good artist does of his work can turn into mass destruction. I spoke this week to Robert Motherwell, one of our greatest painters who is now unmarried and has two children. He is destroying work which undoubtedly ought to be saved if only for historical value. The same is true for other artists. I myself have burned paintings and drawings and will eventually have to destroy ruthlessly much of my life' work unless the law is changed. I cannot place such a burden on my wife, attempting to retain my work.

Some artists are being advised (badly) to hide their work. This they refuse to do as it means breaking the law. Citizens ought not to be placed in such a situation where to protect the future of their family and their own life's work they must contemplate hiding that work. So most artists are bewildered for they had understood that the government was attempting to encourage the arts.

This situation exists in no other country in the world. It is deeply discouraging to the American artist. Real artists think in terms of making, creating. If they have to face the fact that everything made will pile up into an impossible debt for the family, their desire to work is seriously affected. I for one find myself hesitating to start a canvas. I have to wonder if I have the right to inflict still more of a tax burden on my family. Can it be that in terms of our American heritage such a tax bill will remain to have such a devastating effect. In the past generation American art has taken a position of world leadership. It has brought to this country hundreds of millions of dollars in commerce and has given it a priceless reputation for cultural vitality and imagination. I pray this will not be lost. This bill, S1078, goes a long way in correcting these problems.

Cleve Gray

Senator BYRD. Would this legislation apply to an artist who has not sold any works of art?

VOICE. The contribution is a limited amount to the art, limited to 50 percent.

It is limited to 50 percent of the income derived from art.

Senator BYRD. Then if he sold no work of art throughout the years, he would not contribute to anything.

The next witness?

STATEMENT OF DANA FRADON, CARTOONIST, NEW YORKER, CARTOONIST GUILD, THE COUNCIL FOR CREATIVE ARTISTS AND THE AUTHORS LEAGUE OF AMERICA

Mr. FRADON. Mr. Chairman, Senator Javits, my name is Dana Fradon. I am a cartoonist for the New Yorker magazine. I would like to speak to you today as a member of the Cartoonist Guild and its representative on the executive committee of the Council of Creative Artists, Libraries, and Museums and also as a former contributor to the Library of Congress, and other libraries, and museums.

Like virtually all other cartoonists, I stopped contributing to these institutions when in 1969 the law on charitable gifts was changed.

I would like to express our collective appreciation to Senator Javits for introducing S. 1078, and to Senator Long and Senator Byrd for scheduling this hearing today, and for all those members of the Senate Finance Committee who are seriously considering the testimony of those who are here today.

If enacted, S. 1078 would make it possible for us once again to contribute our original drawings to those qualified institutions that request them. In the case of the Library of Congress, we would be pleased to once again become part of the cartoon collection that dates back to the American Revolution.

The bill meets very much with our favor, but we would appreciate it if the words "income derived from the sale of art work" were

broadened in some manner so as to include income derived from the granting of publication or performance rights. As with authors and composers, this is the source of our major income. Some money is also generated from sale of originals, but it is minor compared to that received for publication.

From our past contacts with Senator Javits' staff, we are certain that the intention was to include us in this bill, and it may be that the wording is sufficient. Broadly, we do indeed earn our living from the sale of art work. But to avoid possible future bouts with IRS interpretation if the bill should pass, we would appreciate some broadening of the sentence in question that specifically include income received from creative works conceived for publication as performance.

I deeply appreciate this opportunity to speak on behalf of many American artists, authors, cartoonists, musicians, who have been adversely affected by inequalities in our present tax laws.

Senator BYRD. Thank you.

Let me see if I understand this correctly. If an artist sells during a particular year $100,000 worth of paintings, for example, then he could contribute $50,000 worth of paintings.

VOICE. There is a further limitation of $35,000 in any one year.

Senator BYRD. To take another example, if he sold $10,000 worth of paintings, he would be limited to $5,000?

VOICE. Yes, sir.

Senator BYRD. That is different from anything that this committee has considered in the past, as I recall. I think that is a very important limitation.

[The prepared statement of Elie Siegmeister follows:]

October 22, 1979

STATEMENT OF

ELIE SIEGMEISTER
CHAIRMAN, EXECUTIVE COMMITTEE
COUNCIL OF CREATIVE ARTISTS, LIBRARIES & MUSEUMS

BEFORE

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

Mr. Chairman and Members of the Subcommittee:

I speak to you today in two capacities: as a composer, and as Chairman of the Council of Creative Artists, Libraries and Museums. The Council is a federation of seventeen national organizations including museums, libraries, authors, painters, sculptors, composers, other artists, and members of the art-loving public, totalling more than one and one-half million Americans.

I should like to begin, if I may, with the year 1913. It was then that the Income Tax law was enacted by Congress, and a few years later, the law on Charitable Contributions. For fifty years, from about 1919 to 1969, as a direct result of these two laws, American museums and libraries throughout the country were able to acquire, by the gifts of the artists themselves and other taxpayers, a magnificent treasury of paintings, sculptures, prints, cartoons, and the original manuscripts of poems, plays, novels, operas, musical comedies, and symphonies that form a great heritage of the American people. Each year millions of Americans visit the National

Gallery, the Metropolitan Museum, the Chicago Art Institute, the Library of Congress, the New York, Boston, Chicago, and other public libraries, as well as the libraries and museums of Yale, Harvard, Stamford, UCLA and many others, to look at the great collections of painting and sculpture, and study the original manuscripts of Eugene O'Neill, William Faulkner, George Gershwin, Aaron Copland, Richard Rodgers, Oscar Hammerstein, and other great Americans. Many, if not most of these art works came to the libraries and museums as gifts of the artists themselves, as a direct result of the law on Charitable Contributions which for fifty years granted the artist the same rights as other citizens, to make contributions and receive the deduction based on the fair market value of the works. For fifty years American institutions were vastly enriched as a result of the equitable working of this law. Nor, I may add, was the U. S. Treasury bankrupt as a result. Quite the contrary: because many of the art works were donated during the artists' lifetime, they cost the government a small fraction of what they would cost today after the artists have passed away. Across the street, in the Library of Congress, there is the original manuscript of a great American opera: "Porgy and Bess". I have no idea what tax deduction George Gershwin received for the gift of this priceless document, some thirty or forty years ago. But whatever it was, I am sure it was a tiny fraction of what it would cost that Library -- which of course is supported by the U. S. Treasury -- to

purchase that manuscript today. The law on Charitable Contributions as it worked for fifty years was a wise, humane, and thrifty law.

Why, then, am I here today? Because, as you gentlemen undoubtedly know, that law was changed by the Tax Reform Act of 1969 in such a way as to destroy the giving of artworks by the living artist. Prior to the 1969 Tax Reform Act, authors and artists could deduct the fair market value of their manuscripts, papers and paintings that they donated to tax-exempt libraries and museums. The exemption was removed by a provision of the 1969 Act designed to deal with donations of public papers by political figures. As a consequence, artists and other creative individuals no longer may deduct the appreciated market values of their own works contributed to tax-exempt organizations. The only deduction available is for the cost of materials, which is a nominal amount. On the other hand, collectors are permitted under the law to deduct appreciated market values in connection with the contribution of works they own. Authors, artists and composers consider this current tax treatment of their contributions of artworks as unfair and discriminatory.

As a result the past ten years, as any museum director or librarian can tell you, have been a disaster for American culture. I don't want to bore you with statistics, but the fact is that contributions of original works by artists, writers, composers, and other creators has practically ceased.

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The artist feels the law has made him a second-class citizen, one who is deprived of rights that the wealthy businessman or collector can still exercise. Our country is perhaps alone among the civilized nations of the world in using tax policy to penalize the artist. Other countries, among them Ireland, France and Holland, encourage the arts by granting special tax advantages to the artist who enriches his country's culture; we do the opposite.

As a result of the 1969 amendments, artists' donations of paintings, manuscripts, musical compositions and other artworks to museums and libraries have been severely curtailed. Many cannot afford to give away valuable property without a realistic charitable deduction to offset the income lost by not selling the property. As a consequence, not only the artist, but the student, the scholar, the American people as a whole have lost and are losing their priceless heritage. To take one instance, Stravinsky's greatest composition, the "Rite of Spring" could have been given to the Library of Congress a few years ago. Because the great composer learned that he would be treated worse than an average citizen, he did not make the gift, and the work went into private hands. Many paintings by our leading artists have been sold privately, some out of the country, when the artist would have been happy to donate them to an American museum where our own people could see and enjoy them.

Before concluding these remarks, I wish to say that our organization supports Senator Javits' bill which, if enacted, would go a long way toward remedying the bad situation that exists. I would make only one small suggestion. The bill as drawn would allow tax deductions for charitable contributions of artworks to be applied only to income derived from the "sale" of artworks. I should like to point out that this would benefit only graphic artists who earn their living from actually selling their physical creations. Authors and composers, however, derive the greater part of their living not by selling their original work, but from royalties derived from licenses covering the publication or performance of their works. I respectfully urge that the language of S. 1078 be amended so that the "attributable tax" limits of the bill will include taxes on income received by authors and composers from licenses and other dispositions of their creative works as well as sales. We understand that such a change is agreeable to Senator Javits, the primary sponsor. It would place all creative artists on equal footing and would enable the libraries and museums to acquire the original works directly from these creative artists.

With this slight modification, for myself and for the members of our organization, I heartily endorse S. 1078 and urge its passage in this Congress.

Senator BYRD. The next witness?

STATEMENT OF ROBERT WADE, GENERAL COUNSEL, NATIONAL ENDOWMENT FOR THE ARTS

Mr. WADE. We have had some difficulty getting the wisdom of our views on the issue accepted by the Treasury Department. We do disagree with Treasury and we are trying to work that out with OMB, but I am authorized to share with you today our concern over the issues that you have heard discussed earlier.

Chairman Biddle has authorized me to tell you we are very concerned when we can see things such as the inconsistency between the evaluation of art works for estate tax purposes and the evaluation of art works for contributions by the artists to nonprofit institutions.

As you may know, the artist is limited to the cost of his materials when he contributes a work, while he is taxed for the fair market value of such works as a part of his estate.

We feel that is an inconsistency, at least, that needs to be carefully studied, and something better worked out.

We are concerned very much when we see the drying up of contributions to the great public institutions of this Nation. We feel this is not in the public interest.

As you know, as we all know, the museums of this country are overflowing with people during their free time, that the family life of the Nation is enriched to a great extent by the availability and accessibility of our cultural resources.

We are particularly concerned when we see something like the hobby loss rule that presumes one is not a serious artist if he does not make a profit in 2 out of 5 years—very few, if any, artists make profits during their first 5 years of work. Some not for 20 years.

The Tax Court of the United States recognized this when it overruled the IRS recently in a case where a woman artist did not return a profit for 20 years, but considering all the other factors, the seriousness of the endeavor, her academic background, the length of her efforts, the Tax Court recognized that the lady was a serious artist and therefore gave her recognition of the tax benefits that other business-oriented activities are entitled to under the rules as they are now written.

I personally feel that 2 out of 20 years would not be too great a presumption. We know of artists who never make a profit—in fact, whose works are not recognized as being significant until they die, so there are other factors here.

We feel that the Treasury is not really looking at the total picture, as it looks at it in the very simplistic terms of a profit in 2 years out of 5, or what have you.

We are also concerned when we see other nations of the world, such as Mexico and France, treating artistic property so differently. I personally feel that the Treasury Department does not recognize the special significance and value to the public of artistic property, while these other nations have.

Congress has recognized the value of cultural activities in passing the National Foundation on the Arts and Humanities Act of 1965. The public recognizes it, as proven by their interest in the cultural activities.

But apparently Treasury, in its concern that special interests not receive special tax treatment, to my mind oversimplifies the situation with respect to artistic property.

I will finish simply by saying that we are very gratified for these hearings. We feel that they are of utmost importance. The Javits bill should assure that artists will receive fully equitable tax treatment and that the interest of the American people is fully recognized in these respects.

Senator JAVITS. I hope very much that the Endowment and the Treasury both get together. I don't think we should have to jump that hurdle again before we go into the Senate. Whatever they agree on, they should agree on something. At least then we will know where we are.

Mr. WADE. We will definitely be working on the Treasury Department, Senator.

Senator BYRD. That would be very helpful.

Thank you, gentlemen.

[The following was subsequently supplied for the record:]

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November 16, 1979

Mr. Michael Stern
Staff Director
Senate Finance Committee
Dirksen 2222
Wash. DC 20510

Dear Senator Byrd:

S1078, the Artists Tax Equity Act of 1979, is a bill that will greatly help American artists. Since 1969, when tax reforms caused great inequities in the law for artists, A.R.T. has been working closely with outstanding leaders in the arts community and various legislators at both the state and federal levels to attempt to introduce some legislation that would help ease the economic "catch 22" that artists are presently caught up in. We have been working with Senator Javits on this bill because it addresses the 4 areas of major concern for artist: Contribution deductions, the Hobby Loss, Estate Taxes and the issue of capital gains taxes on the sale of inherited art work.

As so many artists, museum directors, librarians & individual Americans have pointed out, in our present tax structure artists are allowed to deduct only the cost of materials when they make a contribution of their work to a charitable institution, even though a collector can at present deduct 100% of the entire fair market value of an art work should he choose to donate a piece of art. This has resulted in the loss of many valuable master pieces of national heritage American Art, to Museums, Universities and Libraries throughout the U.S. All of this is carefully documented in reports in various journals and in the testimony presented for the Congressional Record by Mr. Boorstin, Librarian of Congress and Dr. Tanis, Director of University Libraries. Legislators at the state level are concerned enough about this inequity and the implications of this great loss of American art that already three states, Oregon, California and Kansas have passed legislation that would correct the problem by allowing an artist a deduction of 100% of the fair market value. Furthermore in July of this year The NCSL recommended that this legislation be seriously considered by all of our states. At least six other states we know of are attempting to write similar legislation and the number is rapidly growing. There is no question but that this is an area of deep concern to many Americans.

ARTISTS RIGHTS TODAY, INC. **A.R.T., Inc.** 250 West 57th Street, New York, N.Y. 10019 (212) 581-5348

Mr. Javits' solution to this problem with the introduction of S1078 is a compromise proposing a 30% tax credit. This same legislation was passed by the Senate a few years ago but did not pass the joint House-Senate Committee. Enough evidence has accumulated since that time to strengthen the support for this bill and we feel the additional provisions Mr. Javits has made in S1078 to deal with the problem of Estate taxes, the hobby loss and capital gains taxes on inherited Art, are equally important and equally supported.

We have met with several members of the Treasury over the past few months to discuss some of the contradictions in the tax structure and some contradictory rulings that have adversely affected Artists and we believe it important to point out that Treasury's estimation of the losses in revenue caused in S1078 do not measure or account for the additional revenues gained through a Collection of a Treasury of National Artwork valued at upwards of 15-20 million dollars a year; nor does Treasury in its arguments against this legislation attempt to measure the additional revenue gained from people engaged in the industry because of increased tourism and commerce resulting from the display of the Art work. The Connecticut Commission on the Arts, and many other universities and institutions are compiling an impressive account of figures that reveal how deeply Arts stimulate commerce and the economy. We feel more structured discussion with the Treasury is necessary to discuss these new figures and research that Arts councils and universities as well as the U.S. Dept of Commerce are engaging in.

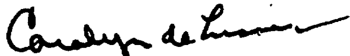
We would like to mention that the third provision of the Artists Tax Equity Act that of permitting payment of estate taxes with the inherited Artwork, is a solution also studied by the Arts Task Force of the NCSL and as a result is now recommended for state arts legislation by the National Conference of State Legislatures.Maine has already adopted this plan this year- in a more inclusive and comprehensive way. Representatives Merle Nelson and Jim Tierney of the Maine State Legislature were two of the many people who offered to testify at these hearings to indicate the success of that legislation passed in Maine. Pennsylvania is about to introduce this same legislation as a solution to the difficult problem of artists' estate taxes in Pennsylvania, and we know of three other states working on similar bills.

We would also like to mention the great economic hardship young artists must face by the present tax laws mandating that they must show a profit in two out of five years in order to deduct materials they need to produce Art. We feel the extension of time to 2 out of 10 years in S1078 will provide some relief to young artists especially who must work many years to develop the skill necessary to become professional. The law as it now exists shows little understanding of the unique path the development of a good artist must take.

To conclude, the Artists Tax Equity Act of 1979 does not offer all that the Arts community is hoping for; but it is enough to raise the hope and morale of the contemporary artists most of whom feel insurmountable economic pressure in this country. This legislation besides creating some temporary relief, will be a symbolic statement of some hope to many American artists who are bewildered and upset at the rigid, hostile laws that are certain to cause a swift decline in this nation's world leadership position in the creative arts.

We urge you and memebers of the finance committee to recommend that S1078 be adopted as law as it stands as soon as possible.

Respectfully yours,



Carolyn N. deLisser
Executive Director, A.R.T.

Enclosures

THE NATIONAL CONFERENCE OF STATE LEGISLATURES

ARTS TASK FORCE

RECOMMENDED STATE ARTS LEGISLATION

The Arts Task Force of the National Conference of State Legislatures at meetings in San Francisco July 23 and 24, 1979 adopted the following as recommended state action for the arts. While not every proposal was recommended unanimously, each of the recommendations received a majority vote of those members voting. The Task Force recognizes that not every proposal may be suitable for enactment in every state. Additional proposals may be recommended by the Task Force at subsequent meetings.

A. ARTS FUNDING

1. Art in State Buildings: Appropriate a specific percentage, often 1%, of the annual construction budget for state buildings to commission and/or purchase art for new and existing state buildings; or, less preferably, require legislative consideration of an annual appropriation to commission and/or purchase art for new and existing state buildings.

2. Artists in Residence: Establish an artist-in-residence program for such institutions as schools, hospitals, and prisons.

3. Direct Appropriations for Art Institutions: Consider direct appropriations to major arts institutions either for specific capital expenditures or to provide a significant portion of the institution's budget. Such appropriations are in addition to the regular funding of the state arts agency.

4. Local Arts Funding: (1) Authorize local governments to provide funding for arts performances such as operas, symphonies, concerts, theater, and dance; for arts exhibitions; and for a percent-for-art program for local public buildings. (2) Allow local governments to institute a hotel-motel tax or other taxes to fund cultural and tourism-related institutions and events.

B. ARTISTS' RIGHTS

5. Artist-Art Dealer Relations: Provide protection to artists who give their works to art dealers on consignment to sell or exhibit. The dealer acts as a trustee in holding the art and funds from sales. Some laws also protect artists against loss or damage to the artworks while in the dealers' possession and against claims by dealers' creditors.

6. Artists' Live-Work Space: (1) Allow local governments to establish zones where artists may live and work in buildings in urban areas previously zoned for commercial and/or industrial use and authorize alternative building code requirements in those areas; or (2) where appropriate, enact a state zoning statute establishing live-work zones.

7. Art Preservation: Provide artists, and in some cases the public, the right to bring legal action against intentional physical defacement, alteration, or destruction of artworks of recognized quality by government agencies or private owners. Both injunctive relief and action for damages may be authorized. Sometimes referred to as "Artists' Moral Rights."

8. Resale Royalties: Provide artists with a percentage of the resale price of their artworks, provided that the resale is profitable to the seller and the resale price is in excess of a specific minimum amount.

C. TAX LEGISLATION

9. Artists' Income Tax Deductions: Enable professional artists to deduct for state income tax purposes the fair market value of artworks donated to museums and other charitable organizations. Current law limits the artists' tax deduction to the cost of materials only.

10. Death Taxes: (1) Allow beneficiaries of artists' estates to defer death taxes, and/or (2) allow the death tax to be paid with art as valued by the state death tax appraiser and delivered to an appropriate institution.

D. ARTS EDUCATION

11. Basic Education: Amend the state education act to redefine basic education to include arts education at the elementary and secondary levels.

12. Gifted and Talented: Include children gifted and talented in the arts within categorical state funding of gifted and talented programs.

E. HISTORIC PRESERVATION

13. Historic Preservation: Encourage legislation to provide incentives as well as funding for the preservation of landmarks and properties of artistic, cultural, historic and architectural significance.

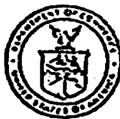
F. CONSUMER PROTECTION

14. Disclosure: Protect purchasers of fine art prints and other art issued in limited editions by requiring art dealers to disclose specific information regarding each piece sold.

15. Warranties: Require art dealers to provide express and implied warranties of genuineness with respect to the sale of limited edition prints and other artworks.

G. STATE ARTS AGENCIES

16. Composition of State Arts Agencies: Consider the feasibility and advisability of (1) legislative representation on or appointments to the state arts council or commission, and (2) one or more professional visual, literary, or performing artists on the council or commission.



U.S. DEPARTMENT OF COMMERCE
Office of the Secretary
Washington, D.C. 20230

CULTURAL RESOURCES FUNCTION AT THE DEPARTMENT OF COMMERCE

HEADED BY: Louise W. Wiener
Special Assistant to the Secretary

PURPOSE: To gather economic data on the arts; to review how the Department's policies and programs affect the development of the cultural industry; and to make recommendations on how to incorporate the insights and information gathered into the Department's programs.

ECONOMIC DATA

The economic data gathering has focused on two major undertakings. First, in January of 1978, the Department submitted a paper entitled The Economic Development Potential of Cultural Resources to the White House Conference on Balanced National Growth and Economic Development. That paper was the first formal acknowledgement by any Administration that the arts produce not only quality of life benefits but generate ancillary economic benefits. The study isolated four development properties of the profit and non-profit elements of cultural resources:

- Cultural resources are "people magnets". Investment in the arts could bring people into an area and enhance its appeal to consumers, tourists, and, therefore, investors.
- Cultural resources are labor intensive and involve the full range of skill levels.
- Cultural resources are small businesses which create a demand for a variety of other small businesses. (A recent Joint Economic Committee study indicates that small businesses are more labor intensive than large businesses.)
- Cultural resources are an environmentally sound avenue for economic development.

This document has been widely distributed and used by local, state, and federal officials to justify expanded allocations to the arts.

Second, the Department is developing a cultural service industry profile. The purpose of the industry profile is to create a tool to identify the many profit as well as non-profit activities generated by cultural activity, to understand their business development needs and opportunities, their capacity to absorb labor, their energy needs, their concerns regarding international trade, and their relationship to various legislative positions.

The Commerce Department uses this data to insure that government actions recognize cultural production as a valid and important contributor to the community and to the economy whose best interests must be taken into consideration in formulating policy.

IMPLEMENTATION OF CULTURAL RESOURCES INITIATIVES

What specifically has the Department of Commerce done to implement the new perspectives on cultural resources?

- o In the past two years, the Economic Development Administration has awarded grants to Cleveland, Minneapolis, Winston-Salem, Memphis, San Antonio, and New York City, to name but a few, for technical assistance and/or construction funds for cultural facilities and is currently collaborating with several other cities on developing investment and tourism strategies that integrate cultural resources and economic development to the benefit of both.

- o The Travel Service has hosted the first cultural familiarization tours for foreign journalists and is working with cultural leadership and tour brokers on how to more effectively entice international tourists to the United States to enjoy our abundance of first rate cultural resources.

- o We are developing a profile of cultural sensitivities and their implications for packaging design and product saleability in our export market in collaboration with the Industry and Trade Administration.

- o We are collaborating with the Department of Energy and the cultural agencies on identifying energy consumption issues in the cultural industry both in terms of facilities' needs and transporation access issues related to the gasoline shortage.

- o We have given testimony on legislative issues as diverse as recording rights royalties and the protection of archeaological sites in mining regions.

FURTHER INFORMATION AND BACKGROUND MATERIAL,
CONTACT: Louise W. Wiener
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U.S. DEPARTMENT OF COMMERCE
Office of the Secretary
Washington, D.C. 20230

March 12, 1979

MEMORANDUM FOR: The Record

FROM: Louise W. Wiener
Special Assistant to the Secretary

SUBJECT: Cultural Resources and Economic Development

I. Policy Perspective

- o The Joint Economic Committee of Congress Study of 1979, "Central City Business: Plans and Problems," states that quality of life issues are a pervasive element in a city's economic fate -- often outweighing tax rates, labor supply, and other traditional measures.

- o The 1977 Rand Study on urban development concludes that people do not necessarily follow jobs: Increasingly, jobs follow people.

The evidence and conclusions of these and other studies by Government agencies, private foundations, and public interest groups suggest that successful economic development strategies must include an assessment of what constitutes an economically invigorating quality of life.

The phrase "quality of life" is fraught with ambiguity. There is, however, general agreement that cultural resources, profit and non-profit elements of the arts, humanities and historic preservation, are a major component of the positive aspects of quality of life. Because they can be defined, developed, and more accurately measured than the totality, cultural resources provide a valuable avenue to assessing and integrating quality of life issues into development strategies.

The Commerce Department Study of the Economic Development Potential of Cultural Resources isolated four development properties of the profit and non-profit elements of cultural resources.

- o Cultural resources are "people magnets".

- o Cultural resources are labor intensive and involve the full range of skill levels.

- o Cultural resources are small businesses which create a demand for a variety of other small businesses. (The Joint Economic Committee Study indicates that small businesses are more labor intensive than large businesses.)

- Cultural resources are an environmentally sound avenue for economic development.

Of these concepts, the most significant in development terms i he "people magnet" property, because it addresses the principle jobs follow people. It has long been noted that industries increasingly footloose. The equalization of the various opp unities in location and relocation decisions, engendered by advances in transportation, communication and technology, has inspired a new emphasis on the economic implications of the quality of life. This suggests devices previously used to attract tourists must now be applied to attracting and retaining both residents and businesses in what has become an intensely competitive market.

II. Current Status

The Economic Development Administration has implemented economic development through cultural resources without acknowledging it as such. The earliest grant to promote economic development through cultural resources was the 1968 contruction funds to Ashland, Oregon, for the expansion of the Shakespeare Festival facility. That Public Works investment of less than $1 million has been returned many times over to the community and region by means of tourism development dollars. In the first year, tourism figures jumped by 59,000 attendees from outside the Rogue River Valley, with $667,000 new tourist dollars directly attributable to their expenditures. By 1977, the annual attendance rate had increased from 64,000 in 1970 to 232,000.

During Local Public Works Rounds I and II, a far more extensive priority on cultural resources development was manifest than was anticipated or predicted. Large and small cities as well as rural counties targeted Local Public Works money to cultural institutions. The emphasis on renovation, restoration, expansion, and new construction for the full range of cultural resource facilities suggests more than the availability of large sums of dollars to be expended rapidly. It reinforces the perception of a broad-based priority on cultural resources as an enrichment of the quality of life and a recognition that the communities must maintain and market more than their industries.

Building renovation, restoration, and reuse have beeen promoted through an alliance of historic preservation and other cultural constituents working in collaboration with economic development communities. The renovation of the Lone Star Brewery in San Antonio to house the City's Museum is a striking case in point. Few adaptive reuse plans could insure the quantity or quality of people relocation the museum is generating. The museum has become a nucleus for extending a comfortable and economically viable sense of downtown into an abandoned and depressed area.

The Ozark Cultural Center in Stone County, Arkansas, reaffirms that the process can be as successful in rural as in urban areas. Folklore, which was seen as the strongest local asset, became a development tool as the foundation for a cultural program, which was then encased in a cultural center. The result is not only the $18 million in annual income to the County, but a perceived shift in the population's sense of self-respect, reflected in a new focus on preventive health care.

Boston, Cleveland, Winston-Salem, Seattle, to name but a few, are implementing economic development projects through cultural resources by means of EDA funds. These successes have occurred almost in spite of, rather than because of, federal policies and initiatives.

III. Program Initiatives

Communities should be encouraged to assess elements of qualitative, as well as quantitative, growth, because the two are ever more closely bound.

Planning funds should emphasize establishment of a management tool to showcase and reinforce positive quality of life elements with development potential. Funds should require collaboration between economic development and cultural agencies for dispersal. They might be for any or all of the following:

- o Recognition and assessment of buildings of architectural and cultural merit for adaptive re-use.

- o Recognition and assessment of existing or projected cultural activities and physical location opportunities and needs which could enrich commercial and/or neighborhood revitalization.

- o Recognition and assessment of history, folklore, crafts, and other indigenous ethnic cultural strengths which can be targeted to distinguishing and reinforcing a locale as a good site for business and resident attraction and retention.

Guidelines should encourage recognition of the programs and planning guidelines of the National Endowment for the Arts, the National Endowment for the Humanities, the Department of the Interior and the Department of Housing and Urban Development in order to capitalize fully on the variety of federal programs which can support creative approaches to economic development.

Limiting funds to assessment and planning tools targets local strengths and recommends local reassessment of economic development opportunities without creating an incentive to build cultural facilities because that's "in style" in federal funds.

The evidence that quality of life affects business, residential, and tourism location is compelling. It is thus appropriate that the comprehensive economic development strategies assist in recognizing and utilizing this information. Our current posture is ambivalent and ambiguous. It should be clarified, strengthened, and institutionalized.

56-073 O - 80 - 30

Senator BYRD. We have two more pieces of legislation. S. 1467 will be addressed by Mr. William H. Dempsey, president of the Association of American Railroads.

[Pause.]

Senator BYRD. Mr. Dempsey?

STATEMENT OF WILLIAM H. DEMPSEY, PRESIDENT, ASSOCIATION OF AMERICAN RAILROADS, ACCOMPANIED BY RICHARD BRIGGS, EXECUTIVE VICE PRESIDENT, AND ROBERT CASEY, COUNSEL

Mr. DEMPSEY. Thank you, Mr. Chairman.

I am accompanied by Mr. Richard Briggs, who is executive vice president of our association, and by Mr. Robert Casey, who is our outside counsel in this matter.

Senator BYRD. Welcome, gentlemen. We are glad to have you.

Mr. DEMPSEY. I have a prepared statement which I would ask be included in the record.

Senator BYRD. Yes, it will be inserted in the record.

Mr. DEMPSEY. I will just take a few minutes to summarize that statement, Mr. Chairman.

I appear on behalf of the railroad industry to register our very strong endorsement for S. 1467, a bill that would validate the so-called RRB or retirement-replacement-betterment system of tax accounting that has been in use in this industry for some 75 to 100 years.

It has been recognized by this committee and the Congress, in a couple of places in the code. It has been explicitly endorsed by the Treasury Department in revenue rulings, and by every court in which it has ever been drawn into issue.

The problem here, then, arises, as Mr. Lubick indicated, simply by virtue of the fact that the Interstate Commerce Commission, for its own regulatory purposes, is at the present time reconsidering the use of the so-called RRB method of accounting. And as Mr. Lubick indicated, IRS is prepared to permit the industry to retain this system of tax accounting if ICC does not change our accounting method for regulatory purposes. However, if ICC does change, then for reasons that I think are, I may say with all deference, largely unexplained, the IRS would take the position that we should change to a ratable method of depreciation for tax purposes.

The method that we use, Mr. Lubick described, and I won't continue with any details about it. The key factor is that so far as track is concerned, when we install new track on a new branch line, we capitalize that and we write nothing off until that track is either retired, and if it is not replaced then we write off the original cost, but if it is replaced, then we write off in that year the cost of the replacement.

Now, it was interesting to listen to the testimony this morning having to do with the deficiencies in the ratable system of depreciation, and as Professor Jorgenson testified, much of that is due to the fact that it is based entirely on historical costs, and therefore in an inflationary cycle, which is what we are encountering now, it does not really give you an accurate picture of how that enterprise is doing, because it does not take into account replacement costs.

Our system does. In that sense, it is a very conservative system. It reflects much more accurately what is really happening to the railroad industry than the ratable method of depreciation would.

If we were to change over to ratable depreciation, the cost to the industry would be staggering. We estimate something in the range of $300 million a year. This is a cost that we cannot afford. We are an industry that is in meager financial condition at the present time. We are faced with huge capital demands. The DOT and the ICC estimate that our capital expenditures should be running at the rate of about $4 billion a year, and in fact they are running at a rate of about $2.5 billion a year.

DOT estimates therefore that by 1985 outside the Northeast, putting aside ConRail's problems, the rest of the industry will face a $13 to $16 billion shortfall, and this is at a time when the industry will be called upon in an ever-increasing fashion to lay down more track and to rehabilitate our track structure in order to carry the coal that is going to be required to deal with our energy crisis.

I might mention that a number of letters have been sent to the committee by leading representatives of the financial community and the accounting profession, including the Association of Certified Public Accountants who supported this legislation, and I would hope that they could be made a part of the record as well.

Senator BYRD. In Mr. Lubick's comments, he indicated that the railroads and the Treasury had not sat down together to try to work something out.

Mr. DEMPSEY. Well, I didn't understand him to say that, because I know that he knows that we have been working with the Treasury Department for 2 or 3 years on this matter. It is so that last Friday I received a letter from Mr. Halperin inviting us to go back into conferences with them, and of course we are prepared to do that, but I will note that the efforts of the last 2 or 3 years to find a system to go over to ratable depreciation without injury to the industry have not been successful.

We are perfectly prepared and eager to continue those discussions, but in the interim, in order that we may be able to make the kind of capital commitments that are necessary in this industry, we feel that it is essential that the existing system of RRB accounting be codified. Then if something can he worked out with Treasury that would be satisfactory to this committee, well, all well and good. That could be used then as a substitute for the existing system.

Senator BYRD. But in your discussions over the last several years, you have not been able to work out anything?

Mr. DEMPSEY. That is correct, Mr. Chairman. Yes; I may say, with all respect to the Treasury Department, that it is somewhat ironical that they would be proposing a terribly—if you will read Mr. Lubick's statement, you will see a terribly elaborate, prolonged system of moving this industry over to a system of depreciation that this committee is now considering in terms of its deficiencies.

That, I think, concludes my remarks, Mr. Chairman. I would be glad to answer any other questions that you might have.

Senator BYRD. Thank you, Mr. Dempsey. Thank you, gentlemen.

Mr. DEMPSEY. Thank you very much.

[The prepared statement of Mr. Dempsey follows:]

STATEMENT OF WILLIAM H. DEMPSEY
PRESIDENT, ASSOCIATION OF AMERICAN RAILROADS

Mr. Chairman and Members of the Committee:

My name is William H. Dempsey. I am President of the Association of American Railroads, with headquarters in Washington, D.C. The railroads which are members of the Association operate 92 percent of the line-haul mileage, employ 94 percent of the workers and provide 97 percent of the freight revenues of all railroads in the United States.

S. 1467, which is supported by the Association of American Railroads, would clarify the tax law by adding to Section 167 a new subparagraph (b)(4) to codify the Retirement-Replacement-Betterment (RRB) method of depreciation of railroad track structure for tax purposes. This method has been recognized by this Committee and the Congress by inclusion in the Internal Revenue Code Sections 48(a)(9) and Section 263(f). This method has also been accepted in every court in which it has been considered, including the Supreme Court, as an appropriate method of depreciation of railroad track. The Treasury Department in published Revenue Rulings (67-22, 1967-1 CB 52, 67-145, 1967-1 CB 54, and 67-285, 1967-2 CB 7) has held the method to be appropriate for accounting for depreciation of track structures. However, Section 167 of the Code does not specifically define this accounting practice as a method of depreciation and we submit it is important that S. 1467 be enacted for reasons we will demonstrate to this Committee.

At the outset it should be clear that there is no revenue loss involved and the amendment would not affect present

or proposed Interstate Commerce Commission or Securities and Exchange Commission regulation.

For over 75 years, long before the imposition of the Federal income tax, the railroad industry has depreciated its track under the RRB method of accounting prescribed by the Interstate Commerce Commission (ICC). For all other assets, the industry uses a ratable method.

Under this method when additions to the track structure, such as new branch lines, are installed, the cost is capitalized. No depreciation is allowed on account of the capital investment until the branch line is either retired from service or its components are replaced. When the useful life of a 120-lb. rail is exhausted and it is replaced by a new 120-lb. rail, the cost of the new "replacement" is deducted as a depreciation expense. If the 120-lb. rail is replaced by a 130-lb. rail, the old rail is retired at the current cost of a new 120-lb. rail, and the difference between that amount and the cost of the new 130-lb. rail is capitalized as a "betterment". When the track is taken up and not replaced, the track is "retired" and the amount lodged in the capital account representing the original cost plus subsequent "betterments" is deducted as depreciation expense.

The RRB method is a conservative method of reporting operating results. It is much like the last-in, first-out (LIFO) method of accounting for inventory, in that it is more sensitive to inflation than a ratable depreciation method based on historical cost because the current cost of replacing track is

treated as a cost of operation. Because track components have long service lives, use of the RRB method tends to offset much of the inflationary cycle in contrast to a ratable method, which also recovers only original cost but over long periods of time. Thus we are talking about a matter of a "timing difference".

The industry is gravely concerned at this time because the RRB method is under current review, for reasons other than Federal income tax, by the ICC and the SEC. The treatment of our track expenditure for regulatory purposes currently depends on the ICC accounting rules. Any change in these accounting rules to provide for a ratable method of depreciation would significantly increase income for ICC purposes by reducing the current charge on account of depreciation expense. Such a change might cause the Internal Revenue Service to seek a similar change in the accounting for depreciation for tax purposes. The resulting reduction in depreciation expense would increase reported income and, consequently, federal income taxes.

Ironically, a change in the accounting method would produce an illusory increase in income for book purposes, but would not increase cash receipts from railroad revenues one cent. In fact, the cash flow from railroad earnings would be seriously reduced by the additional tax payments at both Federal and state levels.

RRB is not attractive for use by any other industry because it permits no cost recovery for an entire life cycle of the asset or until it is replaced. The benefit of the

RRB method requires that the taxpayer have had at least one life cycle for the depreciable asset. For example, a taxpayer changing to RRB at this time would have no recovery of his investment for the entire life of a newly acquired asset. When an industrial enterprise computing its federal income tax on an accelerated method of depreciation invests in new plant equipment, an allowance for depreciation commences immediately. The capital cost is recovered through tax savings in a period shorter than that which is available under the RRB method.

Capital needs of the railroads have been estimated by the industry, the ICC and the Department of Transportation (DOT) to be in the neighborhood of $4 billion annually while actual expenditures have been about $2.5 billion per year. In 1977, capital outlays exceeded internally generated cash flow by $1.6 billion, a real threat to a viable private sector railroad system. This is no time to risk the possible diversion of an estimated minimum of $300 million from the industry to the Treasury.

The condition of the track is a matter of continuing concern confronting the industry. The heavy coal traffic generated by a national energy program which demands conversion to coal will necessitate even greater track expenditures. Because railroad mortgages generally are liens against after-acquired property, the industry cannot borrow but must rely on internally-generated cash flow to upgrade and maintain its track structure.

To reduce cash flow by requiring the use of ratable depreciation for tax purposes would be decidedly counter productive.

Further, equity supports the retention of the RRB method. The only asset to which this method applies, track, is the counterpart of the asset supplied by public funds to competing modes -- highways, airports, harbors, channels and wharves. Any charges exacted for use of such facilities are currently deductible. To require the railroads to use their own capital and then to delay recovery of that capital over a long period would compound the inequity. The cash shortfall could only be recouped through increased freight rates, if feasible.

On September 27 when the Ways and Means Subcommittee on Select Revenue Measures held a hearing on the bill identical to the one before this Committee, the bill was actively supported by leading representatives of the financial community and the accounting profession, including Salomon Brothers, the Chase Manhattan Bank, First Boston, Lehman Brothers Kuhn Loeb, Morgan Stanley, Price Waterhouse, Deloitte Haskins & Sells, and the American Institute of Certified Public Accountants. In addition, Professors Lowell Harris and Ernest Williams of Columbia University voiced their support of H.R. 4446. Only the Treasury Department opposed codification of the RRB method. Deputy Assistant Secretary of the Treasury, Daniel I. Halpern, cited as reasons for Treasury's opposition to the measure that RRB

1. in effect is indexing;
2. is subject to various "abuses;"

3. retention for tax while changing to ratable for ICC would be an administrative burden for both the IRS and the taxpayer; and

4. that it did not clearly reflect income.

I would like to address briefly each of these positions.

1. Indexing: Inherent in the RRB method is the reflection of replacement costs. This factor makes the method extremely sensitive to the inflationary and deflationary pressures on the economy. Over the near century of RRB's use we have experienced both inflation and deflation. In times of deflation when the cost of replacements were less than the original cost of the component replaced, the railroad industry suffered because it was recovering less than its original investment. In fact, RRB is not "indexing" as that concept is generally understood. It is a precise reflection of actual replacement costs unrelated to the Consumer Price Index or any other criterion. The accurate measurement of economic income is a characteristic of RRB which inhered in the method from the first day of its use. The Congress, the courts and the Internal Revenue Service have consistently held it to be an appropriate method for depreciating track. Every authority on depreciation has agreed that proper provision for the recovery out of earnings of replacement cost rather than historical cost is the true measure of economic income. The Treasury itself in its statement to the Subcommittee on Select Revenue Measures stated:

> "An ideal tax base would indeed have depreciation allowances adjusted for inflation, along with other inflation adjustments, where appropriate."

Treasury's sole criticism is that RRB does a better job of offsetting the impact of inflation and is thus very much closer to meeting Treasury's "ideal tax base." The fault found, then, is not that RRB does not reflect sound tax policy but simply the fact that other industries do not have the same sound depreciation policies available to them. We also found out that RRB is not unique in its reflection of replacement costs. Congress has permitted the LIFO method of valuing inventories, a similar reflection of replacement cost. It makes little sense to require the abandonment of the method of depreciation which most nearly reflects real income while at the same time recognizing that every taxpayer should be on a method of depreciation which, like like RRB, reflects replacement cost.

2. "Abuses": In opposing the codification of RRB the Treasury cited two situations which it termed "abuses." The so-called "abuses" in the Treasury opposition are merely the frequent questions of allocation of purchase price to assets in an acquisition of a going business for less than book value. These questions are resolved by settlement negotiation or litigation in the ordinary course of tax disputes. This kind of dispute has nothing to do with the method of accounting for depreciation employed by the parties. Disputes involving the allocation of the purchase price in arriving at the cost basis of the assets to be depreciated arise regardless of whether the purchaser intends to recover his investment by way of straight-line, sum-of-the-years-digits, double declining balance, unit of production, RRB or any other acceptable method of deprecia-

tion accounting. To label an audit question an "abuse" peculiar to the RRB method is wholly misleading.

Lastly, Treasury states that "abuse" situations will be "more difficult to detect if RRB is used solely for tax purposes." The fact is that every single difference between book and tax treatment of expenditures is reconciled on Schedule M of the Federal tax return and is thus called to the attention of the examining agent.

If these are the only "abuses" seen by the Treasury, their irrelevance attests to the integrity of the RRB method. Treasury has tried and failed to find an "abuse" which inheres in the RRB method.

3. <u>Administrative Burden</u>: Again the argument advanced is specious. At the present time the railroad industry as well as nearly every other industry must keep two sets of records showing the varying depreciation allowances for book and for tax purposes. For the railroads these records are required for most assets except for track since both the method of depreciation and the rate of recovery vary for ICC and IRS purposes. Whatever the severity of those burdens, neither the taxpayer nor the Service have sought to eliminate the tax systems of depreciation. If the ICC requires a change to a ratable method for track depreciation then the industry will have to add only the last group of assets to those schedules. The additional cost and the administrative burden on both the Service and the railroad will be minimal.

4. <u>The Proper Reflection of Income</u>: The RRB method of depreciation has been used consistently for tax purposes since

the inception of the Federal income tax laws and it clearly reflects income. As previously mentioned, it has been recognized consistently by the courts as an appropriate method of depreciation and has been accepted by the Internal Revenue Service. This consistent use is, in itself, an essential element in establishing that revenue is clearly reflected.

The AICPA has recently reviewed the application of the method and concludes:

> "We believe that this legislation is warranted to formally recognize, as an acceptable method of depreciation, a procedure which is an historical tax practice of long standing in the industry. In general, we feel that accounting methods in any industry that have been acceptable for many years should be interfered with as little as possible. Resistance to such changes is helpful to tax simplification and stability. In addition, an effort to change the depreciation method for the common carrier industry would, we believe, be contrary to the important goals of stimulating capital investment and encouraging transportation which is consistent with energy conservation and development."

Treasury recognizes the severity of the tax burden with which the industry would be faced if a ratable method of depreciation were to be required for tax purposes. However, to place the industry in the same cash position under a ratable method as it is under the RRB method would require the most complex set of statutory provisions imaginable.

It must be emphasized that the complicated legislation contemplated by a statutory formula would likely open the door to other taxpayers' use of the method. Presently no other taxpayer, including a new railroad, can use the RRB method because

there is no capital recovery for one full life cycle.

In urging the enactment of S. 1467, the railroad industry seeks insurance against possible tax deficiencies which would seriously weaken the stronger roads and would bankrupt the weaker. It is hard to imagine any administrative action, short of nationalization, which would more seriously threaten the continued existence of a viable private railroad industry.

In summary we support S. 1467 which would amend Section 167(b) of the Code by renumbering subparagraph (4)as (5) and adding as a new subparagraph:

> "(4) the retirement-replacement-betterment method for property used by a common carrier by railroad (including a railroad switching company or a terminal company)"

This amendment would preserve the use of the RRB method for tax purposes regardless of any new ICC and SEC requirements for regulatory purposes. ICC accounting for rate regulation would not be affected by the amendment.

The proposed legislation would effectively codify the retirement-replacement-betterment method of accounting for track structure and prevent any loss in cash flow from increased taxes. The SEC and the ICC could continue to explore whether financial conformity requires a change in the method of accounting for depreciation of track.

This legislation would preserve this traditional and well-recognized method of depreciation. Thus it would maintain the status quo for tax and have no impact on the revenue flow to the Treasury. Adoption of this legislation will help preserve a productive, energy-efficient railroad system.

It would further serve the public interest by conserving energy resources and advancing the solution of our energy problem.

Senator BYRD. The next piece of legislation is S. 1021. Mr. Lawrence H. Brown, senior vice president, Northern Trust Co., and chairman, Public Securities Association, and Mr. Robert S. McIntyre, director of tax reform research group of Washington, D.C.

Before that testimony is taken, the Chair has some insertions to make which have been requested to be made in the record. Without objection, I will have these items inserted.

[The material referred to follows:]

Congress of the United States
JOINT COMMITTEE ON TAXATION
Washington, D.C. 20515

October 18, 1979

MEMORANDUM

TO: Members of the Senate Finance Committee

FROM: Bob Shapiro

SUBJECT: GAO Report on IRS' Handling of Taxpayers' Problem Inquiries

Enclosed is a copy of a recent report to the Joint Committee on Taxation by the Comptroller General, entitled "Taxpayer Satisfaction with IRS' Handling of Problem Inquiries Could Be Increased." The General Accounting Office (GAO) undertook this study at the request of the Joint Committee. The GAO report deals with taxpayers' satisfaction or dissatisfaction with the manner in which the IRS handles their "problem inquiries." (Problem inquiries are defined by the IRS as those requiring the taxpayer to contact the IRS more than once in order to solve the problem and those requiring the IRS to research the problem and recontact the taxpayer.)

According to the GAO, the IRS could improve the method in which it handles taxpayer problem inquiries by refining its special handling system (referred to as the Problem Resolution Program). IRS generally agreed with the thrust of GAO's recommendations.

Also enclosed is a summary of GAO's findings and conclusions, GAO's recommendations to the IRS, and IRS' comments on the report.

Enclosures

Joint Committee on Taxation
October 18, 1979

SUMMARY OF GAO REPORT ON IRS' HANDLING OF TAXPAYERS' PROBLEM INQUIRIES

The GAO report, entitled "Taxpayer Satisfaction with IRS' Handling of Problem Inquiries Could Be Increased" (GGD-79-74, September 18, 1979), evaluates taxpayers' satisfaction with the manner in which the Internal Revenue Service handles their problem inquiries. This report was requested by the Joint Committee on Taxation. According to the GAO, the IRS could improve the method in which it handles taxpayer problem inquiries by refining its special handling system (commonly referred to as the Problem Resolution Program). The following is a summary of the major points of the GAO report, GAO's recommendations to the Commissioner of Internal Revenue, and IRS' comments on the report.

GAO Findings and Conclusions

According to the GAO, taxpayer problem inquiries represent only a small part of all taxpayer inquiries handled by the IRS. However, since taxpayer problem inquiries generally involve problems that are difficult to resolve, such as locating misplaced refund checks, the way in which these inquiries are handled often may lead to taxpayer frustrations and dissatisfaction with IRS practices. (The IRS defines problem inquiries as those requiring the taxpayer to contact the IRS more than once in order to solve the problem and those requiring the IRS to research the problem and recontact the taxpayer.)

The majority of taxpayers who responded to a GAO questionnaire were satisfied with the way IRS handled their inquiries, with 32 percent expressing dissatisfaction. This ranged from 24 percent dissatisfaction by those taxpayers whose inquiries were handled by IRS district offices, 40 percent dissatisfaction by those whose inquiries were handled by IRS Service Centers, and to 54 percent dissatisfaction expressed by those taxpayers whose inquiries were handled by the IRS National Office. Most taxpayers who were dissatisfied were concerned with the manner in which IRS communicated its answer to their questions or problems; many complained that too many contacts and too much time was required for IRS to resolve their problems. The GAO is concerned that extensive taxpayer dissatisfaction could have an adverse effect on voluntary compliance with the tax laws.

Currently, IRS has two systems for acting on taxpayer inquiries: normal handling and special handling. The normal handling system is intended to resolve most taxpayer inquiries on the first contact. The special handling system (the Problem Resolution Program) was established in 1977 to deal with problem inquiries.

The GAO found that, due to weaknesses in implementing the special handling system, many problem inquiries which should have received special handling either did not or were referred too late. The GAO also found that IRS follow-up of taxpayers with problem inquiries is too limited. According to the GAO, follow-up is needed to assure that taxpayers' problems have been resolved and also provides data for the systematic evaluation of possible problem causes.

In addition, the GAO believes that IRS could increase taxpayer satisfaction with the handling of problem inquiries by making district office special handling units the focal point for controlling more of such inquiries. While this would result in an increase in the number of problem inquiries handled by IRS district offices, the GAO believes that the number of unnecessary and time-consuming recontacts by taxpayers could be decreased.

GAO Recommendations to the IRS

The GAO recommends that, in order to improve its handling of problem inquiries, the IRS:

(1) Require all IRS employees who are contacted by taxpayers to obtain information on any prior contacts in order to assure that all problem inquiries are property referred for special handling;

(2) Increase the extent to which problem inquiries are handled and controlled by IRS district offices;

(3) Send comprehensive follow-up questionnaires to a statistically valid selection of all taxpayers with problem inquiries; and

(4) Increase the evaluation and correction of common causes of taxpayer problem inquiries.

In addition, as part of its effort to simplify tax forms and instructions, the GAO recommends that the IRS look for ways to improve its methods of communicating responses to taxpayers' inquiries.

IRS Comments

Appendix I of the report contains the response of the Commissioner of Internal Revenue to the GAO report and recommendations. The IRS agrees that providing efficient taxpayer service and handling taxpayers' problems expeditiously contributes significantly to voluntary compliance and points out that it has devoted increasing resources to taxpayer service efforts in recent years.

While the IRS generally agrees with the thrust of most of GAO's recommendations, it believes that the report would have been more useful had it covered a more current period. For example, the IRS indicates that revised guidelines, issued in October 1978, implemented a number of actions to improve the Problem Resolution Program along some of the lines suggested in the GAO report. Further, the IRS notes that the Problem Resolution Program was implemented cautiously in order to avoid the possibility of overloading it with the attendant risk that taxpayers might encounter the same type of delays in dealing with this program that caused their case to be referred to it in the first place.

Finally, the IRS indicates that it is giving careful management attention to GAO's comments and suggestions.

Availability of GAO Report

Additional copies of the GAO report (GGD-79-74) are available from the U.S. General Accounting Office, Distribution Section, Room 1518, 441 G Street, N.W., Washington, D. C. 20548.

Columbia University in the City of New York | New York, N.Y. 10027

DEPARTMENT OF ECONOMICS International Affairs Building

October 15, 1979

The Honorable Harry F. Byrd, Jr., Chairman
Subcommittee on Taxation and Debt Management Generally
Committee on Finance
United States Senate
Washington, D. C., 20510

Dear Senator Byrd:

The economic aspects of tax and related issues of a change in methods of depreciation used by railroads are examined in the study submitted herewith. Although a variety of topics have relevance and are discussed, the conclusions of dominating significance can be summarized briefly.

A shift from replacement (RRB) depreciation to ratable depreciation would increase tax burdens, reduce cash flow, and have other economic results. They would not be matched by any identifiable benefits. The effects would conflict diametrically with needs for economically efficient cost measurement.

The loss of purchasing power of the dollar (inflation) makes the use of historic cost, as under ratable depreciation, utterly inaccurate for measuring true economic cost. Distortion and over-statement of income would result from inadequate recognition of past, present, and prospective inflation.

The correct economic cost of providing any product or service is the current worth of inputs. Replacement (RRB) depreciation does now yield this desirable result for a portion of railroad expenses.

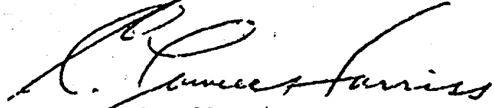
Accountants and others now quite generally recognize that ratable depreciation based on expenses of past years is misleading, but methods of correction are still debated. To extend this defective system to railroad

trackage would be retrogressive and would unjustifiably raise reported earnings. Income taxes would go up substantially (and property taxes somewhat). Railroad cash flow and the industry's ability to finance maintenance would be reduced. Such a consequence would be exactly the opposite of what would be desirable for the whole economy with its need for efficient transport.

Ratable depreciation using figures made obsolete by inflation would also be inferior for management decisions. The report examines the reasons which over the years have been cited in favor of a ratable system. They are found unconvincing, especially in an era of inflation. If present reporting is felt to have gaps, such as on the adequacy of maintenance by certain railroads, additional information to serve any specific needs could be required.

Please be assured of my willingness to assist you and your associates in dealing with this issue.

Respectfully yours



C. Lowell Harriss
Professor of Economics

Columbia University in the City of New York | *New York, N.Y. 10027*

GRADUATE SCHOOL OF BUSINESS Room 504 URIS HALL

October 16, 1979

The Honorable Harry F. Byrd, Jr.
Chairman, Subcommittee on Taxation and Debt Management
General Committee on Finance
U. S. Senate
Washington, D.C. 20510

Dear Senator Byrd:

The attached paper addresses the question whether, at this time, substitution of a ratable depreciation plan for rail track for the present method of retirement and betterment accounting is desirable in principle or in respect of its potential effects upon the railroad industry. The conclusion is that it would be a retrograde step, out of tune with the probings of FASB and SEC which seek accounting methods more appropriate to a period of high and prolonged price inflation, bound to increase the overstatement of rail earnings already present because of inflation and to reduce cash flow. Hence this shift of accounting methodology would, by its tax effects, diminish the already limited ability of railroads properly to maintain their road property and to improve it in response to new demands for rail service.

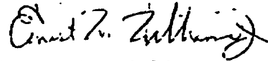
The cost of maintaining, improving and increasing the capacity of road property is increasing at an accelerating rate. RRB accounting recognizes this at least to the extent that it charges the costs of replacement to operating expenses at current prices whereas depreciation, based upon historic cost recorded in the asset accounts, falls far short of producing such a result. Taxable earnings are increased by such a system of ratable depreciation, thus cash flow available for application to the maintenance of the properties is reduced. In the case of track, internal cash generation is almost the only available source of funding.

Track is not an entity, but a structure comprised of a number of components which have different physical and economic life expectancies. Moreover these depend not only upon use, but upon location, climate, character of subgrade and other factors. Assignment of a composite life therefore presents serious difficulty. The life assigned to any asset for depreciation purposes is conjectural--it is much more speculative in the case of track than it is for motive power or cars.

Most railroads today require as much cash flow as they can possibly generate in the face of continuing competitive pressures and inexorable

inflation. Any reduction imposed by a shift in a long standing, well understood, and hitherto acceptable accounting practice would be damaging not only to the industry, but also to the nation. For it increasingly appears that larger reliance on rail transport will become a necessity in the face of the need to improve national productivity and to conserve fuel.

Sincerely yours,



Ernest W. Williams, Jr.
Professor

EWW:hl

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DEPARTMENT OF ECONOMICS
International Affairs Building

October 16, 1979

Honorable Harry F. Byrd, Jr.

Dear Senator Byrd:

A personal note may help to underscore the significance I attach to the material enclosed. You are devoted to making public policy as good as possible. Preserving the long-established methods of railroad accounting seems to me clearly in the public interest.

The memorandum, the result of my examination of all the material I could find, spells out the issues and the conclusions to which the evidence leads.

The country will be around a long time. Governmental policy should rest upon the long view and our best judgment of what will be constructive — and, of course, avoiding avoidable errors. I hope that you and your associates will find this material helpful.

Cordially yours

C. Lowell Harriss

PROPOSALS TO SUBSTITUTE A RATABLE METHOD OF DEPRECIATION FOR THE RETIREMENT, REPLACEMENT, AND BETTERMENT METHOD OF DEPRECIATION FOR RAILROADS

C. Lowell Harriss

Professor of Economics, Columbia University; Economic Consultant, Tax Foundation Incorporated; Associate, Lincoln Institute of Land Policy. Views expressed are the author's and not necessarily those of any organization with which he is associated. July 1979.

The following observations emphasize economic aspects of tax and other issues of a proposal to change the method of depreciation used by railroads.

Conclusions

A shift from replacement (RRB) depreciation to ratable depreciation would increase tax burdens, reduce cash flow, and have other adverse economic results. They would not be matched by any identifiable benefits. The effects would conflict diametrically with needs for economically efficient cost measurement.

The loss of purchasing power of the dollar (inflation) makes the use of historic cost, as under ratable depreciation, utterly inaccurate for measuring true economic cost. Distortion and overstatement of income would result from inadequate recognition of past, present, and prospective inflation. The correct economic cost of providing any product or service is the current worth of inputs. Replacement (RRB) depreciation does now yield this desirable result for a portion of railroad expenses. Ratable depreciation based on expenses of past years is now recognized as misleading, but methods of correction are still debated. To

extend this defective system to railroad trackage would be retrogressive and would unjustifiably raise reported earnings. Income taxes would go up substantially (and property taxes somewhat). Railroad cash flow and the ability to finance maintenance would be reduced. Such a consequence would be just exactly the opposite of what would be desirable for the whole economy with its need for efficient transport.

Ratable depreciation using figures made obsolete by inflation would also be inferior for management decisions. The report examines the reasons which over the years have been cited in favor of a ratable system. They are found unconvincing, especially in an era of inflation. If present reporting is felt to have gaps, such as on the adequacy of maintenance, disclosure of additional information could serve the needs.

Introduction

Many important features of a new method remain to be specified. Until that is done, some conclusions are partially tentative. Yet for the forseeable future, the companies would suffer. Those they serve -- the public -- would also suffer. The U.S. Treasury would, in effect, "tax inflation," a practice which cannot be justified. Advocates of change do not explicitly rest the case on higher tax burdens. Arguments made over the years by groups whose views must be respected, such as the Arthur Andersen accounting firm, have now been overwhelmed, in the author's view, by recent and prospective inflation.

The topic has been examined, off and on, for more than

half a century. Although entirely new points are not likely to appear, a series of questions posed by the Interstate Commerce Commission raises points of possible implementation that need not be covered here. Basic to the central issue is inflation of large amounts. It must have profound significance for the choice in today's world.

Accounting principles and practices raise questions related to, but also different from, those of economics as such. Not all of the points which accountants and others have examined over the years need to be studied here. Some elements important for the discussion involve specific operating and financing practices of the railroad industry -- and of the better positioned and maintained railroads in particular. Further checking may be necessary before some conclusions can be deemed solid, especially as to amounts. Some matters of practical importance depend upon decisions not yet made final, or subject to change and development. For example, the actual magnitudes will be influenced greatly by transition provisions and the specific features of the rules that would be applied for ratable depreciation.

Significance of Price-Level Change in Evaluating the Two Alternatives

Briefly, inflation removes what a few years ago might have been room for doubt about choices. For tax and other purposes the present system has clear superiority over the proposed change. Over many years an economist might have seen only a modest amount of potential significance in the difference between the two methods of accounting for depreciation: (1) retirement, replacement, and

betterment -- RRB -- and (2) what is termed "ratable," such as straightline. However, when prices in general change as much as they have in recent years and as much as seems to be in prospect -- and in one direction only, upward -- this reality alone will have decisive influence upon the conditions for choosing the first over the second method of depreciation.

Today, adequate quantification of what a business does during any period requires explicit recognition of changes in the worth of the dollar as the unit of measurement. Nevertheless, for a variety of reasons, business and tax policy have been slow to adapt to the reality of change in the buying power of the dollar. The economic significance of continuing to use the RRB method of depreciation of track as against ratable depreciation has elements much like those which result from using LIFO as against FIFO for inventory accounting.

The need to do more to allow for inflation has gained increasing support as the differences between historical cost and current prices have grown larger. Accountants and others have not been blind to the existence of a problem but doubtful as to means of dealing with it adequately. The January 1979 Financial Accounting Standards Board (FASB) exposure draft statement marks a major step. Very real difficulties are recognized in any steps for adjusting for changes in the unit of measurement (dollar). The initial results of new reporting would be more tentative than conclusive. They would have no immediate impact on taxes nor, presumably, on most management decisions.

What is noteworthy for purposes of railroad accounting is that RRB depreciation already achieves some of the results being sought by the proposals. For railroad track the long-established method of depreciation actually accomplishes much of what the FASB recognizes as desirable -- but not yet generally attainable -- for business in general. To move from RRB to ratable depreciation would be retrogressive by the accounting profession's new statement. This is, under RRB depreciation, outlays to preserve track structure -- roadbed, rail, ties, the "line" -- are treated as an expense for management and tax purposes and deducted when made. Current prices are used in measuring these deductions. Any expenditures to improve the track structure (the difference between 132 lb. rail and 110 lb. rail which it replaces) will be capitalized as were the original outlays. Work on the roadbed and other elements of track structure will go on where it is needed to preserve the ability to provide transport. The ranges of condition which are tolerable from a physical and engineering point of view will depend upon a variety of factors, such as speeds required and traffic density.

The ratable method of depreciation -- under Generally Accepted Accounting Principles and under tax law -- rests on historical cost. In today's world of a rising price level, historical-cost accounting has defects which are being recognized increasingly, even though not so fully as desirable. For three decades or so after the ICC initiated new discussion of RRB in the 1920's, managers, tax officials, and accountants were not irration-

al, at least most of the time, in assuming that prices of the ingredients of track structure might go down (1930's) as well as up or that the forces raising prices in general would be more temporary than enduring (World War II and Korean and Vietnam hostilities). An assumption of long-run price stability might seem more justified than any feasible alternative.

~~As of 1979,~~ however, the outlook is significantly different.

(1) There is absolutely no reasonable basis for expecting declines in the prices of steel, rail, ties, labor, etc., to anything approaching the levels at which much of the structure was originally installed (the capitalized values) or even late replacements. Presumably, a shift in ratable depreciation for existing track structure would utilize as the base some mix of past outlays; even with adjustment of capitalized values now on the books -- write-ups to allow for inflation -- figures would almost inevitably be out of phase with current reality. Without huge write-ups or lives so arbitrarily short as to appear out of reason, and no assurance of such adjustments has been made, ratable depreciation deductions would be utterly unrepresentative of current costs.

(2) Continuation of rising prices seems inescapable, at least for an indefinite period. Prices paid in maintaining track in the 1970's will not prevail in the 1980's for equivalent items.

Facing conditions such as these, what would be the best attainable guide to good policy?

Inflation of Last Ten Years

The Bureau of Labor Statistics Index of Producer Prices formerly Wholesale Price Index does not include a subdivision on just the items covered by retirement (RRB) accounting. Although the series on "railroad equipment" is by no means identical, it may give a suggestion of the price changes of concern here. The April 1979 figure was 269 with 1968 as the base of 100. Obviously, an increase of 169 in 10 years constitutes a change of profound importance. The level was approximately three times that of 20 years earlier. Another series, "steel mill products," is broader than merely steel rails; but it will also indicate orders of magnitude relevant here. The figure for April 1979 was 275, with 1967 as the base of 100. The increases of the Consumer Price Index were of the same order of magnitude. In short, the purchasing power of the railroads' dollars has dropped substantially.

Measuring the Cost that are Relevant

Fundamentally, the goal being sought will be the matching of the worth of what is produced -- the output being freight service -- as represented by current and accrued revenues, with the cost of producing the service. The concern is not last year's expenses nor next year's. In an economic sense the cost of providing services now is today's worth of the inputs.

Economists point out that the costs which are relevant for decision-making at any time <u>are the alternatives</u> or <u>opportunities sacrificed</u> in the period to create or provide that which is produced. For best decisions now, the costs properly considered are not the sacrifices in the past -- not the alternatives of years ago. The issues of "sunk" costs can be complex and can divert attention from the point that is important here. That point is this: The costs to be measured are those which are subject to choice as part of any services being provided. Operations and outlays subject to current decisions -- today's costs of rail, ties, etc., not the costs of past period -- should be measured and serve as guides. This basic principle is inherently logical. It is well established in economics as the principle that should govern in order to get the best results possible from the actions that can be taken. Commitments of the past cannot, of course, be ignored. But to the extent that choices are now possible, the terms of past decisions should not take precedence over today's terms. The terms available today will reflect estimates of the future.

Recognizing the preeminence of the alternative choices now available as the guide which is best "in general," one inevitably finds that the attempt to apply it in specific cases will present problems. These are especially difficult when some of the productive capacity, whether installed in the past or being considered for installation currently, has a long life. How can one estimate the figure to be used for expense during each of the many periods which the property serves? Figures for depreciation that

utilize a rate, say 3 percent a year, may seem to be precise; but the range for error can be large, e.g., the gap between 2.5 and 3.5 percent is approximately one-third.

One set of problems in setting the rate to be used for ratable depreciation arises out of the fact that the <u>years of life</u> will be uncertain and indefinite from both the physical (engineering) and the economic point of view, obsolescence being included. The <u>time pattern</u> best for allocating cost -- straight-line or some other basis -- will also be debated. These familiar points are noted, to remind us that estimates of ratable depreciation can be subject to a considerable range of debate. Outlays under RRB depreciation are clear and definite.

When measurement is in dollars and the worth of the dollar itself changes, the problems become more difficult. Reliance on past prices has, among other things, two distinguishable kinds of effects. First, let us look at a non-tax result to show that concerns are not confined to tax aspects.

(1) For <u>management purposes</u>, historical cost (e.g., 1959 prices, for rails and ties or 1969 prices for locomotives) can give poor, deceptive, misleading signals for 1979.

(a) One example will be an inadequate level of company prices. Generally, goods and services will be underpriced when, for example, locomotives and other rolling stock are assumed in 1979 to cost at the price levels of the years of purchase. A railroad or any replacement prices are used for costing. The supplier

replacement prices are used for costing. The supplier may not try to recover enough in dollars to maintain its production capacity. Consumers then get goods and services at prices which will not permit the continuation of supply. The regulation of a utility will fail to calculate accurately the amounts required for truly adequate return.

(b) Relative costs (prices) within the company and to customers will not accurately reflect the true cost relationships. A railroad utilizes capital facilities which have been acquired at different levels of prices and which have different replacement costs. Management in relying on historical costs will not get accurate indications for adjusting output and prices in line with proper costs if there is a mix of older and newer facilities. For example, if historical costs are used, the output, methods, regions, and types of service which have used larger portions of older facilities will tend to be underpriced relative to those embodying more inputs from the newer plant and equipment.

Numerous factors will be specific to particular situations. But one broad conclusion stands: current prices reflect operating realities better than can prices of the past. Other things being the same, accounting methods which use current prices in allocating (measuring) capital costs will provide better indications of both the general level of expenses and relative costs.

Management decision-making on track structure outlays will now rest on current prices. The proposed change if used internally for decisions and for regulation and ratemaking is doubtful. The tax possibilities would certainly be ominous.

Depending upon transition provisions, the tax burden of inaccurate computation of profit can be substantial. To pay taxes on receipts of capital as if they were income -- as tends to result from using ratable depreciation based on historical cost in times of inflation -- will deplete the economic base of the enterprise (and of the economy).

Progress or Retrogression in Income Taxation?

Income taxation in this country has lagged in recognizing the economic realities of inflation. LIFO is an explicit exception: in effect, accelerated depreciation, although adopted for other reasons, also offers some offset. The principle which LIFO embodies has merits justifying extension if possible -- to fixed, long-lived assets. Such implementation, though a "good idea," would present problems. One kind of difficulty would arise in measuring amounts correctly when new equipment has characteristics significantly different from those replaced. Another problem would appear when groups of assets to be treated together have lives of varying length.

The FASB's steps to get better figures to adjust for inflation call attention to some of the difficulties. For tax purposes neither Congress nor the Treasury shows signs of moving

explicitly annd expeditiously toward a goal more rational economically. However, one element (other than LIFO is now "in place." RRB operates. It functions. It embodies elements which ought to be extended, not withdrawn. To abandon the present treatment for tax purposes would be retrogressive. Such action would move in just the wrong direction.

The tax-logic benefits of RRB are "a bird in hand." No transition difficulties need to be overcome to obtain them. If another depreciation system were now in place for railroad tracks, then shifting from it to RRB as the better method would be a source of problems. Under present conditions, however, it is the holding on to that which exists which can forestall the creation of new difficulties.

Reluctance to Recognize Inflation in Federal Tax Policy

Opponents of recognizing inflation for tax purposes have generally prevailed. Why? Critics of more reform point out that some companies which could benefit by shifting from FIFO to LIFO have not done so. Speculation as to the choice to pay more tax than essential is beyond the scope of the present study. Such failure to utilize opportunities fully will in no sense support a conclusion that it would be wise to deny LIFO to those who do use it. Nor does such failure argue for imposing heavier tax burdens on railroads by moving away from RRB.

One argument against depreciation reform for tax purposes throughout all industry is the revenue effect. It does not apply here. A shift for tax purposes to the recognition of replacement

cost of all business would reduce revenue for the Treasury. Government would no longer force businesses to pay tax on an exagerrated measure of "earnings." Large deficits help explain the lawmakers' reluctance to correct an error which was once minor but has become large.

No such issue appears in the RRB discussion. The government would not give up revenue which it now collects. The change would consist of forcing certain railroads to pay more in tax. Yet the articulate advocates of the shift do not explicitly argue that heavier tax burdens on railroads would be positively desirable. The Treasury Department has not, to the best of the author's knowledge, supported a move to ratable depreciation as a means of getting more dollars from railroads.

As a practical matter, therefore, the problems that generally impede broader recognition of inflation for tax purposes do not need to be overcome. The status quo in this case operates toward the correct result.

Property Taxes

For railroads, more than for many businesses, state-local ad valorem (property) taxes are often significant in relation to net earnings. The proposed change could tend to raise these burdens.

Changing from a depreciation system which uses current prices (RRB) in computing costs to one relying on the past (historic-based ratable depreciation) would increase reported earnings. Where, as is frequently the case, property tax assessments rest in part upon the capitalization of income, tax valuations would go up.

To illustrate, assume that earnings are raised by $10,000,000 through a new system of computing depreciation and that the "cap" rate is 15 percent. Then the estimated capital value of the property rises by nearly $67 million. At a 2 percent rate of property tax, the additional tax would be $1,333,333 a year.

Any forecasts of property tax results must be tentative. Conceivably, capitalization rates would be adjusted to reflect the change in the nature of the income stream -- a rise resting on an erroneous method of computing cost. For example, an increase in reported earnings due to a deterioration in the "quality" of the reported income stream should be matched with an appropriate upward adjustment of the capitalization rate -- in ths illustration to more than 15 percent. However, a result reflecting such intelligent refinement seems less likely than one in which the state took the opportunity to raise property tax burdens.

Book values are used to some extent in assessing for property tax purposes. The proposed shift would over time tend to put current outlays on the books and then depreciate them; figures considerably higher than those today would gradually be entered on the books and thus raise taxes. Actual results would depend upon developments which are as yet unknowable in amount. The transition from RRB to ratable depreciation might involve some revision of historical book figures to get a more realistic base for ratable depreciation. Doing so would complicate the property tax computation in states which make some use of original cost less depreciation.

A third basis used to varying extent in valuation for property tax purposes utilizes the market prices of railroad securities -- the "stock and debt" method. An increase in reported earnings would tend to raise stock prices except as investors realized the source of the change. Since true earnings would be reduced because of higher income taxes, security prices ought to drop. Perceptive investors would allow for the deterioration of earnings. This result would tend to reduce the assessment for property taxation.

The property tax results are unclear. The flux to be expected as a result of the Railroad Revitalization RR law will add to difficulties of prediction. Magnitudes are quite uncertain. Yet the risk of higher property taxes is real, chiefly because the reported income stream would probably rise. At the minimum, more effort would be required to deal with property tax problems in a transition period.

Other Possible Results of Additional Understatement of Costs

A shift from RRB depreciation -- for book purposes, for taxes, or for both -- would mean lower reported cost (not a reduction in real economic costs) in times of inflation. Consequences other than higher taxes are probable. Shippers could cite such figures in opposing rates reflecting current prices rather than some package of prices in the past. The use of historical cost in depreciation of equipment already tends to understate the real expenses of railroads as of many other businesses. Unions might press harder for wages above amounts which can be justified by the net productivity of workers. Anything understating the costs of capital will tend to show labor as responsible for a bigger fraction of the whole output.

Shareholders might press for more dividends. In economic reality some dividends might in fact come out of capital instead of earnings.

The cash drain from higher taxes alone would hamper railroads in modernization. Such matters as bond indentures and other features of debt contracts might be affected. Interline accounting as well as internal management decisions could also be affected.

Adequate study of such points would require various types of special competence. Government should not compel any change without adequate examination of these and any other elements.

Two Arguments Unimportant Here

Because of the emphasis placed here on inflation two points often raised in discussion should be noted. Although neither may seem to have practical significance in the current context, both do enter discussions of inflation as it relates to business accounting.

(1) Railroad property now on hand would often cost much more today than shown on the accounts. The real estate, rails, ties, grading, ballast, and so on would now cost more than is recorded on the books. Other businesses have assets acquired at lower levels of prices. Have not the shareholders gained something as a result of the rise in expense of replacement? In the future will there not be some benefit, admittedly one not yet realized, which should be taken into account as part of a process of adjusting for inflation? These questions are in some respects

perplexing -- and yet not seriously so for railroads.

Whatever the replacement cost of the track structure might be, the worth to the present owners is what they can get for its use. The present worth is <u>not</u> what they would have to pay to obtain the track in place. If there are legal and economic factors affecting sale -- or use -- then these factors influence the worth in its present situation. Rails and roadbed are fixed in a sense quite different from liquid assets, different even from rolling stock.

Current and prospective earnings will determine the value of track structure except as portions may be liquidated on better terms. The practical possibilities of liquidation are generally small. The obligation to provide service generally prevents disposal of parts of the property -- branch lines or rail whose salvage value might be positive. An increase in replacement cost of railroad property does not seem to present a factor of significance in the sense of advantage to owners (stockholders). Earnings are probably not such as to justify the present level of what would be required to install the track structure. Rising replacement cost has not generally brought benefits to railroads which warrant a shift toward depreciation that would raise reported costs. In order words, there have not been benefits in the form of unrealized capital gain as distinguished from payments for services rendered.

(2) Debt issued in the past will be paid off in dollars with lower purchasing power than the worth of the dollars borrowed

originally. Interest rates paid, at least on older debt issued before inflation became generally expected, will not have compensated fully for erosion of capital. (New borrowings, however, will adjust for expected inflation; interest as an annual cost will presumably offset inflation).

On old debt the bondholders suffer. Do the shareholders benefit, more or less as homeowners who borrowed on long-term mortgages with "low" interest rates? Frequently it is said that the stockholders will gain; they owe old debt which can be paid off in cheaper dollars. Bondholder deprivation does not seem to be represented by "high" prices of railroad equities. For railroads, and public utilities in general, neither the dollar earnings nor the prices of common stock indicate that market judgments attribute significant advantages to the existence of debt payable in eroding dollars.

Today's stock market prices are not "saying" that inflation is shifting substantial benefits from the holders of railroad bonds to shareholders. The bondholders do lose real purchasing power. The counterparts of such losses -- the gainers -- probably take the form of benefits (a) to customers (in products and services underpriced), (b) to government in taxes (underdepreciation -- in the case of railroads, of rolling stock), and perhaps (c) to employees in wages (plus fringes) which are higher than a proper calculation of productivity would justify.

Issues Affecting the Desirability of Continuing RRB Depreciation

The fact that RRB reflects current prices more fully than would ratable depreciation which rests upon historical cost provides enough economic merit to resolve any doubts for as long as inflation continues. Management decisions for general operations and payments will rest upon cost measurements which are less likely to be misguided by alterations in the general price level (worth of the dollar). If any change is in order, it would be better (on economic grounds) to shift rolling stock away from depreciation which rests on original cost toward a LIFO-RRB type of basis than to put roadbed on an historical-cost basis.

Comparability with Other Industries

An economist can comment on an argument advanced for change.

It is said that putting railroad accounts on ratable depreciation, much the same general basis as the accounts of other corporations, would permit improvement of investment market decisions. Reported figures would rest on more uniform inter-industry calculations; if so, it is said, well-managed and the more prosperous railroads might do better in raising capital. Even ignoring the adverse effects of higher tax payments, the possibilities seem slight. Inherently, railroading differs from other industries. Accounts are better to the extent that they report the facts relevant to an industry. The literature proposing change

does not indicate why the market prices of outstanding railroad stock would benefit if investors knew that accounting were on bases more nearly comparable with the practices of other organizations. Although somewhat easier comparisons might be possible, would they be better ones? To ignore, obscure, and even cover over differences would impair the accuracy of comparison. Since it is by no means clear which of various choices would eventually be made for the numerous points raised in the exploratory papers, no one can know now just how close the results would be to those for other industries.

Two things are certain: (1) To move from better to poorer bases (less recognition of inflation) could hardly improve results. (2) For some years the comparisons of railroad earnings with those of the past would be more complicated.

The discussion in earlier years often assumed that investors would misinterpret accounting reports (on income and capital) which utilized RRB depreciation. Are railroad earnings and prospects evaluated less well as compared with reports of industries which use ratable depreciation accounting for all types of capital.

Studies in recent years report that financial markets appear to operate quite efficiently indeed. The "rational markets" interpretations have strong support. Information is utilized promptly and with sophistication. The present system of railroad accounting has operated for decades. The major investors and financial advisors understand it and its significance. They know

how to take account of the information as reported. Adequate recognition of all relevant facts seems to depend less on comparability in their presentation than on the availability of the essential materials. The availability can be assured through full disclosure.

Thousands of small investors cannot appraise the intricacies of the many bases of reporting earnings and capital through the economy. Railroads are not by any means the only corporations whose reporting has elements different from some others. Who can possibly learn what myriads of investors are relying on as they make decisions? What does seem to be generally accepted is that knowledgeable investors of large amounts are able to interpret the reports in the forms in which they are made. These interpretations can be adequate to make the adjustments at the margin which keep security prices properly related to data available.

Market experts (from leading securities firms) would be more competent than the author to report on this range of issues. If the present pressure for change does emphasize the value of easy comparability of reports, further discussion would be in order. Judgments about the applicability of "rational markets" conclusions to railroad securities could throw useful light on the probable results of revision of accounting. The advocacy of shift away from RRB depreciation began many years before anyone had the research findings which show that in practice markets do rather quickly recognize subtleties of finance.

Three clear points may be worth repeating. (1) RRB does differ from depreciation methods used by most businesses. Not by

any means will all investors appreciate the significance of differences. (2) In times of inflation RRB depreciation has elements of <u>superiority</u> to accounting procedures which assume price-level stability. In principle, then, should not any efforts for change be directed toward, rather than away from, RRB (or any method which makes at least some allowance for declining worth of the dollar)? (3) The proposed accounting change would have one very substantial effect working to the disadvantage of investors -- heavier taxes. The tax increase would hamper the ability of railroads to preserve existing capital, the cost of obtaining new funds would rise. Cash flow would suffer. Any possible benefits from greater comparability of accounts would be overwhelmed by adverse tax effects.

<u>Quality of Measurement</u>

Let us raise in slightly different context an issue of importance. Would ratable depreciation offer more accurate bases for measurement than RRB -- better guides for management, investors, shippers, regulators, and others? Running through the statements supporting change, such as the materials of the Arthur Andersen firm, there appears to be a belief that new accounting would improve the quality of measurement of railroad activities. Ratable depreciation seems more regular and systematic. It brings into the open, as it were, the regularities and realities of an ongoing enterprise which utilizes much long-lived capital.

Responsible judgment on such conclusions would require

detailed knowledge about a variety of matters -- what now prevails, what is most likely to develop under a new system, and the potentials which could be realized under both favorable and unfavorable conditions. An outside economist has only limited qualifications for predicting results. A priori the dominance of inflation would push all possible gains into clearly inferior position.

Deferred Maintenance

The Penn Central, it is alleged, was not adequately maintained. Moreover, the shortfall, it is said, was not made fully evident. At time, other managements have allegedly engaged in unwise practices of deferring maintenance and in fact disguising the full results because RRB accounting enabled them to do so. When ratable depreciation accounting is not used and reliance is placed on RRB depreciation, undermaintenance may conceal some of the true cost of the period's operations. Operations can in effect consume capital through failure to spend enough on preserving the system.

Two aspects need to be distinguished. (1) One is the amount spent. It may be subnormal because of shortage of funds or for other reasons quite unrelated to accounting methods.

(2) The second is the adequacy of reporting. RRB figures may in a sense fail to disclose the full, actual cost because spending is less than needed to preserve the ability to provide service. In a sense this is concealment. Comparable results would not be so likely if the rules required systematic annual statements of charges as under ratable depreciation. The latter,

it is said, would give better information to investors and others. That result would be realized, however, only if the annual ratable depreciation figures used are relatively good. They may not be. In addition to the many difficulties of defining and applying good depreciation estimates in the best of situations, there must now be the added problems of growing out of inflation.

The unfortunate results of the Penn Central may have been worse than if knowledge of actual events had been more fully understood. That experience in itself, however, must have alerted investors. Will not the lesson be long remembered? There is the possibility that because of cash shortage or other reasons a railroad using RRB may defer maintenance and thereby understate full current operating cost. When a railroad is under stress, the full measure of the trouble may be hidden, deliberately or to some extent by inadvertance.

Deferral of maintenance -- inadequacy of actual outlays (for more than brief periods) -- is possible. Also possible under such conditions, but not inevitable, is a failure of management to reveal its best judgment of the significance of what had (not) been done. Lack of full and complete explanation (possible concealment), not necessarily by design, can in effect mislead investors, shippers, employees, and others. Deferring maintenance has physical results of importance. Changes in accounting as such will not lay better rail, improve ballast, or otherwise make up deficiencies in physical conditions. What can be hoped for is information to permit full understanding of the realities. Disclosure

should be assured to meet the needs.

If data are not now assuredly adequate -- re deferral of maintenance -- what would fill the gaps? Presumably, ratios and other measures of the adequacy of maintenance can be developed to be as good as estimates of ratable depreciation. Measures of either type may be good or poor. A requirement to use ratable depreciation does not in itself indicate anything about the quality of the measures. (Totals for a railroad system as a whole will not reveal the distribution of maintenance among the many parts of the line nor how well each section has been prepared to meet the needs it must serve). If regulatory authorities and others believe that improvement of information is desirable, the suggested shift of accounting methods is not required and would not provide the measures desired. The inputs of figures will be crucial. They can be good (or deficient) with one or another system of depreciation. Information to provide fuller understanding of the physical condition of the parts of system can be supplied without requiring that RRB is abandoned and ratable depreciation used instead.

The measurement of accumulated under-maintenance of railroads has become a matter of concern as part of the country's total transportation problems. Measurement and interpretation are complex. In some cases, for example, what appears to have been inadequate maintenance may in fact have been a rational adjustment to the actual traffic outlook.

In other cases, however, the developments were not fully

understood by all who had some interest. Perhaps different accounting would have revealed more clearly what was happening. The Arthur Andersen material makes a persuasive case to this effect. For the future, however, moving away from RRB would not be needed to learn what provision is being made by a railroad. Its actual outlays, year in and year out, can be related to whatever general standards seem appropriate. Clearly, getting satisfactory data would require overcoming various problems, but they are inescapable if the job is to be done in <u>any</u> way.

<u>Obsolescence</u>

Over the years obsolescence, especially on non-mainline track has probably been greater for most railroads than annual accounting has revealed. Annual accounting has not been designed to show such loss of worth. The decline in current outlays on branch lines as reflected in RRB figures does not in fact show the decline in value that has taken place, often gradually. The drop in demand and market potential does not require explicit recognition in the accounts. RRB depreciation applies to what is spent but does not include items for the drop in worth. Enough may have been spent on a declining branch to preserve its ability to serve a dwindling demand, but the loss of value due to market deterioration is not recorded from year to year. A substantial drop in maintenance gives an incomplete and unsystematic indication of what may have happened to capital value.

Under RRB the (final) loss of worth of branch lines and other such mileage will be shown when they are abandoned. Except

in the special situations for which ICC rules make some provision for write-off, the books will generally not deduct as an expense the decline in value so long as some use is being made of the facilities. Railroads have mileage which is largely redundant but which has not yet been abandoned. The economic worth has eroded without the accruing obsolescence appearing as an expense. Somewhat similar processes may lie ahead.

In more cases than may be recognized, mileage still operated has negative worth in the sense that service must be provided -- but at a loss. Such mileage is a drain on the system. Facilities of this sort are not of zero value. They are worth less than zero because their existence forces the railroad to incur expenses which are greater than the revenues obtained while the prospects of much salvage value are slight (especially if retention for some use is required). The obligation to serve has delayed ending operations. (The new Federal law will assist in the abandonment of such capacity). Existing accounting methods do not serve well to reveal such developments as they occur; methods do not put the accruing loss of value in annual statements.

It would be good indeed if accounting over the years could show accruing obsolescence. Yet doing so is impossible if one does not know what is happening and the dollar magnitudes. As obsolescence actually accrues, even the best of estimating procedures are not likely to yield "correct" allowances because, inevitably, the amounts of such change are elusive. Except by luck and accident, declines in maintenance outlays (RRB) -- and a low

level -- will not serve well to reveal what is taking place. Conceivably, systematic ratable depreciation rates could embody amounts for such loss of worth -- for "economic" as well as "wear and tear" elements. Inherently, measurement of accruing obsolescence is difficult. Who can know what the future holds? How could agreement be reached to record the estimate with reasonable promptness and get acceptance, e.g., for tax purposes?

Looking ahead, would the ratable depreciation rates to be set for trackage recognize better than will RRB the loss of value due to the obsolescence which is yet to occur? If proper allowance were to be embodied in a new method, then here is one respect in which ratable depreciation might contribute to cost measurement an element which is superior to anything utilized in RRB. But the theoretical possibility does not by any means assure even a modest probability of realization in practice.

Who would know about the future economic prospects of various branch lines? Even when some specific situations might be clear, more typically, doubts would be extensive. Industry-wide figures could hardly be relied upon for individual railroads each of which has unique elements. Averages of the past would scarely apply to the future. No two railroads face the same outlook in this respect. The importance and the difficulties of uneconomic, redundant, obsolete railroad facilities will in all probability continue to call for explicit attention. The methods of dealing with the issues are not clear to the author -- except that the proposed shift of depreciation methods would offer little if any contribution to achieving desirable results over the years.

Does the present system occasionally provide reason to delay abandonment in order to avoid a large negative item in the income statement? If so, uneconomic mileage may be retained somewhat longer than otherwise. But for profitable railroads the strongest incentive would seem clearly to be to get rid of obsolete lines as soon as possible.

Over-Maintenance as a Possibility

Critics of business taxation sometimes argue that the tax purposes expenses are overstated (and taxes thus underpaid) because too much is deducted for depreciation. In the case of railroads, roadway outlays may offer the possibility of treating what in fact is some net capital formation as current expense. It is conceivable that under RRB depreciation rules, some net capital improvement will be deducted currently, rather than being capitalized and depreciated in smaller annual amounts. If such is the case, government receives lower current taxes; corporations get what is called an "interest-free loan" of the element of tax which is not payable as soon as otherwise required. Instead of dividends, shareholders get an enhancement of the value of the corporation's assets. When something similar (accelerated depreciation) happens for rolling stock, the item "deferred income tax" appears in the accounts.

Accounting for book purposes can show one set of results while tax accounts show another. ADR and methods which permit acceleration over straight-line are sometimes criticized as exerting

"artificial" influences on management decisions. But any such issues are rarely included in the literature on the current topic; a proposed actual implementation of a new sytem remains to be defined. Whether or not opportunities would open up is not clear. Cash flow seems to be a factor determining actual expenditure. Moreover, inflation complicates matters so that assertions once perhaps valid are now outweighed by others.

Under RRB is there a possibility, and is there an incentive, for railroads in fact to make net improvements (under the guise of maintenance) because outlays can be charged off at once rather than being capitalized and depreciated? (If so, is such investment practice in some sense not one to be encouraged in the public interest)? The drop in reported net income will, of course, be greater than the decline in tax due. Net use of cash is required, and railroads argue that cash flow imposes strict limits on the outlays possible.

A tax deduction now is better than one of equal size next year or later. Furthermore, in time of inflation, spending in advance of need may save more in expense than the cost of the financing required -- borrowing at X percent to avoid a cost rise of X + Y percent (plus the cost of risk in form of exposure to earlier obsolescence and some misdirection of assets). If a railroad's cash permits, then some speeding up of maintenance may take place from time to time. With what results?

Several questions can be raised. Are the reasons good? Could the amounts of speed-up which cash flow will permit during,

say, five years be significant? Would conditions for (1) management decisions, (2) security owners, (3) taxing agencies, and (4) others be "better," somehow, under ratable depreciation that allocated the costs over more years? What would be the results of a slower pace of replacement and maintenance? How much different would the amounts be in an economy where cash flow exerts a restricing force?

"In theory" for profitable, taxpaying railroads, the present rule would seem to "tilt" maintenance spending budgets toward earlier rather than later use of funds. The reputed condition of much of the country's railroad track structure -- with considerable deferred maintenance -- suggests strongly indeed that any "bias", as alleged, in depreciation methods must have been outweighed by other factors. Low earnings are a dominant reality. Railroad managements emphasize cash flow as a governing force. The proposed change by raising taxes would reduce cash available for railroad purposes.

Relation of Actual Depreciation to Intensity of Use

The intensity of track usage -- tons, speed, "pounding", frequency, and other factors -- will affect what actually happens on particular portions of track structure in any given period of time. Annual depreciation deduction based on the passage of time -- e.g., straight-line or declining balance -- will not take account of the differences in intensity of use as related to the physical characteristics of specific trackage (e.g, 132 or 110 lbs. rail, quality of ballast, curvature, etc.). Frequent and heavy

trains moving at high speeds have results very different from those of lighter traffic moving at low speeds.

A time-based method for allocating cost seems in principle to be inherently crude and inexact. "Unit of use" depreciation would be more nearly accurate. Devising and operating any such method for a railroad would be difficult. Yet for trackage the present method goes far to achieve just such a desirable result. For a railroad which is well maintained over the years, RRB outlays would seem to relate rationally to the volume of traffic and nature of use as they affect the conditions of the track structure.

Furthermore, high usage will generate funds that can be used to provide replacements which are appropriate to the real cost of carrying "more" as against "normal" or "low" traffic. A drop in traffic will reduce somewhat the need for spending, just as it also reduces the flow of cash receipts.

For an entire railroad and the country's system as a whole, RRB does seem likely to relate more rationally to actual usage than would ratable depreciation. Usage can and does change from one period to another. In any one year, of course, particular segments of the track structure will receive only spot maintenance. Such mileage will occasion less charge to cost in that year than would be recorded under ratable depreciation. Some portions will receive replacements at low levels, and some quite infrequently, in accordance with amount of use. The total maintenance outlays for the system will tend to rise and fall with the intensity of use. Usage has some rational, even if not precisely measurable, relation to the total of true "capital exhaustion"

(depreciation) expense in each period.

Any reasonably accurate method of ratable depreciation, one applying more or less average rates of depreciation, should rest upon considered recognition of the significance of differences in traffic intensity. Would not the attempts to take account of such traffic differences (in the setting of depreciation rates) b e merely an indirect way of trying to do what RRB by its essential nature will do over the years if the track structure is preserved appropriately? (This feature of RRB depreciation is to be distinguished from points related to inflation). In any case, determining depreciation (plus obsolescence) rates that relate realistically to true capital cost must recognize the realities of usage in their wide differences.

Climate and Other Factors

Conditions of climate and terrain differ. Their significance for the railroad's expenses will be related to kinds of track structure and traffic -- but in no simple way. Any single standard of ratable depreciation (for one as against another type of track structure -- mainline or branch) would be better suited to some parts of the country than to others. Realities call for differentiation to reflect various kinds of situations, including the current maintenance which would be permitted as an expense.

Who could determine the most appropriate rates of depreciation and obsolescence as related to climate and terrain as well as other factors? Management judgment now reflects the actual conditions of each system as represented by cash outlays. (Cash

flow may not permit adequate maintenance). Perhaps outsiders in regulatory agencies or the IRS could do a better job. But what would be required for them to give adequate recognition of differences in climate, etc.? How could the necessary competence be acquired?

Units for Depreciation

The definition of the units to be used as bases for computation of ratable depreciation would present problems. Sections of the company's system would need different treatments, whether or not the accounting and other problems would present significant difficulties would call for further study. Economic analysis does not offer much as useful guidance for separating an entire railroad track structure into parts for computing and allocating capital cost. Each portion may carry a huge variety of traffic. Distinctions of programmed and spot maintenance affect the decisions. Investment-tax credit considerations can have tax significance.

Starting Bases

Getting the capital figures to use as bases to begin ratable depreciation would present problems. Where and when to start? Original cost? Something more recent, reflecting inflation? The amounts which the accounts do not show (what is on the books) have been spent but not written off -- but rarely will they represent any rational relation to the worth of the property involved. How could such figures possibly give economically useful bases for measurement?

Until proponents of change specify the details of bases proposed for ratable depreciation, analysis and commentary can be postponed.

Costs of A Change

Any change would involve some accounting and management costs. Although these would not be large in relation to total operations of a railroad, any additions to expense have disadvantages. Avoiding them adds to the reasons for continuing the system in use.

Rates of Depreciation

For ratable depreciation to operate well, accurate measures of depreciation of various types of trackage would be required. Figures are easily suggested. But which will really prove to be realistic over time? Estimating obsolescence inevitably presents great difficulties. Advocates of ratable depreciation as against RRB apparently believe that generally good depreciation rates for railroad track structure, etc., could be prescribed.

Spokesmen for RRB, however, state that "wearing out' of line is less characteristic than is preservation through spot and programmed maintenance. Safe and efficient use does not permit deterioration of mainline track.

Whether or not reliable data on depreciation and obsolescence could be found seems questionable. Some railroads, including those in Canada, do now use ratable depreciation accounting. But this fact does not provide convincing evidence that in

a period of stable prices the results would in fact be better than the traditional methods used in this country. Moreover, inflation is a fact of life. When it persists, "standard-level" depreciation rates will be seriously defective.

Management Guidance

Would a change in accounting assist management in its decision-making? Venturing an answer to this and related questions would be presumptuous for an outsider who does not have extensive knowledge of actual operations and who has not made an especially directed study. A 1968 White Paper from the U.S. Treasury raises issues growing out of the differential tax treatments of various elements, e.g., those depreciable and those that are not. If tax neutrality is a goal, then questionable results appeared quite likely. Inflation aggravates the defects noted then. Uncertainty as to tax laws complicates the comparison of alternatives.

Economic principles would emphasize the prospective productivity of capital as the most useful guide for management. Nothing in the proposed change would enhance the opportunities for improving the estimates of capital productivity.

Magnitudes

As already noted, several variables would need to be considered in estimating magnitudes. Professor L. J. Buckwell of Bowling Green State University filed with the ICC in September 1978 estimates for ten major railroads. For them, the apparent 1977 tax cost of a change from RRB would have been $199 million. The

after-tax income would have risen from $881 million under betterment accounting to $1,081 million under ratable depreciation. Assuming that the marginal tax rate would have been around 48 percent (plus something for the state taxes), the additional tax would have been essentially the same as the amount of difference after tax.

Anything of this magnitude projected over a decade points to issues of greater magnitude than the earlier literature may have suggested. Presumably the continuing high rate of inflation provides at least some of the reasons that the burden is greater than once indicated. The assumptions are as follows:

1. Maintenance expenditures reported for 1977 would have been 90 percent capitalized with 10 percent chargeable as current expense.
2. Existing road asset accounts would be depreciated at 10 percent a year, as a composite of all track components, on a straight-line basis (10-year life remaining).
3. For new "maintenance" outlays capitalized, stright-line depreciation would rest on a 15-year life with no salvage value.
4. Property taxes would rise by 2 percent of the increase in pretax earnings. (This assumption admittedly rests upon a report of one railroad only; it would be subject to a considerable margin of doubt). The figure would probably be higher for railroads operating extensively in

states which rely heavily upon the capitalization of income.

5. The effective tax rate paid in 1977 is applied to the increase in earnings. Tax rate figures for the individual lines are not shown. No investment tax credit is computed although Professor Buckwell notes that some credit would probably have been available to reduce the net cost of the change.

Clearly, the added tax costs to railroads would be a cause for concern for anyone interested in the country's transportation outlook. True, some mitigation might be arranged. The portion of current outlays to be expensed under new rules would be one possible variable. Another would be the actual depreciation-obsolescence rates. Yet at best the possibilities of offsetting inflation seem too small to provide any assurance against serious damage through taxation by a policy that conflicts with economic rationality in times of inflation.

Individual railroads and the industry have so much at stake if pressure for change continues that detailed calculations under various assumptions would be desirable.

Nothing, however, seems likely to provide in the future the present element of automatic adjustment for inflation. The system was not originally intended for this purpose. But it is nonetheless effective.

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Honorable Harry F. Byrd, Jr.
Chairman, Subcommittee on
Taxation and Debt Management
General Committee on Finance
United States Senate
Washington, D.C. 20510

October 17, 1979

Dear Sir:

Our client, Union Pacific Corporation, has requested us to address the issue of whether retirement-replacement-betterment (RRB) accounting for railroad track structure is in accordance with generally accepted accounting principles.

Deloitte Haskins & Sells is an international firm of certified public accountants with an extensive practice serving railroad industry clients.

RRB accounting has been used by the vast majority of companies in the railroad industry to account for track structure since before 1900. To this day, it is required to be followed in filings with the Interstate Commerce Commission (ICC), the Federal regulatory agency having jurisdiction over the railroad industry.

RRB accounting has been the subject of extensive discussion over the years. Its principal benefits are summarized as follows:

- It is an accurate and conservative method of accounting for the particular characteristics of track structure.
- It is more sensitive to inflation.
- It recognizes the unique characteristics of track structure and it overcomes the difficult maintenance versus capital measurement questions that ratable depreciation would entail.

The rationale supporting these benefits are discussed in more detail in the attached appendix. A brief synopsis of the results of previous considerations of RRB accounting follows.

On April 1, 1957, the American Institute of Accountants (now the American Institute of Certified Public Accountants) Committee on Relations with the Interstate Commerce Commission submitted a report dated March 29, 1957 to the Chairman of the ICC which considered the prescribed accounting for ties, rails and other track materials on the books of railroads under the jurisdiction of the ICC. The Committee stated the following:

> "The committee believes that 'replacement' accounting does not accord with practices generally followed by other industries. As to track components, however, the committee, in consideration of the long history of the use of replacement accounting by railroads with respect thereto, the unique nature of this category of railroad property, its relatively stable physical quantity, and the mature economic status of the industry, has concluded, with one member dissenting, that no substantial useful purpose would be served by a change to depreciation-accounting techniques in the absence of evidence indicating that depreciation-maintenance procedures would provide more appropriate charges to income for the use of such property."

On December 31, 1957, the Committee reaffirmed its conclusions and stated that:

> "We feel that a practice consistently followed for more than 50 years and which affects a significant segment of the railroads' properties and operations should not be changed unless and until it has been found to be clearly erroneous by a convincing preponderance of evidence. We believe that no sufficient reasons have been presented to justify a change in this accounting method with its resultant tremendous upheavel in the fields of federal, state and local taxes, its substantially increased costs of accounting and no proposals for the protection of both investors and shippers in the transition. The present accounting method has withstood the test of several decades of use without demonstrated proof of harm to any parties. It is now impractical, if not impossible in view of the economic and taxation changes which have taken place during that time to reconstruct the accounts in such a way that all parties will be treated equitably."

In 1966, the Committee restudied the entire subject of RRB accounting and reported to the Accounting Principles Board on April 4, 1966. They concluded that RRB accounting for track structure had substantial authoritative support and is,

therefore, a generally accepted accounting principle. The Committee further pointed out that:

> "In the opinion of an eminent consulting engineer...depreciation would produce no more accurate results than replacement accounting."

As recently as September 1977, the Association of American Railroads (AAR) urged the Securities and Exchange Commission to permit the continued use of alternate accounting methods for track structure so that each railroad can select the method which best reflects its particular operations and financial position.

A limited survey of fourteen 1978 annual reports of railroads or railroad holding companies discloses that thirteen of the companies use RRB accounting for track structure. All of these companies received unqualified opinions from their independent certified public accountants. Clients of four firms were included in this category.

In conclusion, it is our opinion that RRB accounting for track structure has been and presently is in accordance with generally accepted accounting principles.

Yours very truly,

Deloitte Haskins + Sells

APPENDIX

SYNOPSIS OF BENEFITS OF RETIREMENT-
REPLACEMENT-BETTERMENT METHOD
ACCOUNTING FOR TRACK STRUCTURE

Accurate and Conservative Method
of Reporting Financial Results

RRB accounting is an accurate and conservative method of reporting financial results in that it recognizes currently, as expense, the costs incurred to maintain track structure at its initial level.

In a tentative report dated April 25, 1949 the ICC Bureau of Accounts and Cost Finding stated "Track repairs are in substantial ratio to the wear and tear and use of the plant (as measured by gross ton miles) and replacement accounting represents the facts as to wear on the plant better than does depreciation accounting, at least when the latter is applied on a straight-line basis".

In a 1949 study, the Association of American Railroads (AAR) stated "Present replacement accounting for track parts provides an accurate statement of actual expense which is being incurred in the maintenance and repairs of property. This method also has a definite stabilizing influence on the income account regardless of the economic cycle....

Replacement accounting best reflects the company's financial affairs in that it places costs of repairing and replacing track elements in the periods when the expenditures occur.

Because of the relatively unvarying amount of depreciation charges, the resulting net income that would be stated under the proposal would be inflated in periods of high traffic volume and understated in periods of adversity. In both instances, the result would be detrimental to the carriers and is undesirable from the standpoint of sound economics".

Also, in a letter to the Interstate Commerce Commission dated June 28, 1957, the AAR stated "in periods of high traffic volume and use, when more repairs are necessary, the accounts should reflect the charges resulting from such increased use; in periods of decreased traffic, the accounts should recognize the reduced repair expenses. Substitution of the relatively unvarying amount of depreciation charges would defeat both of these ends."

In a letter dated September 19, 1977 the AAR urged the Securities and Exchange Commission not to require railroad companies to adopt ratable depreciation and to permit the continued use of RRB accounting. Two of the reasons given were accuracy and conservatism. The AAR stated "the present RRB method of

accounting resembles depreciation accounting based on the unit-of-production concept rather than the availability of production capacity under ratable depreciation. Additionally, actual annual cash outlays for track replacement are probably of more significance to investors than depreciation of historical track cost over a designated period."

In summary, RRB accounting is a better matching of current costs with current revenue.

More Sensitive to Inflation

In the Financial Accounting Standards Board's Proposed Statement of Financial Accounting Standards - Financial Reporting and Changing Prices, the Board stated "many people believe that financial statements based on historical cost fail to provide all of the information needed by users because those statements normally account explicitly only for the historical cost and sales proceeds of assets and do not identify separately other prices or changes in prices".

RRB has the effect of charging to income the expense for maintenance and repair expenses for track structure at current price levels. This benefit was recognized by the AAR in its letter to the ICC dated January 2, 1942 in which the AAR stated that "replacement accounting adheres closely to the variations of the price cycle and therefore states the cost of track repairs in terms of current prices commensurate with prices used in stating revenues and most other items of expenses."

To require a change from the RRB method of accounting, which more closely approximates replacement cost, to depreciation at a time when the historical cost model is being intensively reconsidered may reduce investors' confidence in the financial statements.

Recognizes Unique Characteristics of Track Structure and Overcomes Maintenance vs Capitalization Question

Track structure for railroads possess some unusual characteristics. For one, there is no sole determinant of useful life because track structure does not deteriorate physically, only as a result of passage of time. Frequency and weight of traffic affect the usefulness of the track. Certain elements of track structure such as ballast, it is argued, do not depreciate at all. For another, there is no uniform understanding as to what constitutes a unit of property.

The railroad industry is a mature one which is not expanding its right-of-way. The track structure has not been subjected to rapid or unique technological changes, although there has been a tendency towards heavier weight rail and reduced curvatures in order to handle greater volume at higher average speeds.

The question then is does RRB accounting for track structure provide for an acceptable charge to expense for the utility cost of using the track structure in the periods in which revenues are derived from the use of the track structure?

As stated previously, physical deterioration of track structure is not a simple function of the passage of time. During periods of lessened economic activity, less freight volume will move and physical deterioration will be slowed. Conversely, when the frequency, volume and weight of freight hauled over a particular section of track increases, the physical wear accelerates. This has been demonstrated over the past several years on those railroads that have experienced recent increases in the hauling of coal over certain routes.

Another illustration of factors other than passage of time affecting the deterioration of track structure is to look at the distinctions between frequently used main lines and more seldomly used branch lines. Although the weight of the rail used may be less on branch lines and the frequency of maintenance and replacement activities greater on main lines, branch line track structure may last longer simply because of lighter traffic loads.

One consideration then would be to adopt a method of charging track structure costs to expense that considers the lack of uniform wear and the somewhat indeterminate life of the assets. One approach would be to adopt some form of an units-of-production method which gives effect to:

- passage of time
- frequency of traffic
- weight or volume of traffic.

RRB accounting resembles such a unit-of-production method. For one thing, routine, scheduled maintenance need be performed to maintain track structure at a minimum operating level. This gives effect to the passage of time. Also, as frequency of traffic and volume increases, greater demands will be placed on maintenance activities, and hence higher costs will be incurred and charged to expense, in order to keep the track in adequate operating status. Thus, frequency and weight of traffic are also considered.

In a mature industry, such as the railroad industry, no significant growth in asset base occurs. No significant new rail lines are being built or contemplated. Rather, the more prominent question is which lines will be retained. In such a situation, over a long period of time, the charge under RRB accounting to replace worn out track will tend to equal depreciation.

Ratable depreciation methods involve estimations of useful lives which are not required by RRB. However, with respect to track structure lives are difficult to determine.

Useful lives for track structure could, in a sense, be considered indefinite in duration. Once the roadbed is in place and properly graded, as long as ballast is maintained, it has an indefinite life. Ties, rails and other track components obviously do have a limited life and need to be periodically replaced, although it is difficult to assess the frequency with which replacements need be made. The lives of the components are all affected, as stated previously, by both passage of time and frequency and volume of traffic and the lives of each component will vary. Consequently, the method used to charge plant costs to expense must give recognition to these factors.

Given the mature nature of the industry, RRB accounting accomplishes a proper matching of expense with freight revenue in that maintenance costs incurred to keep the track in a reasonable operating condition are expensed. Consequently, RRB accounting provides an acceptable method of accounting for track structure.

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One New York Plaza
New York, N.Y. 10004 (212) 747-7000

Salomon Brothers

October 5, 1979

Honorable Harry F. Byrd, Jr.
Chairman, Sub-Committee on Taxation
and Debt Management
General Committee on Finance
United States Senate
Washington, D. C. 20510

RE: Bill No. 1467

Dear Sir:

This letter is submitted in support of the above Bill, which we understand has been introduced in order to codify for tax purposes the Retirement-Replacement-Betterment (RRB) method of accounting for the railroads' track structure expenses.

The RRB method has been employed for more than 65 years and has continued to be found acceptable after intense scrutiny by Congress, the courts and the Internal Revenue Service. Over the last few years, the Securities and Exchange Commission, the Interstate Commerce Commission and the Department of Transportation have been studying whether the RRB method is acceptable for reporting the results of operations to shareholders and to the Commissions. While we believe that the method is appropriate for public reporting purposes and that any change in this context would be most undesirable, it is our opinion that any change for tax purposes would be little short of disastrous for the railroad industry as a whole.

Atlanta / Boston / Chicago / Cleveland / Dallas / Hong Kong / London (Subsidiary) / Los Angeles / Philadelphia / San Francisco

We believe, as we have stated in submissions to the SEC, that the RRB method is appropriate for measuring the true nature of the track structures component of operating expenses for almost all railroads at this stage of the industry's development. While we believe that ratable depreciation might have been applicable from the inception of the industry, and may well be appropriate for virtual "start-up" operations, it is questionable whether any switch now can be accomplished with any real accuracy. Furthermore, in these inflationary times, the RRB method has been found to provide for replacement costs far more adequately than ratable depreciation.

It has been estimated that in 1977 alone a change to ratable depreciation would have cost the industry in excess of $300 million in additional taxes. Apart from the obvious deleterious effect which this would have on the industry's cash position, and the immediate impact that it might have on the ability to meet everyday obligations, the implications for the industry's standing in the investment community are most serious.

By the normal yardsticks of profitability, the railroad industry does not compare favorably with most other industries. Its relatively poor performance, as measured by operating margins, return on investment earnings' growth rates, interest coverage, etc. has caused many railroad common stocks to sell at levels well below those of other

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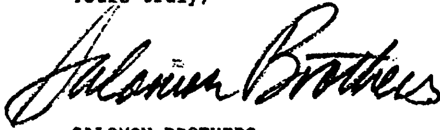
industries. The added impact of the extraordinary cash needs resulting from additional tax payments would, in our opinion, make the task of capital raising by many companies extremely difficult. Consequently, their ability to meet the transportation requirements of the nation would obviously be seriously impaired. Indeed, it would not be surprising if several companies had to seek reorganization due to this additional burden.

In conclusion, we strongly urge the passage of Bill No. 1467 to regularize the RRB method of many years standing and to remove an unnecessary aura of uncertainty overhanging the railroad industry.

Yours truly,



SALOMON BROTHERS

MORGAN STANLEY

MORGAN-STANLEY & CO.
INCORPORATED
1251 AVENUE OF THE AMERICAS
NEW YORK, NEW YORK 10020

October 5, 1979

The Honorable Harry F. Byrd, Jr.
Chairman
Subcommittee on Taxation and Debt
Management General Committee of Finance
United States Senate
Washington, D.C. 20510

Dear Senator Byrd:

I am writing on behalf of Morgan Stanley to express our support for S.B. 1467, which would codify the Retirement-Replacement-Betterment ("RRB") accounting method, currently used by all of this country's major railroads, for federal income tax reporting purposes.

Morgan Stanley is a leading investment banking firm. Since the Firm's founding in 1935, Morgan Stanley has managed over $157 billion of financings in capital markets worldwide for corporations and governments, including over $1.9 billion for U.S. railroads. Morgan Stanley serves as investment banker to several of this country's major railroads. As a member of Morgan Stanley's Railroad Group, I work closely with a number of a railroads not only with respect to financings but also with regard to a wide range of financial and strategic matters.

The railroad industry has used the RRB method of depreciating its track structure since the inception of the Federal income tax. It has been found to be an acceptable method by the Congress, the courts and the Internal Revenue Service. We understand that the Interstate Commerce Commission is giving consideration to a requirement that the railroad industry use a ratable method of depreciation for regulatory purposes. If such a change-over does occur, it could result in the Internal Revenue Service requiring the industry to use a ratable method for tax purposes. We believe that such a move would be ill-advised since it would materially reduce the cash flow available to the railroad industry. The Association of American Railroads examined what the effect would be if the railroad industry shifted to a ratable method for Federal income tax purposes. Their study indicates that in 1977 alone the railroad industry would have paid additional Federal income taxes of approximately $300 million.

As discussed below, we do not believe the railroad industry possesses alternative sources of cash flow to replace such an enormous loss of cash. A switch from the RRB method to a ratable method with the consequent additional tax liabilities would result in a further deterioration of the financial condition of the industry and, hence, the railroad plant in this country. This would be clearly counter to the desire of the Congress, as expressed in the Four R Act, to improve the financial and physical condition of the railroad industry.

The industry has two alternatives to recover this loss of cash flow. Railroads might attempt to raise the cash internally through increased rates. However, this could be both inflationary and counterproductive since, in all probability, additional traffic would be driven off the railroads and into the hands of other transportation modes, hence failing to replace the cash flow shortfall.

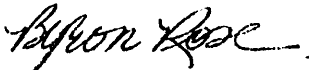
The other alternative to replace this cash flow loss would be to raise cash externally through the sale of securities. Unfortunately, the railroad industry's return on investment is so inadequate that very few railroads have the financial strength and growth prospects necessary to allow them to sell equity capital. Indeed, Morgan Stanley was the managing underwriter for the only major equity issue done by a railroad since the depression, a $100 million convertible preferred issue for Burlington Northern ("BN") in 1977. That issue was attractive to investors due to BN's potential for profit through the transportation of coal out of the Powder River Basin. However, that potential can only be realized through an enormous investment in plant and equipment. To achieve that investment, BN must have available sufficient internally generated cash flow. Consequently, the imposition of a ratable method of depreciation could seriously impair the plans of even those few railroads such as BN who do have the ability to sell equity securities.

Since equity funds are generally unavailable, railroads raise the bulk of their external capital through the issuance of debt securities secured by rail equipment - locomotives, box cars, and other rolling stock. These funds can only be used to purchase equipment. Railroad equipment securities, usually called equipment trust certificates, enjoy an acceptance by investors such that they are normally well-received in the marketplace. Unfortunately, this is not the case for debt securities, such as mortgage bonds, issued to finance non-equipment expenditures. Non-equipment debt securities of railroads have limited marketability, and railroads are often forced to pay high interest rates in order to sell these debt securities. Hence, railroads must usually finance non-equipment expenditures, on such key projects as upgrading roadbeds and track, through internally generated funds rather than through borrowed funds.

Because we believe the industry never would be able to fully replace the cash lost through a switch to a ratable method of depreciation, we believe a decline in the physical condition of the railroad industry, a deterioration in service to shippers and a further weakening in the financial condition of the railroad industry would result.

Consequently, I urge you to codify the Retirement-Replacement-Betterment ("RRB") accounting method for federal income tax reporting purposes.

Sincerely,



Byron Rose
Managing Director

THE FIRST BOSTON CORPORATION

MEMBER NEW YORK STOCK EXCHANGE, INC.

CABLE ADDRESS
FIRSTCORP, NEW YORK

20 EXCHANGE PLACE
NEW YORK, N.Y. 10005

October 3, 1979

The Honorable Harry F. Byrd, Jr.
Chairman
Subcommittee on Taxation and
Debt Management
General Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Senator Byrd:

We are pleased to have the opportunity of commenting on the prospect of a codification of the retirement-replacement-betterment method of calculating depreciation of railroad track structure for Federal income tax purposes. Our comment is based, in part, upon our general view of the capital formation difficulties encountered by railroads over the last thirty years, together with an estimate of the Association of American Railroads ("AAR") that the elimination of the retirement-replacement-betterment method of determining such depreciation would have resulted in an increase in tax expense for all Class I railroads of approximately $300 million for 1977 alone.

We strongly support the retention of the retirement-replacement-betterment method of calculating depreciation of railroad track structure for tax purposes. Our position reflects conclusions reached with respect to the following factors:

1. Assuming that the AAR estimate is reasonably accurate, the impact of an increase in tax expense of $300 million should be gauged by comparing such amount not to aggregate cash flows, but rather to the actual amounts of cash available for distribution or reinvestment after provision for the preservation of the capacity of the rail system to provide competitive service. John R. Meyer and Alexander L. Morton argue that the gross capital expenditures of railroads are a truer measure of "the cost of maintaining capital intact" than depreciation

based on historical prices.*/ Appendix I attached hereto reproduces their Table 11 as updated and supplemented by The First Boston Corporation. The last column shows the aggregate amounts of cash flow available after capital expenditures, but before payment of fixed charges and allowance for the pro forma tax effects estimated by AAR. In our view, the table shows that the increase in tax expense is simply not affordable.

2. Inflation in the cost of maintaining railroad track structure has been significant. Furthermore, these assets are relatively long-lived, resulting in greater than normal variances between historical and current replacement costs. In such circumstances, it is widely acknowledged that ratable depreciation inadequately provides for current replacement.**/ Since the retirement-replacement-betterment method is analogous to last in, first out (LIFO) accounting for inventories, it reflects changing current replacement costs during inflationary periods to a greater extent than ratable depreciation, and should be retained for this reason alone.

3. A cash flow reduction of $300 million per year accumulates to approximately $3.8 billion when compounded annually at a 5% after tax rate over ten years. On this basis, the after tax cash outflow in the tenth year would approximate $490 million. The financial statistics of railroads do not suggest to us a likelihood that these cash flow reductions could be offset by combinations of rate and productivity increases in the future. Alternatively, the incurrance of otherwise avoidable rate increases would tend to exacerbate the intermodal competitive problems of the rail industry.

Due to these foregoing factors, The First Boston Corporation concludes that the application of the retirement-replacement-betterment method for tax purposes provides a partial adaptation to adverse inflationary trends and tends to mitigate the rail industry's acute need for

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*/ "The U.S. Railroad Industry in the Post World War II Period: A Profile," Explorations in Economic Research, National Bureau of Economic Research, Fall 1975, pp. 449-501.

**/ See Exposure Draft: Financial Reporting and Changing Prices, Financial Accounting Standards Board, December 28, 1978.

THE FIRST BOSTON CORPORATION

The Honorable Harry F. Byrd, Jr.
October 3, 1979
Page Three

retained cash flow. Accordingly, we support the retention of the retirement-replacement-betterment method of calculating depreciation of railroad track structure for Federal income tax purposes.

Very truly yours,

THE FIRST BOSTON CORPORATION

By:
Frederick M. R. Smith
Managing Director

The First Boston Corporation — Appendix I

Railway Earnings Computed with Cash Flows Charged with Gross Capital Expenditures Rather than with Depreciation as the Cost of Maintaining Capital Intact

Year	Net Railway Operating Income(1)	Depreciation Accruals(1)(2)	Cash Flow	Gross Capital Expenditures	Adjusted Net Railway Operating Income (Cash Flow – Gross Capital Expenditures)
1950	$1040	$ 430	$1470	$1066	$ 404
1951	943	445	1388	1414	-26
1952	1078	486	1564	1341	223
1953	1109	505	1614	1260	354
1954	874	527	1401	820	581
1955	1128	539(est.)	1667	910	757
1956	1068	553	1621	1228	393
1957	922	582	1504	1395	109
1958	762	602	1364	738	626
1959	748	614	1362	818	544
1960	584	629	1213	919	294
1961	528	641	1179	646	533
1962	726	655	1381	833	548
1963	806	699	1475	1044	431
1964	818	686	1504	1417	87
1965	962	707	1669	1631	38
1966	1046	732	1778	1953	-175
1967	676	756	1432	1522	-90
1968	678	773	1451	1187	264
1969	655	766	1421	1509	-88
1970	486	790	1276	1351	-75
1971	696	800	1496	1178	318
1972	835	776	1611	1216	395
1973	650	1002	1652	1342	310
1974	768	1031	1799	1565	234
1975	351	973	1324	1790	-466
1976	452	927	1379	1725	-346
1977	443	1078	1521	2290	-769
1978	443	1236	1679	2776	-1097

Source: Years 1950-1971, John R. Meyer and Alexander L. Morton, "The U.S. Railroad Industry in the Post World War II Period: A Profile," Explorations in Economic Research, National Bureau of Economic Research, Fall 1975, p. 480. Years 1972-1978, Yearbook of Railroad Facts: 1979 Edition, The Association of American Railroads; Moody's Transportation Manual. Depreciation accruals for the years 1976-1978 provided by the Economics and Finance Department of the Association of American Railroads.

(1) Includes deferred taxes in years 1973-1978.
(2) Depreciation accruals include retirements in years 1975-1978.

October 22, 1979

Before the
Subcommittee on Taxation & Debt Management
Committee on Finance
United States Senate

Statement of The Authors League of America on
S. 1078: Artists Tax Equity Act of 1979

The Authors League is the national society of professional authors of books, plays, poetry and other works, with a membership of 8,500.

The Authors League submits this Statement in support of S. 1078 and urges its enactment. The Bill would eliminate inequities in the taxation of authors, composers, artists and their estates. The League does recommend two changes, or clarifications, of language in Sec. 3, which establishes a tax credit for charitable contributions.

Sec. 2. Estate Tax Credit.

For the reasons discussed in Senator Javits' statement of May 7, 1979 (Cong. Rec. S.5435-7), estates of authors, artists and composers should be permitted a credit against estate tax for donations of their works to the Federal Government.

Sec. 3. Income Tax Credit for Charitable Contributions by Authors, Artists and Composers.

Sec. 3 of S. 1078 would allow authors, artists and composers a 30% tax credit for charitable contributions of their manuscripts, paintings, scores, sculpture and other works. We believe the tax credit should be established. The League's recommendations for changes or clarifications in wording are discussed below.

Before 1970, authors, artists and composers were entitled to a charitable deduction equal to the fair-market value of manuscripts, paintings, scores and similar property which they contributed to tax-exempt libraries, museums and similar institutions. Enactment of Sec. 170(e) (IRC) in 1969 deprived them of that deduction, and allowed them to deduct only the (nominal) cost of materials used in creating the donated property.

As Senator Javits noted in his May 7th statement, abolition of the fair-market value deduction has injured libraries and museums. Since 1970, they have not been able to obtain contributions of manuscripts, paintings and other works from authors, composers and artists, who cannot afford to donate such property without that deduction or a tax credit to offset its value. Prior to 1970, the fair-market value deduction enabled libraries and universities to develop comprehensive collections of the manuscripts and other papers of many distinguished novelists, playwrights, biographers, historians and other authors, through contributions by these authors.

The loss of new contributions by authors and composers since 1970 also hampers scholarship and research. Library collections built by these pre-1970 authors' contributions are invaluable resources for study and analysis, and research for the creation of new works by historians, biographers, critics, social scientists and others. The proposed 30% tax credit would renew the authors' and composers' contributions that develop these collections.

The proposed tax credit would relieve writers, dramatists, artists and composers from the inequitable and discriminatory effects of Sec. 170(e). Prior to 1970, they were allowed the same fair-market value deduction permitted to collectors and others who purchase their manuscripts, paintings, scores, etc., and later donated them to museums and libraries. Since 1970, the collector or other purchaser still is permitted to deduct the current fair-market value of such property, which is usually much higher than its cost to him. And although authors and composers were deprived of that deduction, their estates are nonetheless obliged to pay estate tax on the fair-market value of such literary, musical and artistic property.

Revision or Clarification of Language.

The Authors League respectfully urges that two phrases used in Sec. 3 be clarified to assure that the tax credit is not denied to some authors, artists or composers who wish to make charitable contributions of their manuscripts, scores or other works.

1. Income-From-"Sale" Limitation.

Sec. 3 of S. 1078 (proposed Sec. 44D) places various limits on the 30% tax credit. Among these: the credit may not exceed the tax attributable to the author's or composer's gross income from "the sale of literary, musical or artistic compositions" in the current and previous taxable years. (Subsec. (b)(1)) (Underlining added.) Only income from sales, and no other literary or musical income, would determine the limit on the 30% credit. If income from sales was low, the credit would be reduced far below 30%; if there was no income from sales, the credit would be barred.

However, many authors and composers derive most of their income from licenses, rather than from sales of their works or rights therein. But, as Subsec. (b)(1) is now worded, the tax on income from these licenses, or other non-sale dispositions, could not be included in computing (and thus increasing) the limit on the tax credit. (Internal Revenue Service Rulings make a sharp distinction between "sales" and "licenses" of literary, musical and artistic works. See Rev. Rul. 60-226; Rev. Rul. 75-202.) Consequently, these authors and composers, with substantial literary and musical income from licenses, would be denied the tax credit for charitable contributions or limited to a much lower credit.

The Authors League believes that the "attributable tax" limit on the 30% credit was intended to include the tax on income authors and composers receive from licenses or other dispositions of their works and rights therein, as well as from sales. We therefore suggest that Subsec. (b)(1) be revised to

provide that the credit will not exceed -- the tax

> "attributable to the gross income of the individual for the taxable year attributable to the sale, license or other disposition of literary, musical or artistic compositions, or rights therein in that taxable year and in previous taxable years."

The proposed new language is underlined. The phrase "or rights therein" is added since literary, musical and artistic works are "divisible" for copyright, business and tax purposes. That is, the various rights in a book, play or other work can be (and are) sold, licensed or otherwise disposed of, separately, and to different users. This "divisibility" of property rights under a copyright is recognized in the Copyright Act and Internal Revenue Service Rulings. Many authors and composers derive their income through transactions involving separate rights, and that income should be included in computing the "attributable tax" limit on the 30% tax credit.

2. The Meaning of "Literary, Musical or Artistic Compositions."

The Authors League recommends that the Bill, or the Committee's Report, make it plain that the phrase "literary, musical or artistic composition" applies to both (i) copyrighted works: e.g., plays, novels, songs, operas, etc., and (ii) the physical objects in which they are embodied; i.e., the pages of manuscripts, scores, drafts, memoranda, letters, etc.

When authors and composers contribute their manuscripts, scores, drafts, letters and other papers to libraries and universities, they do not, ordinarily, contribute the rights to publish, perform or otherwise use the copyrighted works which the papers embody or relate to. We believe that such contributions of manuscripts, scores, etc., are intended to qualify for the 30% tax credit -- as they qualified for the fair-market value deduction before 1970. In order to assure that they do, it should be made clear that they are encompassed by the phrase "literary, musical or artistic composition." We might note that the wording of Sec. 1221 is somewhat broader: "A copyright, a literary, musical or artistic composition, a letter or memorandum, or similar property". It also is noted that the key phrase in Sec. 2 of S. 1078 is "a literary, musical or artistic property, or similar property". Because of these differences in wording, The Authors League respectfully urges that the Committee Report, or the Bill, make it clear that the term "composition" includes both categories of property: i.e., copyrighted works; and the physical objects in which they are embodied. We also believe it would be useful if the Report explained that the "attributable tax" limit on the tax credit for contributions of manuscripts, scores and other papers includes the tax attributable to income derived by the donating authors, composers or artists from sales, licenses or other dispositions of their copyrighted works.

Sec. 4. Presumption.

The Authors League supports the proposed change in the presumption period of Sec. 183.

Sec. 5. Capital Gains Treatment for Inherited Copyrights, etc.

Until now, the heirs of authors, artists and composers have been entitled to capital asset status for inherited literary, artistic and musical property. But an unintended effect of the carryover basis provisions (Sec. 1023) would deprive them of that status. Sec. 4 of S. 1078 will prevent such inherited property from losing capital asset status by reason of the carryover section. The Authors League urges that this change be enacted.

Sec. 1023 is intended to prevent a "step up" in the dollar basis of inherited property to fair-market value, by carrying over the decedent's "dollar basis" to his heirs. However, the broad "carryover basis" language of Sec. 1023 interacts on Sec. 1221(3) of the Code, which denies authors, artists and composers -- but not their heirs -- capital asset status for the works they create. Inadvertently, this interaction with Sec. 1221(3)(C) carries over the deceased author's "ordinary income" status to the inherited property -- in addition to his "dollar basis" -- thus depriving creators' heirs of the capital asset status they previously had.

The result is not only unintended, but unfair. Literary, musical or artistic property held by its creator's heirs does qualify for capital asset status just as does the same property in the hands of a purchaser. The special reasons for denying creators capital asset status for their works does not apply to their heirs. Moreover, the imposition of the creator's "ordinary income" basis on his heirs subjects them to heavy and excessive tax rates. Their gains, based on the creator's nominal dollar-cost basis, would be taxed at ordinary income rates as high as 70% -- although the gains would represent an increase in value occurring over a period of years. Moreover, the author's heirs would be denied the right to deduct the fair-market value of inherited creative property which they contribute to libraries, museums or other tax-exempt institutions -- a right that they continued to have after the enactment of Sec. 170(e).

In a letter to The Authors League (dated June 21, 1978), Assistant Secretary of the Treasury Lubick said:

> "We have no objection to an amendment that would prevent these (literary, musical or artistic) assets from losing capital asset status solely because they have become carryover basis property. Of course, such a change should not apply to property that would be disqualified from capital asset status on account of circumstances other than the carryover of the decedent's basis."

We believe that the amendment proposed by Senator Javits is consistent with the Treasury's position.

The Authors League is grateful for this opportunity to present its Statement to your Subcommittee and requests that it be included in the record of the hearings.

Respectfully yours,

John Hersey, President
Irwin Karp, Counsel

Senator BYRD. You may proceed.

STATEMENT OF LAWRENCE H. BROWN, SENIOR VICE PRESIDENT, NORTHERN TRUST CO., AND CHAIRMAN, PUBLIC SECURITIES ASSOCIATION, AND ROBERT S. McINTYRE, DIRECTOR, TAX REFORM RESEARCH GROUP OF WASHINGTON, D.C.

Mr. BROWN. Mr. Chairman, my name is Lawrence H. Brown. I would like to say that the Public Securities Association appreciates the opportunity to comment in S. 1021, the bondholder's taxable option or BTO, introduced by Senator John Danforth.

Senator Danforth has developed this proposal as an alternative to the taxable bond option or TBO which was opposed by State and local government groups and by the PSA. PSA opposed the TBO primarily because we believe that the current method of financing public expenditures for the use of tax exempt securities preserves the appropriate separation of powers between the Federal and State and local governments.

In PSA's view, the TBO would have weakened this separation without providing clear countervailing benefits to the issuers of municipal securities.

Although PSA appreciates the intended objectives of Senator Danforth's BTO proposal; namely, to reduce State and local government borrowing costs and to broaden the municipal bond market, we question whether the present proposal would in fact achieve these objectives. We feel that the proposed legislation could have an effect similar to that of the TBO, weakening the separation of powers between the Federal and State and local governments. In addition, we believe that the proposal would not necessarily broaden the municipal market and could have market effects which could result in higher borrowing costs for many State and local governmental units.

Even though Senator Danforth's proposal does not provide for a direct subsidy of State and local government borrowing costs, as did the TBO, it would involve the Federal Government to a greater extent than is provided under present law. For those who view a broad attack on the tax exemption for municipal securities as being possible, the BTO would have a significant compromising effect on the position that the tax exemption has a constitutional basis. In this regard, we note that the bill would grant the Treasury broad regulatory authority to require taxpayers to report detailed information regarding their municipal holdings.

We would also like to identify several specific questions and problems presented by S. 1021 which would in our view impair the ability of the bill to achieve its intended objectives.

Reasonable certainty of payment of interest and tax consequences are important in establishing a broad market for securities. A serious defect of the BTO proposal is that prospective purchasers may not be certain when bonds are offered that they will qualify for the option. The bill contains several provisions which would make the tax status of bonds unclear at the time of sale.

First, if BTO is to generate new buyers of municipal bonds, investors that would otherwise not have purchased tax-exempt securities must be assured that the option will continue to be available throughout the life of the bond. Nothing in the bill provides

this assurance, and without it few, if any, new buyers will be found.

Second, the bill provides that the BTO will not apply to any obligation meeting the technical definition of an industrial development bond—IDB—under current tax laws. According to that definition, a revenue bond or even a general obligation bond supported by contractual arrangements with private parties may be classified as an industrial development bond.

For example, bonds issued to finance facilities to furnish water or low-income housing may be classified as industrial development bonds even though there is clear public involvement in, and benefit from, the facilities financed. This is a defect in the present statute and should not be made worse by BTO, which would create a market bias against all industrial development bonds, including those with a clear public purpose.

In addition to the bias created in the new issue market, the BTO proposal would create uncertainty regarding the availability of the tax credit for buyers of municipal securities in the secondary market. It is not clear from the description of many bonds in the marketplace whether the bonds are industrial development bonds. New investors will not enter into the market unless the tax consequences are clear at the time they purchase securities.

Another potential market problem is that the BTO would only be available for governmental obligations which are exempt under section 103 of the Internal Revenue Code. No provision is made for obligations which have tax-exempt status under Federal housing laws or which are issued by certain U.S. possessions such as Puerto Rico.

In addition, the bill denies tax credits for refunding obligations issued to refund bonds that were issued prior to the effective date of the bill. Refunding obligations are issued by State and local governments for a variety of legitimate purposes, and there would seem to be no reason to erect a market bias against these issues.

In conclusion, we feel that the BTO proposal has several features which raise substantial questions regarding its overall effect on the municipal securities market. In view of the continued efficiency of the existing market for State and local government obligations, we believe BTO is not warranted at this time.

Senator BYRD. You take the same position the Treasury takes, I see.

Mr. BROWN. In the end result we do; yes.

Senator BYRD. For different reasons, I guess.

Mr. BROWN. For different reasons.

Senator BYRD. Thank you very much.

The next witness is Mr. Robert S. McIntyre, director of the tax reform research group of Washington, D.C.

Mr. MCINTYRE. Thank you, Senator.

We would like to comment on three of the bills that are before you today, the Capital Cost Recovery Act, the Tax Breaks for Artists, and the Bondholders' Taxable Option.

First of all, on the Capital Cost Recovery Act, obviously, the reason that we are talking about depreciation changes now is because we are unhappy with the performance of the economy over the last decade, and I think there is reason to be unhappy with it.

There has been a lot of problems, obviously, but the approach that is offered in this depreciation bill isn't anything new, and it certainly isn't anything we didn't try in the seventies.

We started this decade with substantial cuts in depreciation In other words, increases in depreciation, cuts in the tax on depreciable assets. We followed that up with further investment incentives. Those apparently have failed to achieve the results that we wanted, and this product may be in a new box but it is the same soap that has been sold to us for the last 10 years.

Now, as can be seen on page 2 of my testimony, and was also indicated by Secretary Miller and by Professor Jorgenson, the proposal, the Capital Cost Recovery Act, in conjunction with the investment credit, yields a higher tax benefit than expensing the capital costs immediately.

Now, there is a rough equivalency between expensing capital asset costs and not taxing the income from the capital. So what we are talking about here toa large extent is really eliminating large parts of the corporate income tax. What will be left is tax on profits from labor, the tax on profits from technology, and windfall profits due to market imperfections

We are talking about eliminating taxes on capital here, and that seems to me a step we should be very careful about, because there are a lot of taxpayers out there that are going to have to make up this burden, regular wage earners like most of us.

Now, some of the arguments in favor of this bill, one of them is that we have been overtaxing capital in the last few years because of inflation. Now, there have been studies that have been put out to indicate that. The leading one is Professor Feldstein's study, but it just isn't true, if you look at the other tax benefits in the code. If we had indexed depreciation deductions for inflation, the benefits would not be as high as the benefits under the Capital Cost Recovery Act, as you can also see on page 2 of my testimony, so the fairness argument seems to me not to make very much sense.

Also, the comparison is made with other countries, that we does not invest as much as other countries. Now, a study was done for the Joint Economic Committee about a year and a half ago by Edward Dennison which showed that when you made adjustment for the fact that the capital happens to be cheaper in the United States than anywhere else in the world, that is, capital equipment, that we actually have as high a rate as almost any country in the world, and that in fact even if you ignore that, that the difference in capital investment rates does not explain the differences in productivity and growth between us and other countries. We have done better than some countries that invest more. We have done worse than some countries that invest less.

Now, finally, the reason that this bill may pass is the economic effects that it is supposed to have. Now, one point which we should keep in mind is that obviously when you create a bias in favor of capital investment, you are distorting economic decisionmaking, so if you are a real believer in the free market economy, you should be a little troubled by that, that we are making it more attractive to invest in machines than labor, for example. We are making it more attractive to invest in certain kinds of machines, ones with very long lives, over others that might be more cost-efficient.

The result of that may be to waste energy and it may be to waste our resources.

Now, we have some interest in the proposal put forward by Professor Jorgenson today. We had not seen it before, but it seems to us to be an approach which might solve a lot of problems for everybody. It is obviously fair. It obviously deals with the problem of inflation, which is what has created the situation making this bill something that may well pass. And it will be probably quite beneficial to small business, because it really is much simpler than trying to depreciate access.

My wife runs a small business, and I know how hard that is to do.

At any rate, the recommendation I would make to this committee if it were worried about capital formation and productivity and economic growth is, No. 1, take a good, hard look at Professor Jorgenson's proposal. Second, maybe it is time after 10 or 15 years of trying various kinds of investment incentives, to look at an approach that is really in the opposite direction, to take a lot of these incentives out of the tax code and lower the tax rates a lot. Lower them by a third maybe.

The result of that might be that taxes wouldn't become so important to people when they are making a decision to do something. It would make it easier to move from one area to another. It would make it easier to go into business without being hit with very high taxes at some level.

That is the recommendation we would make, and I have outlined it in more detail in my testimony. Now, the other two bills, just briefly, we endorse the principles behind Senator Danforth's bill on tax-exempt bonds. We think it would lead to a great deal more efficiency in the market, and would end up costing overall Government quite a bit less, and we endorse at least the first three-quarters of Mr. Lubick's testimony.

We understand his reservations about industrial development bonds, and we think that might be able to be dealt with with some technical amendments.

Finally, on the artists bill, my wife is an artist, and I understand some of the problems they have. However, this bill addresses some problems that I don't think really exist for artists in general, and would cost the Government more to acquire art than if it just went out and bought it. That is certainly true of the estate tax credit. It would be cheaper for the Government to go out and buy the pieces of art than to give this particular estate tax credit. This is detailed in my testimony.

These stories about people burning their art works because they were afraid of estate taxes just doesn't make any sense, because you can give them away to museums, to charities, to any tax exempt group, to the Government, and there is no estate tax due.

So, anybody that would be burning their works rather than giving them to the public, there just seems to be something very odd about them.

In addition, when we are talking about this donation of services during your lifetime, that is, the work that goes into creating a piece of art, all kinds of people do that all the time. Secretary Lubick talked about doctors donating their time. Obviously, law-

yers donate their time. Obviously, lots of artists donate their time. I don't understand why they need a special break beyond what anybody else gets for a donation of services in order to get the charitable impulse.

Thank you.

Senator BYRD. Thank you, Mr. McIntyre. Thank you, Mr. Brown.

[The prepared statements of Messrs. Brown and McIntyre follow:]

STATEMENT OF LAWRENCE H. BROWN,
CHAIRMAN OF THE PUBLIC SECURITIES ASSOCIATION

Mr. Chairman and members of the Committee, my name is Lawrence H. Brown. I am a Senior Vice President with the Northern Trust Company of Chicago, Illinois. I am appearing today, in my capacity as Chairman of the Public Securities Association, a national trade association representing some 300 dealers and dealer banks which provide underwriting and financial advisory services for state and local governments. In 1978, PSA members participated in approximately 90 percent of the underwritings of new issue municipal securities that came to market.

PSA appreciates the opportunity to comment on S. 1021, the bondholder taxable option (BTO) introduced by Senator John Danforth. Senator Danforth has developed this proposal as an alternative to the taxable bond option (TBO) which was opposed by state and local government groups and by PSA. At the suggestion of a number of organizations with an interest in the municipal securities market, including PSA, Senator Danforth withdrew his proposed amendment to the Revenue Act of 1978 which would have provided for a BTO.

PSA opposed the TBO primarily because we believe that the current method of financing public expenditures through the use of tax exempt securities preserves the appropriate

separation of powers between the federal and state and local governments. In PSA's view, the TBO would have weakened this separation without providing clear countervailing benefits to issuers of municipal securities.

Although PSA appreciates the intended objectives of Senator Danforth's BTO proposal--namely, to reduce state and local government borrowing costs and to broaden the municipal bond market--we question whether the present proposal would in fact achieve those objectives. We feel that the proposed legislation could have an effect similar to that of the TBO, weakening the separation of powers between the federal and state and local governments. In addition, we believe that the proposal would not necessarily broaden the municipal market and could have market effects which could result in higher borrowing costs for many state and local governmental units.

Even though Senator Danforth's proposal does not provide for a direct subsidy of state and local government borrowing costs as did the TBO, it would involve the federal government to a greater extent than is provided under present law. For those who view a broad attack on the tax exemption for municipal securities as being possible, the BTO would have a significant compromising effect on the position that the current tax exemption has a Constitutional basis. In this regard, we note that the bill would grant the Treasury broad regulatory

authority to require taxpayers to report detailed information regarding their municipal holdings.

We would also like to identify several specific questions and problems presented by S. 1021 which, in our view, would impair the ability of the bill to achieve its intended objectives.

Reasonable certainty of payment of interest and tax consequences are important in establishing a broad market for securities. A serious defect of the BTO proposal is that prospective purchasers may not be certain when bonds are offered that they will qualify for the option. The bill contains several provisions which make the tax status of bonds unclear at the time of sale.

First, if BTO is to generate new buyers for municipal bonds, investors that would otherwise not have purchased tax-exempt securities must be assured that the option will continue to be available throughout the life of the bonds. Nothing in the bill provides this assurance, and without it few if any new buyers will be found. With this uncertainty, pension funds would invest in municipal bonds only if the yield on these bonds plus the tax credit exceeded the yield on comparable taxable securities. This premium is necessary to compensate

these investors for the risk associated with the possible loss of the tax credit and consequent decline in the value of the bonds.

Secondly, the bill provides that the BTO will not apply to any obligation meeting the technical definition of an industrial development bond (IDB) under current tax law. According to that definition a revenue bond or even a general obligation bond supported by contractual arrangements with private parties may be classified as an IDB. For example, bonds issued to finance facilities to furnish water or low-income housing may be classified as IDB's even though there is clear public involvement in, and benefit from, the facilities financed. This is a defect in the present statute and should not be exacerbated by BTO, which would create a market bias against all IDB's, including those with a clear public purpose. Therefore, the BTO as proposed would effectively create an undesirable two-tier market for municipal bonds, thereby increasing the costs of essential public services.

In addition to the bias created in the new issue market, the BTO proposal would create uncertainty regarding the availability of the credit for buyers of municipal securities in the secondary market. It is not clear from the description of many bonds in the marketplace whether the bonds are IDB's. New investors will not enter the market unless the tax consequences are clear at the time they purchase the securities.

Another potential market problem is that the BTO would only be available for governmental obligations which are exempt under Section 103 of the Internal Revenue Code. No provision is made for obligations which have tax-exempt status under Federal housing laws or which are issued by certain United States possessions, such as Puerto Rico.

In addition, the bill denies the tax credit for all refunding obligations. Refunding obligations are issued by state and local governments for a variety of legitimate purposes. There would seem to be no reason to erect a market bias against all such issues because the BTO would not be available. Moreover, it may be difficult for investors in the secondary market to know at the time of purchase whether the BTO would be available with respect to obligations which are part of refunding issues.

In conclusion, we feel that the BTO proposal has several features which raise substantial questions regarding its overall effects on the market. In view of the continued efficiency of the existing market for state and local government obligations, we believe the BTO is not warranted at this time.

Statement Of

ROBERT S. McINTYRE
Director, Public Citizen's Tax Reform Research Group

We would like to comment on three of the bills before the Subcommittee today: S. 1435 ("The Capital Cost Recovery Act") and S. 1078 (Tax Breaks For Artists), which we oppose, and S. 1021 ("The Bondholders' Taxable Option"), which we support.

S. 1435. The Capital Cost Recovery Act.

This is obviously the most important and expensive of the bills before the Subcommittee today. It is also, we believe, the worst, and we strongly oppose it.

S. 1435 would scrap the current depreciation laws, which generally require that business assets be written off only as they wear out, in favor of much faster write-off rules. Under the bill, investments in non-residential buildings could be written off in 10 years – with about 75% of the deductions in the first five years – and most equipment purchases could be written off over five years – with 84% of the deductions in the first three years. (Investments in cars and small trucks could be written of over three years – with 89% of the deductions in the first two years.) In contrast, under current tax rules and standard financial accounting procedures, 25-50 year write-off periods are typically assigned to buildings and 5-35 year periods are used for various kinds of equipment.

The effect of such changes would be to increase depreciation deductions enormously, and consequently to reduce taxes on corporations dramatically – perhaps by as much as 50% within a few years. Current law already yields tax write-offs about 25-30% per year in excess of book depreciation. The "Capital Cost Recovery Act" would add at least 20% over current write-offs, meaning that long-run tax depreciation would be more than 50% higher per year than book deductions. And the short-run effect is likely to be even greater.

Furthermore, supporters of the CCRA make no bones about their intent to press for *immediate* write-offs of all business investments, "once the link between actual lives and tax depreciation lives is broken." Going to expensing would yield annual write-offs almost double those of book depreciation in the long run – and more during the transition.

In fact, since expensing capital investments is the functional equivalent of eliminating the taxes on all but windfall income from such investments, the direction of the CCRA is toward scrapping the corporate income tax entirely – at least as it applies to big, capital-intensive companies. This fact is obviously a happy one for the big business advocates of the CCRA, but it is bad news to the already overburdened average taxpayer who will be called on to make up the lost revenues.

Arguments for the bill:

1. The "equity" argument:

The so-called "equity" argument being put forward for the CCRA is that inflation has made the current depreciation rules unfair. In support of their claim, CCRA advocates point to analyses done by some of the "new economists," in particular Martin Feldstein, President of the National Bureau of Economic Research. In a recent study, Feldstein maintains that companies are paying taxes on $40 billion a year in "phantom profits" that really represent understated depreciation. Feldstein's analysis, however, ignores the important facts.

That inflation can hurt investors is obvious to anyone who has a savings account. A rising price level also reduces the value of depreciation deductions, since an asset is purchased with "real" dollars, while the write-offs in later years can be in deflated ones. But counterbalancing the damage caused by inflation are the many tax breaks in the Internal Revenue Code for capital investments.

Feldstein's approach in his study, however, is to ignore the tax expenditures for business investment. It's reminiscent of the method he used last year in a study purporting to show that inflation was causing the overtaxation of capital gains. His major premise for his conclusion was that the inflation-offsetting effects of the (then) 50% capital gains exclusion should not be considered! If the tax savings from the exclusion were taken into account, his data showed that inflation was far more than offset, especially for the high income people to whom the capital gains cuts were targeted.

Similarly, a close look at the current tax breaks for capital investments shows that Feldstein's conclusions in his depreciation study are not supported by the data either. As the following chart shows, the combination of the ADR system of shortened depreciation lives, accelerated depreciation formulas, and the investment tax credit yields tax benefits for corporations well in excess of what would result from correcting book depreciation of equipment for inflation. And, as Feldstein himself admits, for real estate the tax benefits (and inflation offsets) are even greater.

AN EXAMPLE OF HOW EQUIPMENT IS WRITTEN OFF
($110 Machine, 10-Year Estimated Life, $10 Salvage Value)

	Book Depreciation (Straight Line)	Current Law (ADR, Double-Declining Balance)	Indexed Book Depreciation (Inflation = 10%)	Capital Cost Recovery Act	Expensing (Immediate Write-Off)
YEAR 1*	$ 5	$13.75	$ 5.00	$22.00	$110
YEAR 2	10	24.06	11.00	35.20	--
YEAR 3	10	18.05	12.10	26.40	--
YEAR 4	10	13.53	13.31	17.60	--
YEAR 5	10	10.15	14.64	8.80	--
YEAR 6	10	8.70	16.11	--	--
YEAR 7	10	8.70	17.72	--	--
YEAR 8	10	8.70	19.50	--	--
YEAR 9	10	4.35	21.44	--	--
YEAR 10	10	--	23.58	--	--
YEAR 11	5	--	12.97	--	--
[Salvage Basis:	$10	$ 0.00	$33.96	$ 0	$ 0]
"Present Value" Of Tax Benefits**:	$25.62	$45.89	$38.96	$52.04	$50.60
"Present Value" As Percentage Of:					
Book:	100%	179%	152%	203%	198%
Indexed:	66%	118%	100%	134%	130%

* Assuming the asset is put into service at the middle of the tax year, or the half-year depreciation convention is employed.

** Assuming a 46% corporate tax rate, and using a 15% discount rate (equal to the average, after-tax return on equity for major corporations in 1978, or to the interest rate on an unsecured, uncollateralized, non-recourse loan). The tax benefits computed for the current system and the Capital Cost Recovery Act include an $11 investment tax credit.

In fact, in conjunction with the 10% investment tax credit, the CCRA would result in a *better* deal on depreciation for business than it would get under expensing! The present value of the tax benefit from an immediate write-off of a $110 asset is $50.60 — less than the present value of the CCRA and the investment credit, as the above chart shows.

2. Comparisons with other countries:

The proponents of the CCRA are fond of pointing to the depreciation rules in other countries as examples of how "antiquated" our approach of trying to measure net income accurately is. Some other countries *do* allow faster equipment write-offs, but the comparative data actually show how little either the depreciation rules or the ratio of investment to GNP relates to relative rates of economic growth or productivity gains.

The United Kingdom, for example, allows immediate expensing of capital investments, yet its economic growth and productivity gains are well below ours, while its inflation rate is worse. Japan's high growth rate has occurred in spite of higher taxes on capital than the U.S.'s.

A study done for the Joint Economic Committee in late 1977 by Edward Denison found that "[i]n no case where growth rates of the United States and another country differ considerably does capital account for as much as two-fifths of the difference. Usually, it accounts for much less than that, and in important cases for none at all." Denison also notes that the prices of machinery and equipment compared to other components of GNP have been lower in the U.S. than anywhere else, and when GNP for other countries is restated at U.S. prices, the U.S. actually has the *highest* ratio of nonresidential structures and equipment to GNP of any country in the world. Denison's study concludes that:

> "[w]e should not try to provide more generous investment incentives because some other countries may do so. We should not imagine that investment would be raised radically if we did. And we should not imagine that the growth rate of output would jump up to foreign rates if investment could be so raised."

3. The claimed economic benefits:

Perhaps realizing the lack of credibility of their "equity" argument and the shakiness (at best) of their international comparisons, the proponents of the CCRA prefer simply to allege enormous economic benefits which trying something "new" could result in. In fact, however, hearing their claims brings on a strong feeling of *deja vu*. In spite of all the fuss and rhetoric about the "new economists" and "supply-side theory," starting the 1980s with business demands for increased "capital formation" subsidies — and, in particular, for more accelerated depreciation — is startlingly reminiscent of the events of the past decade.

The 1970s have been characterized by a series of stunning corporate tax cuts, beginning, coincidentally enough, with sharp increases in depreciation write-offs. In 1971, the Nixon adminstration — one of whose advisors included "incentive economist" Arthur Laffer — sought and obtained enactment of the ADR system of accelerated depreciation, which shortened depreciation lives — and upped depreciation write-offs — by 20% (for those corporations large enough to be able to take advantage of it). The Nixon package also included a 7% investment tax credit for purchases of new equipment (a similar credit had been repealed in 1969), and the export subsidy DISC, which exempted from taxation half the profits from exporting.

When these "supply-side" tax cuts failed to revitalize the economy sufficiently, further attempts followed. In 1975, depreciation deductions were further liberalized and the investment credit was increased to 10%. Last year, the top corporate rate was cut, the lower rates graduated, and the investment credit expanded and made permanent. The result has been to cut effective corporate rates by about 30%, and to reduce the share of Treasury revenues supplied by corporate taxes from 19.5% in fiscal 1969 to an estimated 14.1% in fiscal 1980. At the same time. of course, individual rates have remained about constant, supplying about 45% of budget receipts, and social security taxes have increased enormously, from 21% of receipts in fiscal 1969 to 32% in fiscal 1980.

This tremendous shift in the tax burden from business to individuals, from capital to labor, has not satiated the appetites of the corporate lobbyists, nor has it diminished the capital investment problem they bemoan. Instead, the exact opposite has occurred: Appetites have been whetted and the "need" for further business tax cuts has allegedly increased.

Old-fashioned believers in learning by trial and error might think that the failure of business tax breaks to solve our economic problems in the 1970s argues for a different approach in the 1980s. But the "new wave" economists and the corporate lobbyists advocate a bolder plan: Start the next decade exactly as the last, with further increases in depreciation write-offs. There is one difference this time: As already noted, many supporters of the CCRA see it as the first step toward complete elimination of the corporate income tax, and potentially *all* taxes on investment income.

In spite of the fact that the current level of business investment is close to its all-time high as a percentage of GNP (even not counting investments in pollution control equipment), supporters of faster write-offs argue that their measure is needed to spur even more investment. They point to the decline in labor productivity gains in the 1970s, and maintain that only a surge in capital spending to higher levels than ever before can revitalize our economy. Without this intensified investment, they contend, our future standard of living will be too low.

There's no question that replacement of workers with more efficient machines has historically been one of the major factors in boosting labor productivity — along with improvements in "soft" technology and advancements in worker skills. But the other side of the coin is that worker productivity *suffers* when machines become *less* efficient, and that is exactly what happened as energy prices shot up in the 1970s. And unfortunately, the recent OPEC price increases and the decontrol of domestic oil prices are going to reduce the efficiency of machines even further (at least in the short run), and labor productivity will again suffer.

In the face of higher energy prices, it is, of course, necessary for businesses to become more energy-efficient. Quite rationally, they have already moved quite far in this direction — using machines that require less energy and placing greater reliance on labor. This has mitigated the effects of higher energy prices, but the fact remains: We are less rich because of the OPEC cartel's actions than we otherwise would be.

The CCRA seems to operate on the premise that changes in the tax laws can reverse the effects of higher energy costs. In fact, however, although most of the tax breaks it would grant would go to reward companies for doing what they would have done anyway, any economic effects the bill did have would be harmful to our need for greater efficiency and less waste.

For example, the bill would tilt business spending decisions in favor of equipment purchases, even where the labor, materials, and energy necessary to construct and operate a machine utilize more of society's resources than would hiring workers. Excess-

ively costly durable machines would be favored over less sturdy, more cost-effective ones, because the bill's flat 5-year write-off period favors machines with long actual lives. And perhaps most significantly, real estate would attract more capital, and equipment purchases less, because the bill grants its largest breaks to investments in commercial buildings.

Even many of the proponents of the bill admit the problem with faster write-offs for real estate. *Business Week* notes that it "could be the best tax shelter opportunity to come along in years . . ., a tax bonanza for real estate speculators." Since *nobody* claims there's currently a shortage of tax incentives for putting up commerical buildings, why were faster write-offs for buildings included in the bill? Why indeed, since real estate subsidies are fundamentally inconsistent with the sponsors' putative goal of encouraging investments in equipment? The answer, of course, is that the real estate break was necessary to win the support of retailing and service industries — companies like Sears, Roebuck. "Politically, everybody had to get something," the draftsmen of the bill have admitted.

The willingness of the lobbyists for the CCRA to include real estate within the bill indicates how little they really care about or believe in the alleged economic benefits of their plan. Their main goal is simply to reduce taxes on large corporations, that is, on their clients.

Alternatives:

If the Capital Cost Recovery Act is approved by Congress, one reason will be that the lobbyists for the bill have convinced the legislators that their proposal holds out some hope for reversing the discouraging decline in labor productivity gains over the past six years. This will be in spite of the fact that most economists have little faith that the bill even addresses the real problem.

Since 1973, labor productivity gains have fallen to a fraction of the 2.4% per year they averaged in the previous quarter century. Some of the causes are obvious. OPEC's quadrupling of oil prices in 1973-74 is one. Another is a flaw in the measurement of productivity. In this decade, the U.S. finally started to pay attention to protecting the public's health, the environment, and worker safety. The *costs* of the laws and regulations implementing these overwhelmingly popular goals show up on business balance sheets, but the benefits to society don't. The result — because of the GNP myopia of the Commerce Department's economic statistics — has been to make things look worse than they really are.

But energy and the environment fail to explain the whole plunge in productivity, and a recent study by the associate director of the Commerce Department's Bureau of Economic Analysis, Edward F. Denison, concludes that other factors sometimes cited do not add much to furthering the explanation. Denison looked at two dozen potential causes — ranging from government paperwork requirements to the effects of taxes on working and investing — and concluded that all of them put together did not come close to answering the riddle.

Studies like Denison's indicate that this Subcommittee is unlikely to solve our economic problems by recommending tax changes. Certainly, tax proposals like the CCRA, which tilt toward rewarding otherwise uneconomic and wasteful business investment, are not the answer. But there is one tax change, accomplishable next year, which could improve economic decisionmaking, offer a stimulus for increased economic activity, and not be inflationary; and there is a long-run approach to tax reform which could

lead to greater economic efficiency, an improved public mood, and a far fairer tax system.

The first, which we recommend if there is a tax cut next year, is a reduction in the payroll tax. This regressive tax is becoming more and more burdensome on low, moderate, and middle-income workers. It is also a major problem for small business. As it has increased, while subsidies for capital investment have also gone up, business decisions have been artificially tilted away from labor, leading to economic waste. Finally, the payroll tax is inflationary, leading to higher prices and wages to make up its cost. We are not ones to believe in panaceas, but at the present time a cut in the payroll tax — with the lost collections being made up from general revenues — appears to have overwhelming economic advantages.

The long-run approach we recommend is one we have advocated for a long time, but, unlike the philosophy behind the CCRA, it has never really been tried. We think that this Subcommittee and the Congress should attempt to jettison much of the baggage which the tax system has acquired over the past 60-odd years, and move to a simpler, fairer system with much lower rates. By making taxes a significantly smaller factor in economic decision-making, we believe the economy would work better, that people would be happier, and, in all likelihood, labor and business would be more productive.

S. 1021. The Bondholders' Taxable Option.

This bill would provide holders of otherwise tax-exempt state and local bonds with the option of including the interest from the bonds in income and taking a tax credit for 67% of the interest. A similar proposal was tentatively approved by the Finance Committee in its mark-up of the 1978 Revenue Act, but the provision was later withdrawn by its sponsor pending further study. We endorse this bill.

Currently, the tax-exempt treatment granted to municipal bonds is a notoriously inefficient means of subsidizing the borrowing costs of state and local governments. It is estimated that only $5.5 billion of the $7.7 billion annual revenue loss of this exemption translates into lower borrowing costs for states and municipalities. S. 1021 would improve the efficiency of the subsidy substantially.

The inefficiency of the current system is apparent. Suppose that the current market rate for well-secured taxable bonds is 10%. A taxpayer in the 50% bracket would be willing to buy a tax-free bond paying only 5%, since this will yield the same after-tax profit as if he or she received 10% and paid a 50% tax. A person in the 70% tax bracket would accept a tax-free yield of only 3%. Most of the purchasers of municipal bonds are in high brackets. In fact, 83% of the individual tax savings from the exemption go to the top 1% of all taxpayers. But, in order to attract a wider range of lenders, state and local governments have to set the interest rates on their bonds to appeal to taxpayers in the 30% bracket and up. This means that with a market rate of 10%, the tax-exempt rate would be 7%. This gives windfalls to taxpayers in higher brackets, resulting in a loss to the Treasury substantially in excess of the interest savings to states and cities.

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TAX-EXEMPT BONDS AT 7% UNDER CURRENT LAW

Tax Bracket	After-Tax Yield	Taxable Bond Equivalent
20%	7%	8.8%
30%	7%	10 %
40%	7%	11.7%
50%	7%	14 %
60%	7%	17.5%
70%	7%	23.3%

The 67% taxable tax credit option in S. 1021 would allow state and local governments to issue bonds at 40% below the market rate, rather than the current 30% – a 33% increase in the federal subsidy. This would mean that, for new borrowing, interest rates would be about 14% lower than they otherwise would have been. While the benefits to states and cities would thus be very substantial, the increased cost to the federal government would be much less. The result would be reduced costs of overall government – with the difference being made up through lower returns to high income investors.

TAX-EXEMPT BONDS AT 6%, WITH OPTIONAL CREDIT

Tax Bracket	After-Tax Yield	Taxable Bond Equivalent
20%	8%	10%
30%	7%	10%
40%	6%	10%
50%	6%	12%
60%	6%	15%
70%	6%	20%

We do not believe that the Bondholders' Taxable Option is the perfect solution to the municipal bond problem; the Carter administration's proposal to allow states and cities to issue taxable bonds with a 40% interest subsidy was preferable. But the BTO would be a substantial advance over current law, and we urge its favorable consideration.

S. 1078. Tax Breaks for Artists.

This bill would make changes in the estate and income tax laws to provide special credits for contributions of artistic, musical, and literary works and to make it easier for losses incurred in producing such works to be written off for tax purposes. We are opposed to the bill.

1. Estate tax credit: Section 1 of the bill would provide a 100% credit against estate taxes for bequests of "significant" artwork, etc. to the federal government, if the decedent was the artist. In essence, it would allow taxes on the estates of prominent artists to be paid in works of art.

The major purpose of this provision is apparently to encourage bequests of artworks to the government. As such an "incentive" it is terribly inefficient. The cost to the government of acquiring artwork in this manner would be higher than if the government simply purchased the works. This is true not only because appraised values would often exceed the market price, but also because if the government paid for the works directly it would recoup both the income taxes on the profit and the estate taxes on the net proceeds. In addition, there would likely be pressure for federal museums to accept bequests of works which are not particularly wanted or needed. (In fact, the bill encourages such actions, by making it explicit that the acquiring agencies would not have to repay the Treasury for the estate taxes foregone.) The result would be that the government would be paying premium prices for art that it otherwise would not have acquired at lower prices.

Another purpose of this provision — suggested by the short title of the bill — may be to provide "equity" for artists' estates. Since most artists — even "significant" ones — are unlikely to leave behind sufficient wealth to be subject to estate taxes, the benefits of the tax subsidy will go only to the estates of very wealthy artists. The heirs of struggling artists will receive nothing. And, in any case, current estate tax law already provides fair treatment to wealthy artists. As is the case with anyone else, bequests to the government (or to charity) are entirely excluded from the gross estate. (The famous case of Arizona artist Ted DeGrazia, who allegedly burned $1.5 million of his paintings rather than "burden his heirs with high estate taxes" is a rather shocking illustration of the misconceptions about current law which apparently exist. It also illustrates a shocking indifference to his art on the part of DeGrazia.)

If the government is not currently purchasing enough "significant" artwork for public display, the Congress should appropriate more money for that purpose. Funding such acquisitions through a "backdoor" tax expenditure, however, is wasteful and inefficient. And there is no reason based on "equity" to provide more generous tax treatment for the estates of a handful of very successful artists.

2. The income tax credit: Section 2 of the bill would provide an income tax credit of 30% of the value of "significant" artwork contributed to charities or the government by the creator. This provision is apparently designed to provide an incentive for artists to donate their works for public purposes (rather than selling or keeping them).

The rationale for this tax break probably stems from the claim that is sometimes made that artists are disadvantaged insofar as charitable contribution incentives are concerned, because they are allowed to deduct only the *cost* of their artworks, which is generally quite low. In comparison, it is pointed out, someone who buys a work from an

artist and donates it to charity gets to deduct the entire fair market value.

This argument reflects a misunderstanding. In fact, the artist choosing between selling a work and giving it to charity faces exactly the same tax considerations as does a person who has just purchased a work and is contemplating a charitable donation. In the artist's case, if the work is sold, he or she will have taxable income equal to the price minus cost. If the work is given away, there will be no taxable income. If the work is sold and the cash given away, the result is also no taxable income. For a purchaser of the artwork, the same rules apply. If he or she gives it to charity soon after acquiring it, the income which was spent to acquire it will not be taxed.

The same rules apply to donations of services, to which donations of artwork by artists are closely akin. A person who gives $100 worth of his or her time to charity is not taxed on the value of that time; a person who earns $100 and gives it to charity is also not taxed on the earnings.

The point is that the charitable deduction generally does not make charitable giving free. What it does do is exempt from tax "income" which is not put to personal use, but is rather donated for the public good.

There is, of course, one, important difference between artists and collectors, and, in general, between donors of cash or services or self-created items, on the one hand, and donors of appreciated property, on the other. If someone purchases property and holds onto it while it appreciates in value, and he or she *then* gives it away, he or she will get a tax deduction for both the cost *and the appreciation*. This has long been recognized as one of the more egregious loopholes in the tax laws. In fact, until relatively recently, it was possible actually to make money by giving away appreciated property. Nowadays, the best that can be done is to break even (in other words, a 100% federal subsidy).

We do not believe a special break for artists – as opposed to anyone else who donates time and effort to charity – is justified. Certainly, such a tax subsidy should not be rationalized because of the loophole for donations of appreciated property.

3. *"Hobby Artists":* Currently, the tax code allows business deductions only for expenses related to activities engaged in for profit. The reason for such a restriction is obvious: otherwise the expenses of engaging in a whole range of pleasure or recreational activities could be written off. The classic case, of course, is the "hobby farm," a tax dodge in which a taxpayer attempts to write off much of the cost of living or vacation facilities merely by keeping a few cows and calling the farm a "business."

In order to reduce disputes in this area, Congress in 1969 established a presumption (rebuttable by the IRS in extreme circumstances) that an activity which generates net income in two out of the previous five years (2 out of 7 for horse-breeding) is engaged in for profit. S. 1078 would expand the hobby loss safe harbor rule to two out of *10* years, for artists, composers, and writers.

The apparent rationale for this extension is that some works of art take a long time to create, and therefore an artist might have numerous "loss" years and only sporadic "profit" ones. Actually, this is probably not true for most artists. Most of the costs of producing a work of art – such as materials, equipment, studio rental, and so forth – are deductible only when the work is sold, under normal principles of tax accounting. The primary exception to this would probably arise in the case of writers – whose research costs would be currently deductible. The significant research cost which comes to mind is travel expenses.

There are certainly some non-dilettante writers who take long periods to complete their works and who therefore might not meet the current safe harbor test. But making it slightly easier for this limited group to deduct losses would also open up the tax

laws to abuse by "hobby" artists – a result which we do not believe is justified. One can easily imagine a part-time writer who tours the world every summer for 10 years – except for two years when he or she writes a summary of the travels which is published in a magazine. Under the bill, the modest income in those two years could allow the substantial cost of the trips to be deducted. Of course, in theory the IRS could attempt to rebut the presumption of deductibility – but going back 10 years is very difficult for the Service to accomplish in practice.

The philosophy behind S. 1078 was well summarized in an article in the May 1979 issue of *American Artist*. Defending similar tax breaks for artists, William Behrenfeld argued: "Since the present laws discriminate in favor of other taxpayers, I see no reason why our laws cannot benefit the heirs of American artists." This approach – abandoning even the pretense of fairness in our tax laws – is a formula for a taxpayers' revolution. We urge that S. 1078 not be favorably reported.

The committee will stand in recess.

[Whereupon, at 1:30 p.m., the committee was recessed, subject to the call of the Chair.]

[By direction of the chairman, the following communications were made a part of the hearing record:]

NATIONAL FOREIGN TRADE COUNCIL, INC.
10 ROCKEFELLER PLAZA • NEW YORK, N. Y. 10020 • (212) 581-6420

November 2, 1979

Mr. Michael Stern
Staff Director
Committee on Finance
Room 2227
Dirksen Senate Office Building
Washington, DC 20510

Dear Mr. Stern:

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 S. 1435, and requests that these comments be made part of the record of the hearings held on October 22, 1979.

We believe that a program to stimulate export expansion is essential in view of the high cost of energy imports and the magnitude of recent trade deficits. 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.

We believe that investment in more efficient plant and equipment is needed to improve productivity, reduce inflation, and improve America's position in the world marketplace. But there must be an improvement in capital formation in the United States to provide the funds needed to make the necessary investment. We believe the capital cost recovery provisions of S. 1435 will provide the cash flow needed to make the necessary investment, and we urge enactment of the Capital Cost Recovery Act immediately. While we recognize the budget impact of the provisions, we believe the only escape from declining productivity, declining world market shares, and increasing inflation, is to provide the funds necessary for American business to invest in more efficient plant and equipment.

Respectfully submitted,

Carter L. Gore, Director
Tax/Legal Division

CLG:acf

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.

STATEMENT

of the

NATIONAL CATTLEMEN'S ASSOCIATION

to the

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

COMMITTEE ON FINANCE

United States Senate

Relative To

S.1435

"Capital Cost Recovery Act of 1979"

Submitted By

Lat H. Turner, Chairman
Taxation Committee

November 1, 1979

The National Cattlemen's Association is the national spokesman for all segments of the nation's beef cattle 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 15 affiliated national breed organizations.

STATEMENT

S.1435

"Capital Cost Recovery Act of 1979"

The National Cattlemen's Association strongly supports the concepts embodied in S.1435 of accelerating and simplifying depreciation requirements and procedures for income tax purposes.

Present depreciation requirements and procedures adversely impact farmers and ranchers because of their inherent complexity and deleterious effect on capital formation. The complexity issue is especially troublesome to small and medium-sized operators who typically do not have professional accounting or legal assistance available to them.

In addition to the simplified classification of property and the accelerated rates, two other provisions of the proposed legislation would be especially helpful to farmers and ranchers. The elimination of salvage value under the bill would greatly simplfy the depreciation procedure. Also, making no distinction between new and used property with respect to the applicable percentages would be particularly helpful to farmers and ranchers.

Certain other amendments provided in the bill, such as the changes with respect to investment credit and specifying July 1 of each year as the starting date for depreciation even if the property is acquired or placed in service later on in the year, are supported by the NCA.

In the Association's view, the proposed legislation would make a significant contribution toward correcting the present bias in the tax system against investment in capital assets.

AMERICAN TEXTILE MANUFACTURERS INSTITUTE, INC.
1101 CONNECTICUT AVENUE, N.W., SUITE 300, WASHINGTON, D.C. 20036
TWX: 710-822-9489
TEL: 202/862-0500

November 2, 1979

Honorable Harry F. Byrd, Jr.
Chairman
Subcommittee on Taxation and Debt Management
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

We are pleased to have the opportunity to record our strong support of S. 1435 and request that this letter be included in the record of the subcommittee's hearing on this bill.

The American Textile Manufacturers Institute, Inc. (ATMI) has repeatedly urged revision of our tax depreciation rules in order to bring capital cost recovery allowances in this country to a level comparable to that allowed by other major industrial countries of the free world. Such changes are urgently needed at this time to help counter the impact long-continuing inflation is having upon funds available for investment in modern, efficient plant and equipment.

A rough rule of the thumb in the textile industry is that over the long run capital expenditures should be financed from cash flow arising from depreciation and retained after-tax earnings. This has been increasingly difficult, and in most cases impossible, to accomplish in our industry which traditionally is a low profit margin industry. This critical situation (where essential capital investments are just not being made) is caused in large part by the tremendous impact of inflation upon working capital needs, as well as upon the costs of new plant and machinery in our industry. For example, a modern fully equipped loom in 1975 sold for $34,000 and today it is selling for $72,000.

If we are to contin-- as a viable industry directly employing nearly one million workers, the -xtile industry must make substantial investments in new equipment to take account of or adjust to technological changes, foreign competition and shifts in market demand, and to combat air, water and noise problems.

The textile industry has demonstrated one of the highest equipment spending ratiosof all U.S. manufacturing industries. During 1976-77, 78 for instance, the textile industry spent an average of 80% of its retained cashflow for new plant and equipment in the U.S. This compares with only 56% for all U.S. manufacturing industries.

AMERICAN TEXTILE MANUFACTURERS INSTITUTE,INC.

Honorable Harry F. Byrd, Jr.
Page 2

Enactment of S. 1435 would provide significant cash flow benefits to the textile industry, as well as to business generally. It is line with longstanding ATMI policy positions - namely, that a five-year write-off should be provided for all new machinery and equipment, with no cutback in allowable investment credits, and that a statutory cost recovery period of no more than ten years be provided for industrial buildings.

A continuing high level of employment in our industry, with facilities in all but one state, is dependent upon a high and sustained level of capital investment, which, in turn, depends upon the availability of funds. Faster depreciation write-off for tax purposes will be of help in this area, and we urge approval of S. 1435 as promptly as possible.

Sincerely yours,

W. Ray Shockley

WRS/mvh

We are disturbed by the carry over tax reform act, passed in 1976 & is to go into effect after Dec. 1979-

This is double taxation, to pay both estate tax and income tax on inherited property. This rule is bad for everyone - We think with inflation, cheap money and the hundreds of other rules the government imposes on the people - This should be amended for the good of all the people.

Thank You

Mr. Darwin C. Banta
Rosie M. Banta
R1.
Delia, Kansas
66418

Please make these comments part of the hearing.

STATEMENT OF

MACHINERY DEALERS NATIONAL ASSOCIATION

FULL INVESTMENT TAX CREDIT FOR SMALL BUSINESS

The decline in our productivity is caused by several conditions. For the first time in twenty years, the Joint Economic Committee Annual Report of 1979 unanimously concluded that an increase in productivity is vital to the improvement of our economic standard of living and in the reduction of inflation. A partial cause of this situation are the antiquated and poorly designed production facilities of many American manufacturers. Another partial cause is the utilization of inefficient equipment; and yet another partial cause is the overall age of our country's industrial machinery. The most recent U.S. survey of machine tools shows only 11% of the industrial machinery in use today is less than five years old; 76% is at least ten years old. Equipment renewal and upgrading are necessary in both large and small manufacturing companies. Increasing productivity through equipment renewal can be best achieved for small business through the purchase of used machinery and equipment.

Under present law there is a $100,000 limitation on the amount of used equipment eligible for investment tax credit, but there is no limitation on the investment credit available for new equipment. Similarly, the carryover provisions available for new equipment are not allowed to purchasers of used equipment, who therefore must take the entire tax credit in one year or lose it. This discriminatory tax treatment impacts directly and primarily on small business which is already hindered by its inability to externally or internally generate capital necessary to buy new equipment.

In order to increase productivity in small businesses, the discriminatory ceiling on the amount of used property eligible for a tax credit must be eliminated; and, the carryover provisions available for new property must also be available for similary situated used property. Traditionally, small businesses purchase used capital equipment; large businesses basically purchase newly manufactured capital equipment. The cost of obtaining capital for production equipment is high for everyone, especially those who cannot borrow at the prime rate. Firms purchasing used capital equipment do not have a chance to offset some of their costs through this tax credit. Confining the investment credit to only equipment with the latest technology helps primarily the largest enterprises and basically ignores the largest segment of our economy which needs this tax credit the most. Because the small business sector offers the greatest potential for increasing employment, there is normally a direct relationship between increased installation of used machinery and increased employment.

Mr. Chairman and Members of the Committee,

This statement is submitted by Anthony Schopp, Executive Vice President of the Machinery Dealers National Association (MDNA) on behalf of the small businesses who are members of this organization. These comments are concerned with the Capital Cost Recovery Act of 1979.

The MNDA is an international trade association which includes approximately 400 small businesses in the United States which invest in and resell about 70% of the used machinery sold in this country each year. One of our objectives is the growth of manufacturers whose productive capabilities depend on used machinery. MDNA also speaks for hundreds of thousands of small and medium-sized manufacturing firms in the United States. These small businesses represent approximately 87 percent of the firms in the metalworking industry. We thank you for this opportunity to present our views and observations which, we believe, are shared by small businesses throughout the country.

We are concerned about the future of small business in America. We fear that in our present economy, we will not be able to generate sufficient capital to start new businesses, to expand our current capacity, or to even stay in business. Inflation has taken a heavy toll.

We share the concern of the Joint Economic Committee about the potential of our economy over the long term to increase the standard of living for the average American, to create a job for every American who wants to work, and to help hold down the cost of living by increasing the goods on the shelves of the nation's businesses.

Decline in Productivity

For the first time in 20 years the 1979 Annual Report of the Joint Economic Committee was a unified report endorsed by both the majority and minority members of the Committee. We agree with its unanimous conclusion that an increase in productivity is vital to improvement in our economic standard of living and in the reduction of inflation. The fall in productivity in our country has been well documented, and this ominous trend has been the subject of discussion and concern of all of us for many years. The Council of Economic Advisors, in their 1978 report, referred to the productivity slow-down as "one of the most significant economic problems in recent years." As Chairman of the Federal Reserve, William Miller testified before the Senate Finance Committee on September 6, 1978, that:

> Inflation is our most important economic concern today. . . . The only way I know that we are going to break the cycle of wages chasing prices and prices chasing wages is to begin to realize productivity gains so that the prices do not have to go up in order to maintain profitability. Capital accumulation is a critical ingredient in the long-range growth of labor productivity and the raising of living standards. . . . Throughout the 1970's, the ratio of capital stock to labor has fallen ever shorter of its earlier growth trend line, and this, undoubtedly, has been a significant factor in the slower growth of productivity that we have experienced over this period. . . . (part 5, page 1173 et seq.)

This testimony was echoed in the 1979 Joint Economic Committee Report, which was issued on March 15, 1979:

> The lower rate of productivity growth in recent years is one of the causes of today's inflation, worker dissatisfaction, the deficit in our balance of payments, and the weakening of the international position of the dollar. Productivity gains provide the means by which historically disadvantaged minorities can increase their economic welfare. Thus, the adverse effects of a low rate of productivity growth extend far economic issues. . . . (p. 119)

> One factor cited in virtually all studies of the productivity slow down as a major or a paramount cause is the low capital stock due to the recent inadequate levels of investment. If the capital stock-labor force ratio is to rise, that investment (gross investment less deprecition) must be sufficiently large so that the capital stock grows more rapidly than the labor force. This was the case until 1974, when the capital stock-labor force ratio peaked at $10,604 (in 1972 dollars) per person. Since then, investment has been inadequate relative to the rapid labor force growth, and the ratio has fallen by nearly 3 percent. This will adversely affect economic growth for several years in the future. (p. 130-131)

We agree with the conclusions of these authorities that further steps to increase productivity are sorely needed. From the small business perspective, this can be achieved through measures that will stimulate the purchase of used machinery and equipment. Capital stock formation among small business has been impeded by high interest rates, restricted availability of credit, regulatory burdens imposed by government, and tax laws which discriminate against small business. At this time, we believe that the Congress should focus its attention on reforming our tax laws in such a manner as to stimulate capital stock formation among small businesses through a simplified and accelerated capital cost recovery system and the removal of discrimination in the investment tax credit.

Allow a Full Investment Tax Credit for Used Machinery and Equipment

In addition to the depreciation proposals which have been discussed today, the small businesses of this country need reform of the investment tax credit. Under present law, there is a $100,000 limitation on the amount of used equipment eligible for the investment tax credit, but there is no limitation on the investment credit available for new equipment. Similarly, the carryback/carryforward provisions

available for new equipment are not allowed to purchasers of used equipment who must, therefore, take the entire tax credit in one year or lose it. This discriminatory tax treatment impacts directly and primarily upon small business which is already hindered by its inability to externally or internally generate the capital necessary to buy new equipment. In order to increase productivity in small and medium-sized businesses, this discriminatory ceiling on the amount of used property eligible for the investment tax credit must be eliminated; and the carryback/carryforward provisions available for eligible new property must also be available for similarly situated used property. We must allow small business to receive the same tax incentives provided to big businesses. The investment tax credit limitation is primarily a small business issue. Traditionally, small businesses purchase used capital equipment; large businesses basically purchase newly manufactured capital equipment. If used machinery and equipment is eligible for the full investment tax credit, the following benefits at least can be expected:

(a) the ability of small business to compete, to maintain its current market share, and to expand its output and productivity will improve;

(b) employment in the most labor-intensive part of the capital equipment industry will increase;

(c) the current demand for less expensive machine tools will be alleviated and the incentive to turn to imported new machine tools will be reduced;

(d) the demand for new domestic machine tools should increase;

(e) the short-term inflationary impact of the tax credit will be reduced to the extent used machinery is purchased; and

(f) the full benefit of the investment tax credit as an incentive for capital formation will be available to <u>all</u> businesses, <u>equally</u>.

<u>Competitive Ability of Small Business</u>

Of all the challenges facing small business, our inflationary economy is perhaps the most difficult. The cost of obtaining capital for production equipment is high for everyone, especially those who cannot borrow at the prime rate. Those firms purchasing used capital equipment do not have a chance to offset some of their cost by taking the tax credit. This contrasts with large corporations borrowing at prime and purchasing new equipment with the unlimited tax credit. Because large and small companies do compete, smaller firms are disadvantaged.

Large firms buy <u>new</u> machine tools that are either highly automated multi-operational machines or numerically controlled equipment, often designed for a specific purpose. Confining the investment credit to only equipment with the latest technology helps primarily the largest enterprises and basically ignores the largest segment of our economy which needs this tax credit the most. Normally, small and medium-sized companies are competing in industries dominated by a handful of giant corporations.

We believe that our government must adopt policies which will reverse the decline of small business in this country. Much of the reason for this decline lies in the inability of small businesses to

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acquire capital at the same costs as large businesses. These points were stressed in the Final Report of the 1978 hearings on the Future of Small Business in America, conducted by the House Small Business Subcommittee on Antitrust, Consumers, and Employment:

> We must recognize the necessity for major changes in our governmental policies--at both the Executive and Congressional levels--with regard to the preservation of competition and free enterprise. . . including a reformulation of government policy on such matters as tax structure and industry regulation. . . . (House Report 95-1810).

We believe that small business is crucial to the survival of a free enterprise system and that governmental policy must be adopted which will allow catch-up programs to enable faster growth for small business than in the past.

Small business is an effective force even in heavily concentrated markets, but its position is fraught with difficulties. The tax laws should not further handicap small businesses struggling to compete with industrial giants. We urge, therefore, that used equipment, as well as new equipment, qualify for the full 10 percent credit to offset tax liability, with full carryback/carryforward options and with no $100,000 limit on eligible used property. If the additional handicap of this tax discrimination is removed, small businesses will be able to maintain their market share and to compete against the larger domestic and international corporations.

The Ability of Small Businesses to Increase Productivity

The decline in our productivity is caused by several conditions. A partial cause is the antiquated and poorly designed facilities. Another partial cause is the utilization of inefficient equipment, and yet another partial cause is the overall age of our country's industrial

machinery. The 1978[1] American Machinist Inventory showed that the majority of machine tools in use today, in small and large companies, are over 20 years old and less than 11 percent are five years old or less. An urgent need for upgrading and/or renewal of equipment exists.

Therefore, to increase a plant's production capacity, or to develop a new production line, many machines must be acquired. Major corporations renew equipment which is 7 to 10 years old with new equipment, some of which cost over a million dollars. Medium to small firms renew equipment which is 15 to 18 years old with used equipment, usually 7 to 10 years old, some of which cost over $300,000. Very small or new firms may renew their equipment which is 25 years old or more with used equipment which is 15 to 18 years old. If the full investment tax credit is allowed for used capital stock, it will speed up the process of renewal and upgrading of our industrial plants. The demand for used equipment will increase the price and market for a large firm's used equipment. This will encourage the large firm to sell its used equipment and buy new capital stock to replace the used. This will result in a significant increase in productivity throughout the economy.

Improving productivity does not necessarily require aquisition of younger machines. Often small manufacturers can increase their productivity by purchasing used equipment manufactured in the same year as its current equipment but more efficiently designed for its particular production needs.

When the small businessman is denied these incentives to replace current equipment with used machines that are either more sophisticated or more appropriate for his operation our economy looses. His alternatives are to make do with existing equipment, to merge, to be acquired, or to close up shop.

[1] US, Twelfth American Machinist Inventory (December 1978)

For these same reasons, a carryback and carryforward provision should apply to tax credits for eligible used machinery, as well as eligible new machinery. To penalize the manufacturer who installs $1 million of used machinery in a single year over the manufacturer who merely installs $100,000 worth, simply makes no sense in a sluggish economy and times of slowing economic growth.

Allowance of the Full Investment Credit
for Used Machiuery Would Create Jobs

The investment credit should not only stimulate productive capability but it should also stimulate immediate employment. The members of the Committee are keenly aware of the unemployment problems with which the country is beset. Moreover, this Committee knows that the small business sector offers the greatest potential for increasing employment. The purchase of used machinery not only increases productivity but also directly creates new jobs. As noted earlier, small businesses increase productivity primarily with used equipment. This Committee has learned that small business is responsible for 55 percent of all employment in the private sector. Recent studies by the Massachusetts Institute of Technology, The Job Generation Process, show that job replacement is achieved through the small business sector. When a small manufacturer goes into business or expands his capital stock, he needs additional employees to operate the used equipment he has purchased. Typically, there is a direct relation between increased installation of used machinery and increased employment.

Alleviating the Shortage of Used Capital Stock

Today there is demand for late model used machinery. In many instances, later year domestic used machinery and newly manufactured foreign machinery are price competitive. The new foreign machine has an

advantage since there is an unlimited tax credit, with carryback and carryforward provisions available to its purchasers. Thus, industries seeking to retool are faced with three choices:

(1) making do with inadequate equipment;

(2) purchasing imported new machine tools; or

(3) acquiring more efficient used machinery.

If a manufacturer retains his inadequate machinery, there is no increase in productive capability and the goal of economic growth is frustrated. Retooling with imported machine tools is obviously undesirable, both in its ultimate effects on the domestic machine tool industry and in its adverse effect on the balance of payments. Only by retooling with more efficient used machinery can the maximum economic benefits to the nation be realized. The full investment tax credit should apply to purchases of used machinery so these benefits can be realized.

Investment Credit and Inflation

While acknowledging the investment tax credit's effectiveness in stimulating capital investment, most economists recognize its potential to cause short-term inflation. This is a function of the lead time to implement investment decisions and the concomitant increase in prices for scarce supplies. In many instances, the lead time to place new equipment in service is as much as thirty-six months. The installation of used machinery, however, does not have this undesired inflationary impact since the equipment already exists and the time taken to install it is usually a matter of days, not months.

Inflation has made the $100,000 limit on the amount of eligible used equipment against which the credit can be applied woefully inadequate. The cost of both new and used machinery has increased dramatically since the $50,000 limit was imposed in 1962. In 1975, the limitation was

increased to $100,000. Whatever basis there may have been for a limitation has been severely weakened because of inflation. In 1975 the MDNA found that the average price for 44 randomly selected machine tools then 20 years old, came to $13,000. In 1978 we found that the same 44 machine tools, now 23 years old, are fetching an average of $16,000 each. Such dramatic jumps in price are typical with all machine tools. Indeed, prices of used machine tools have increased more than 250% since 1962. The average cost of used machines sold by our members is $20,000. A manufacturer has hardly begun to retool before his $100,000 allowance is completely expended.

Not only has inflation caused a continuing increase in prices for used equipment, but technological advances have dramatically increased prices. The most striking advance in the machine tool business has been the development of computer-directed or numerically controlled tools. However, the technological superiority of these machines is matched by their greater costs. Today the average used numerically controlled machine costs $70,000. The price of such a machine on the used market reflects its original costs. As more of these machines appear on the used machine market, the average cost of available used machines will again increase, thereby making the existing limitation even more inadequate.

The failure of Congress to eliminate the limitation currently imposed on purchases of used property eligible for the credit penalizes the users of such property - and the users are small businesses.

Capital Cost Recovery Legislation

Several bills have been introduced this year which would allow the rapid recovery of capital costs through depreciation reform. On January 23, 1979, Senator Nelson introduced S. 110, the "Small Business Depreciation Reform Act of 1979." On June 27, 1979, Senators

Bentsen, Nelson, Packwood and Chafee introduced S.1435, the "Capital Cost Recovery Act of 1979." We enthusiastically endorse the concepts of all these proposals. In order to stimulate capital investment and increase productivity, we must reform the current tax system for depreciation on equipment. These bills would permit a small business to recover more rapidly capital investment that it has invested in machinery and equipment.

In its 1979 Report, the Joint Economic Committee found that one of the deterrents to investment spending has been the interaction of inflation and current tax law. The Joint Economic Committee concluded that:

> Some of the provisions of the corporate income tax code which were designed in a noninflationary economy, act as a deterrent to investment in the current inflation. Depreciation allowances based on historical costs do not allow sufficient deductions to recover replacement costs. Similarly, profits on inventory in one sense may be illusory, because inventory must be replaced at current cost. On the other hand, in inflationary periods, corporations benefit from reductions in the real value of outstanding debts. . . . (p. 132)
>
> Some of the tax changes in the Revenue Act of 1978 will stimulate investment. But these are not sufficient. We believe that per dollar of revenue loss, liberalization of depreciation allowances would be the most effective stimulant. (p. 133)

As Chairman of the Federal Reserve, William Miller emphasized accelerated depreciation as a needed tax change in his testimony before the Senate Finance Committee on September 6, 1978:

> Accelerated depreciation is a very efficient way to encourage investment. The tax benefits of faster depreciation accrue to a firm only after new plant and equipment has been put in place. In addition, enlarged depreciation allowances would redress the serious drag on real corporate profitability that has occurred in recent years as inflation has caused replacement costs to exceed depreciation deductions by a wide margin. (emphasis added) (part 5, page 1173 et seq.)

We agree with the conclusions of the Joint Economic Committee and Mr. Miller and urge the passage of legislation which would allow the rapid depreciation of used equipment and machinery over a maximum period of five years. For many of the reasons previously stated with regard to the full investment tax credit, such depreciation tax reform would aide small businesses in generating the capital neccesary to buy used machinery, resulting in expanded capacity and increased productivity.

Although we endorse the concept of S.110, we wish the committee to know that we are concerned that the $25,000 limitation in S.110 on the amounts which may be depreciated imposes too low of a ceiling to be a meaningful stimulant to small business in the investment of machinery and equipment. As I pointed out earlier in my testimony, the cost of both new and used machinery has increased dramatically. In 1978, the average cost of all used machines sold by our members was $20,000. Perhaps the $25,000 or $50,000 limits would accomodate the small service company or retail store. However, a small manufacturer has hardly begun to retool before he has exceeded the limitations provided for in those two bills. Such limitations are even more detrimental when applied to used computer-directed or numerically

controlled tools. As I pointed out earlier, the average used numerically controlled machine cost $70,000. From a small business perspective, a one million dollar ceiling on the amount of annual depreciation would encourage the investment in capital which would ultimately lead to increased productivity of small businesses in our country. However, for the entire machine tool industry, an unlimited annual depreciation should encourage the most capital investment.

The simplification of our tax laws with respect to depreciation, which would result from all of these proposals, would be of great benefit to small businesses. Small businesses cannot afford a cadre of tax lawyers and accountants to plan their capital investment. Being able to understand the simplified depreciation schedule, the small business person would be more encouraged to increase investment in machinery and equipment. Under existing law, a great deal of time is wasted by small business executives in trying to comprehend our complex depreciation laws and in computing the allowable depreciation for their equipment. One result is that depreciation accounting is one of the leading causes of errors on small business tax returns. Simplification of the depreciation system will result in savings of money and time for both small businesses and the government tax officials who must process the current complex returns.

In some cases, the current depreciation tax laws are so complex that small businesses have chosen not to use the depreciation allowable. For example, the Asset Depreciation Range (ADR) System was used in 1974 by only .7 percent of all corporations or 11,042 corporations out of a total of 1.6 million. Yet this system shortens the useful life of assets by up to 20 percent. While 94 percent of the firms with over $1 billion worth of assets use ADR, only 1 percent of the firms that have

assets of less than $500,000 used ADR. (93.3 percent of the firms in this country are small businesses that have assets less than $500,000). It is clear that small business does not use ADR. We believe that it will use the simplified system.

The rapid capital cost recovery allowed by these four bills will protect the capital investment of small business against the erosion of inflation, which currently causes replacement costs to exceed depreciation deductions. Small businesses will be able to reinvest their capital in more or upgraded equipment. With the resulting increase in productivity, the entire economy will benefit and we will have scored another victory in our constant battle against inflation.

Furthermore, we need the proposed rapid capital cost recovery system in order to be competitive with other industrialized nations which have already adopted rapid capital cost recovery systems. For example, Canada has adopted a two-year depreciation system for most machinery and equipment, and Britain has adopted a capital recovery time of a single year. This has resulted in an accelerated capital stock renewal process which I annalyzed earlier in my testimony. Used equipment is being replaced more rapidly by new equipment, and small businesses are replacing old used equipment with later year more advanced used equipment. The result is a more modernized overall industrial plant for those countries. The high demand for used machinery in these countries, we believe, is at least partially caused by the greater supply of used equipment created by the two or one-year depreciation system. We must adopt a similar rational tax policy which will stimulate domestic economic growth and allow us to be competitive in the international arena. If such steps are not taken, we will see increasing balance of payment deficits and further devaluation of the dollar.

Conclusion

In summary, we must reverse the decline in productivity in our country through the increased capital stock formation which will be stimulated by reform of our tax laws through removal of discrimination in the investment tax credit and through a simplified and accelerated capital cost recovery system. Between these two reforms, we believe small business will benefit more by allowing it an equal opportunity to full use of the investment tax credit on its purchase of used machinery and equipment. The tax credit is applied to taxes due, while the value of the depreciation deduction hinges on the amount of capital stock owned and the tax rate applicable to each company. However, we believe that both reforms are necessary and must be enacted in the very near future. These reforms will allow the generation of capital necessary to the renewal and upgrading of our nation's industrial plants. They will give small business a fighting chance against inflation and an opportunity for catch-up growth which we need in order to compete effectively against large domestic and international corporations. Most importantly, we can increase the productivity of our country, achieve real growth, and assure a better standard of living for all Americans.

Thank you Mr. Chairman and members of the Committee.

Statement of the
Machinery and Allied Products Institute
to the
Subcommittee on Taxation and Debt Management
Senate Finance Committee
on
Secretary of the Treasury Miller's Testimony on the
Proposed Capital Cost Recovery Act of 1979
(S. 1435)

October 31, 1979

The Machinery and Allied Products Institute is the national organization representing the capital goods and allied product industries of the United States. From its inception in 1933, MAPI has given primary attention to capital formation, capital investment, and technological advancement together with government policies--including tax policy--as they affect these central issues. This has been reflected in original research, numerous publications, and public policy statements to the Congress and to the Executive branch. It is, therefore, consistent and fitting for the Institute to present for the record certain comments on the testimony of The Honorable G. William Miller, Secretary of the Treasury, in hearings conducted by this Subcommittee on certain proposals for liberalization of capital cost recovery for tax purposes.

The Focus of This Presentation

It is not the primary purpose of this statement to address the details of the 10-5-3 proposal (S. 1435) which would substantially modify and liberalize capital cost recovery allowances under the present law and regulations. Rather, we wish to deal in a general way with certain of the issues raised by Secretary Miller. In so doing, we trust that our statement will contribute to a more balanced record with respect to the initial views of the Administration as expressed by the Secretary.

<u>Treasury Recognition of the Need for an Appropriate Capital Cost Recovery System</u>

First, it should be acknowledged that the Treasury testimony recognizes the great importance of an appropriate capital cost recovery system. The following excerpts from Secretary Miller's testimony reflect this recognition:

* * *

I am pleased to see the broad interest in legislation to encourage capital formation and increase productivity.

* * *

At the appropriate time, you should be prepared to act on a program carefully structured to expand economic capacity, to reduce production costs, and to promote productivity. Appropriate depreciation allowances can help to accomplish these goals and should be given serious consideration as an element of any future tax package.

* * *

The present tax depreciation system is cumbersome and complex. It involves a number of choices and uncertainties, and is especially burdensome for small businesses. It should be simplified. The present system provides an insufficient incentive for capital expansion in periods of rapid inflation and financial uncertainty. These incentives should be strengthened as much as our budget resources will allow.

* * *

Acceleration of depreciation allowances can be effective in providing investment stimulus. The direct tax savings that accompany the acquisition of capital provides additional cash flow to business firms for further investment and replacement.

* * *

Inflation, however, increases capital consumption as measured in current dollars, and, therefore,

> depreciation allowances based on historical cost may be inadequate. Acceleration of tax depreciation may compensate for the general understatement of depreciation.
>
> * * *
>
> I believe we should analyze carefully a wide range of depreciation plans, and I will continue to develop and work with you to promote a depreciation or capital recovery system that we can all regard as simple, effective and fair. Such a system should be put into effect as soon as budgetary resources and prudent fiscal policy permit.
>
> * * *

These excerpts are taken from various portions of the Treasury statement, and we cannot quarrel with them as far as they go. They appear to represent, however, an understatement of the problem of the inadequacy of capital cost recovery allowances in this country. For example, the impact of inflation on depreciation allowances is given only brief treatment by the Secretary; it deserves much fuller coverage.

Effect of Inflation on Capital Cost Recovery

The Institute has published over the last several years a number of studies on inflation and its effect on profits, depreciation, and inventory valuation. A key publication in this series is MAPI Memorandum G-70, a copy of which is appended as a part of this statement. This commentary was originally issued in January 1974 and has been periodically updated through April 1979. Note particularly Table 1 which shows a comparison of current-cost straight-line depreciation of nonfinancial corporations with the depreciation allowed them for income tax purposes. The excess of current-cost over tax depreciation has grown from a negative amount in 1965 to $18 billion in 1978.

A major liberalization of our capital cost recovery system would be justified by the impact of inflation alone. There are other considerations, however, some of which are at least touched upon by the Treasury testimony including the need to improve productivity. It should be added that the international competitive position of the United States is adversely affected by the state of our plant and equipment. Moreover, it is our understanding that foreign industrial competitor nations have adopted very liberal systems of capital cost recovery.

Issues Raised by Treasury Testimony

Now let us turn to consideration of some of the direct and implied issues raised by Secretary Miller. His principal concern appears to be the timing of the proposal, and he and the Treasury statement underline the conclusion that a commitment to widen the budgetary deficit by the magnitude of S. 1435 would be premature at this time. Although this is the heart of the Treasury Department's position, which we are sure is an Administration position, the statement develops in some detail criticisms of the 10-5-3 proposal which deserve attention in terms of their general significance.

Productivity and investment.--With respect to productivity the Treasury starts from the proposition that the stimulation of investment and improvement of productivity performance must be among the foremost objectives of economic policy. It is then acknowledged that aggregate productivity growth has shown serious decline in the last decade. However, emphasis is placed on the point that productivity performance varies across the economy when major productive sectors are

examined. This leads to the conclusion that in developing a program of tax incentives for investment, close attention should be given to "the distribution of tax incentives among sectors of the economy." This is the kind of fine tuning which does not work in a broad economic sense and will not be effective in terms of investment incentives.

The Treasury seems to concede that declines in productivity may not be wholly attributable to lagging capital formation. Secretary Miller's statement also acknowledges that tax policy should not attempt to direct all of the tax relief to industries that have poor productivity records or those that have performed well. These two concessions water down the point that the statement seems to be making at this juncture. It is our view that any attempt to structure an enlarged investment incentive so as to vary its intended impact between sectors or industries in the economy on the basis of productivity performance is much too complex an undertaking. Indeed, it would probably be counterproductive. It clearly would not meet the test of simplicity and would almost certainly create a range of inequities. The proposition advanced is a strained effort to criticize an across-the-board and relatively simple approach to tax incentives for investment.

The concept of an interest-free loan.--In one or two places in the statement, there is reference to the fact that if the allowable depreciation deduction is greater for any year than the amount of capital consumed, the government is granting what is tantamount to an "interest-free loan." This is a "buzzword" which shows up all too frequently when the Treasury Department is opposed to a particular proposal. In the

case of depreciation, we are dealing essentially with a question of timing. Moreover, even under present law, and clearly under any proposal for liberalization of tax incentives for investment, precise matching of capital recovery to capital consumed in any particular year is not undertaken. The government is deliberately providing an element of incentive beyond consumption of capital in any particular year of the write-off period.

Matching investment incentive with "true depreciation cost".-- There is a related statement in the Treasury's presentation which is either ambiguous or reflects a lack of understanding of the true nature of tax incentives for investment even under present law. The statement appears on page 9 and reads as follows: "I would further suggest that you should consider the continuation of some administrative mechanism for the system to assure that the capital recovery deductions allowed for tax purposes are consistent with changes in true depreciation costs." If we understand the statement correctly--and it is somewhat ambiguous, as already indicated--there is an implication that a capital cost recovery system should be limited to the recovery of so-called true depreciation costs as distinguished from having a significant incentive element in its structure. This principle is not observed under present law and regulation which includes an element of incentive, and what is under discussion is how that incentive for investment should be enlarged.

What the Treasury may be saying is that it objects to 10-5-3 on the technical ground that it departs from the concept of useful lives which is preserved in the ADR system now in effect. The 10-5-3 proposal deliberately moves away from the useful life approach, and a

strong case can be made for this departure. If the Treasury favors continuation of the useful life approach, it should argue the point forthrightly. We, of course, concede that a substantial increase in tax incentive for investment could be adopted within the ADR framework and that, of course, is the approach that Congressman Al Ullman incorporates in his proposed Tax Restructuring Act of 1979 (H.R. 5665).

The phase-in of increased capital cost recovery.--On two grounds the Treasury Department expresses disapproval of a phase-in system for increased capital cost recovery. First, it makes the point that under any phase-in approach there would be a different set of rules applicable from year to year as the phase-in takes place. This is considered to be complicated. In other words, it does not meet the test of simplicity. Also, Treasury argues that a phase-in creates a perverse incentive effect by encouraging deferral of investment until a subsequent year when the rate of capital recovery allowance is greater.

Technically speaking, both points are valid. However, a phase-in approach for any substantial increase in capital cost recovery allowances is designed--as Treasury admits--to spread the revenue losses over a longer period of time than otherwise would be the case. And it is those revenue losses which seem to give Treasury most concern in terms of the present economic policy of the Administration. The Treasury cannot have it both ways. If its principal concern is revenue loss, then it should accept a phase-in approach even if that carries a certain

amount of disadvantage. Otherwise, it should be prepared to reject the phase-in and accept the larger revenue loss over a shorter period of time.

Creation of tax shelter opportunities.--The Treasury argues against what it describes as a dramatic increase in capital recovery allowances on another ground, namely, that it would invite and greatly increase so-called "tax shelter activity." Almost any substantial improvement in capital cost recovery allowances will create tax benefits. Regardless of what they are called, the Tax Code is replete with special benefits conferred on certain categories of individuals or corporate taxpayers for rationalized purposes. This is not to say that a tax benefit which is unacceptable in terms of public policy should be tolerated.

The tax shelter argument as stated by Treasury is not impressive. For example, it overlooks the fact that buildings--particularly industrial structures--have been the subject of adverse discrimination under our capital cost recovery system for decades. It is high time that this discrimination be eliminated or at least moderated. If a capital cost recovery system invites unacceptable abuse in terms of what the Treasury calls tax shelter activity, then the loopholes should be plugged, if they are indeed loopholes. However, the essence of a proposal, if well rationalized, should be preserved.

Alleged wide range of differential benefits.--The Treasury states that another result of 10-5-3 is a wide range of differential

benefits among businesses according to the types of assets that they use and their present industry classification. Treasury goes on to say that the variation in benefits provided by the proposal under discussion is most pronounced when industry categories are compared. This is correct in a technical sense, but the problem which Treasury underlines is inherent in any attempt to design a capital cost recovery system which is relatively simple and represents a substantial liberalization.

To illustrate, the investment tax credit, which has become generally accepted as an appropriate, simple, and significant incentive to capital investment, favors capital intensive corporations and industries. But when national policy in the form of the investment tax credit is intended to stimulate investment, and that investment is largely made by capital intensive businesses and industrial sectors, it automatically follows that a differential benefit is created. We do not argue that unacceptable differential benefits should be adopted, but some differential benefits are inevitable in a wide-ranging capital cost recovery system. The "perfect world" in this area, as is true of most tax policy issues, will not be achieved.

* * *

As previously indicated, it is not the purpose of this commentary to develop a full discussion of the merits of S. 1435. We have concentrated on certain issues raised by the Treasury Department in the context of S. 1435 which concern us on their merits in terms of tax policy in the broad area of capital cost recovery allowances. These issues will undoubtedly arise as the Treasury addresses alternative forms of liberalization of depreciation which Secretary Miller indicates are already under study.

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INFLATION AND PROFITS

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MACHINERY AND ALLIED PRODUCTS INSTITUTE

MACHINERY & ALLIED PRODUCTS INSTITUTE AND ITS AFFILIATED ORGANIZATION, COUNCIL FOR TECHNOLOGICAL ADVANCEMENT, ARE ENGAGED IN RESEARCH IN THE ECONOMICS OF CAPITAL GOODS (THE FACILITIES OF PRODUCTION, DISTRIBUTION, TRANSPORTATION COMMUNICATION AND COMMERCE), IN ADVANCING THE TECHNOLOGY AND FURTHERING THE ECONOMIC PROGRESS OF THE UNITED STATES

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EDITOR'S NOTE: *The seventh republication of this Memorandum is occasioned by the availability of data for the full year 1978. Its general conclusions are in no way altered by the latest figures.*

Single copies of this memorandum are being distributed without charge to MAPI member companies. Additional copies are available to member companies at $3.00 and to nonmembers at $4.00 each.

INFLATION AND PROFITS

The effect of rising price levels on the accounting of profits is not a new subject. During the sharp postwar inflation of 1946-48 it generated a lively discussion in accounting and management circles. This was revived, on a lesser scale, by the price run-ups of 1950-51 and 1956-57. But under the relatively stable price level of 1958-64 interest waned. It was widely believed that inflation was a thing of the past, that the aftereffects of earlier inflation would gradually wear off, and that no corrective action was needed. This proved to be an illusion. By 1965 inflation was under way once more, and it has continued at a distressing pace ever since. It is now high time to take another look at the problem.

The Principle

The overstatement of profits during and after a period of inflation arises from the practice of charging only the historical cost of physical asset consumption (fixed assets and inventory). When the purchasing power of the dollar is shrinking, the charging of historical costs--reflecting earlier, and hence lower, price levels--is insufficient for the restoration of real assets used up in production. A proper reckoning requires the restatement of previously incurred costs in the dollars of realization, that is to say, in the revenue dollars against which they are charged. Only when costs and revenue are measured in the same dollars can the difference between them (profit) be correctly determined.

It follows that when the real cost of physical asset consumption is undercharged the shortfall is accounted as profit. It follows also that this much of the reported profit is fictitious, representing simply the understatement of costs.

The Project

The foregoing statement of principle refers to the conversion of historical costs into their equivalents in current dollars. This implies the use of an index of the general purchasing power of the dollar. Unfortunately from our standpoint, the official conversions are based on a multiplicity of specific price indexes purporting to reflect the current replacement costs of the individual items or classes of items processed. We refer to the Department of Commerce conversions, which are applied both to fixed-asset consumption (in the Capital Consumption Adjustment) and to inventory consumption (in the Inventory Valuation Adjustment) by means of such replacement-cost indexes. While we prefer the use of a single comprehensive index of prices, the overall results obtained from a multiplicity of specific indexes are not far different. In any case, we are constrained

by the nature of the available data to use the latter, which represents a conversion of income-tax costs into current-cost equivalents, rather than into current-dollar equivalents./1

In the project in hand, we propose to compare current-cost depreciation with tax depreciation and current-cost inventory consumption charges with their tax counterparts. We can then see what difference the conversion makes in the profit figures. The study is limited to the corporate system because profit as such is not available for the unincorporated sector, and more specifically to nonfinancial corporations, the category principally concerned with physical asset consumption. It is limited also to the inflation of 1965-78.

I. FIXED ASSETS

The Department of Commerce computes annually current-cost depreciation on the fixed assets of nonfinancial corporations, using two write-off methods (straight-line and double-declining-balance) and a variety of service-life assumptions. It has expressed its preference in service-life assumptions (85 percent of Bulletin F lives), and we shall use that assumption.

In previous issues of this memorandum, we argued for and used the Department of Commerce estimates of current-cost double-declining-balance depreciation. While we consider them more realistic than the straight-line alternative employed in the Department's "Capital Consumption Adjustment," we have concluded that the difference no longer justifies departure from the official figures, which have been substituted for 1978 and all prior years, in the tables that follow.

The following table compares the Department's computation of current-cost straight-line depreciation with its estimate of the depreciation allowed for income tax purposes.

1/ For a discussion of this issue, see Realistic Depreciation Policy, MAPI 1954, Chapter 12.

Table 1

Comparison of the Current-Cost Straight-Line Depreciation of Nonfinancial Corporations With the Depreciation Allowed Them for Income Tax Purposes
(Billions of Dollars)

	(1) Current Cost S/L	(2) Income Tax Depreciation	(3) Excess of (1) over (2)
1965	$ 32.8	$ 36.4	$ -3.6
1966	35.7	39.5	-3.8
1967	39.3	42.9	-3.6
1968	43.0	46.6	-3.6
1969	47.8	51.3	-3.5
1970	53.1	54.6	-1.5
1971	58.2	58.7	-0.5
1972	62.6	65.3	-2.7
1973	68.7	70.5	1.8
1974	80.8	77.8	3.0
1975	96.8	84.9	11.9
1976	106.7	92.4	14.3
1977	115.6	100.9	14.7
1978	126.5	108.8	17.7

Note that the excess of current-cost over tax depreciation has grown from a negative amount in 1965 to $18 billion in 1978.

II. INVENTORY

As indicated earlier, the conversion of tax inventory consumption charges to their current-cost equivalent is computed by the Department of Commerce as the Inventory Valuation Adjustment (IVA). The calculation allows for inventory consumption presently charged for income tax purposes by LIFO and similar current-costing procedures, and converts only the balance under historical-costing systems. The results follow.

Table 2

Inventory Valuation Adjustment for Nonfinancial Corporations
(Billions of Dollars)

Year	Amount
1965	$ 1.9
1966	2.1
1967	1.7
1968	3.4
1969	5.5
1970	5.1
1971	5.0
1972	6.6
1973	18.6
1974	40.4
1975	12.4
1976	14.5
1977	14.8
1978	24.4

Here again we have a gradual rise in the excess of current-cost over income-tax charges, culminating in this case in a sudden surge to $40 billion in 1974, with a 1978 level of $24 billion.

III. ADJUSTMENT OF PROFITS

We are now ready to put the pieces together and adjust profits as reported for income tax purposes.

Table 3

Adjustment of Reported Profits of Nonfinancial Corporations (Billions of Dollars)

	(1) Profits Before Tax as Reported	(2) Income Tax Liability	(3) Profits After Tax as Reported (1) - (2)	(4) Under-statement of Costs/a	(5) Profits Before Tax as Adjusted (1) - (4)	(6) Profits After Tax as Adjusted/b (3) - (4)
1965	$ 64.4	$ 27.2	$ 37.2	$ -1.7	$ 66.1	$ 38.9
1966	69.5	29.5	40.0	-1.7	71.2	41.7
1967	65.4	27.7	37.7	-1.9	67.3	39.6
1968	71.9	33.6	38.3	-0.2	72.1	38.5
1969	68.4	33.3	35.1	2.0	66.4	33.1
1970	55.1	27.3	27.8	3.6	51.5	24.2
1971	63.3	29.9	33.4	4.5	58.8	28.9
1972	75.9	33.5	42.4	3.9	72.0	38.5
1973	92.7	39.6	53.1	20.4	72.3	32.7
1974	102.9	42.7	60.2	43.4	59.5	16.8
1975	101.3	40.6	60.7	24.3	77.0	36.4
1976	130.2	53.0	77.2	28.8	101.4	48.4
1977	143.5	59.0	84.5	29.5	114.0	55.0
1978	167.1	68.5	98.6	42.1	125.0	56.5

a/ The sum of the excesses of current costs over tax costs shown in Tables 1 and 2.

b/ Since this is a retrospective recomputation of profits, it takes as given the corporate income taxes actually paid. If tax liabilities had been figured on the adjusted pre-tax profits, the after-tax effect of the adjustment would, of course, have been reduced by the tax saving resulting therefrom. But since they were actually figured on the reported profits throughout, there were no such tax savings. Adjusted after-tax profits are simply adjusted pre-tax profits minus actual taxes on reported profits.

Here is a startling picture. Adjusted after-tax profits started out in 1965 slightly greater than the reported figure. They wound up in 1978 only 57 percent as large./1

Restatement of Retained Earnings

An even more startling picture emerges when we subtract dividend payments from adjusted after-tax profits to derive adjusted retained earnings.

Table 4

Adjusted Retained Earnings of Nonfinancial Corporations (Billions of Dollars)

	(1) Adjusted After-Tax Profits	(2) Dividend Payments	(3) Adjusted Retained Earnings
1965	$ 38.9	$ 17.2	$ 21.7
1966	41.7	18.1	23.6
1967	39.6	18.9	20.7
1968	38.5	20.7	17.8
1969	33.1	20.7	12.4
1970	24.2	19.9	4.3
1971	28.9	20.0	8.9
1972	38.5	21.7	16.8
1973	32.7	23.9	8.8
1974	16.8	26.0	-9.2
1975	36.4	28.5	7.9
1976	48.4	33.5	14.9
1977	55.0	39.1	15.9
1978	56.5	45.0	11.5

1/ It should be acknowledged that there is a slight duplication in combining the depreciation and inventory adjustments. Practice differs widely with regard to the treatment of depreciation, some companies charging it into cost of sales, others treating it as an expense. Overall figures on the relative prevalence of the two procedures are not available. To the extent that depreciation is included in the cost of sales, there is of course some duplication of the separate adjustment for depreciation. It is not important, however. Even if all depreciation were so charged, it would make up only 5 or 6 percent of total inventory-consumption charges, and the maximum duplication would therefore be this percent of IVA, a relatively insignificant amount. Since the actual duplication is only a fraction of this, it can safely be disregarded.

Over the past nine years, 1970-78, adjusted retained earnings have been relatively small (averaging a little over $7 billion a year). Nonfinancial corporations have been distributing most of their adjusted earnings, the bulk of their reported savings representing the amount required to cover the understatement of costs.

Adjusted Profits and Retained Earnings in Constant Dollars

To make the horror story even worse, the dollar has been shrinking over the interval and it is necessary to adjust for this by stating the results in constant dollars. We use for this purpose the GNP deflator (1972 = 100).

Table 5

Adjusted Profits and Retained Earnings of Nonfinancial Corporations in 1972 Dollars
(Billions of Dollars)

	(1) Adjusted After-Tax Profits	(2) Adjusted Retained Earnings
1965	$ 52.3	$ 29.2
1966	54.3	30.7
1967	50.1	26.2
1968	46.6	21.6
1969	38.2	14.3
1970	26.4	4.7
1971	30.1	9.3
1972	38.5	16.8
1973	30.9	8.3
1974	14.5	-7.9
1975	28.6	6.2
1976	36.2	11.1
1977	38.8	11.2
1978	37.1	7.6

In constant dollars, the adjusted earnings of 1978 were only 71 percent of 1965. As for retained earnings, the comparison is even more dismal. Here the 1978 figure was only 26 percent as large.

IV. EFFECTIVE INCOME TAX RATES ON ADJUSTED PROFITS

Since the income tax liability (federal and state) is computed on overstated historical-cost profits it is obvious that the effective rate on profits adjusted for the overstatement is higher than the rate reported. The following table shows the difference.

Table 6

Effective Tax Rates on the Pre-Tax Profits of Nonfinancial Corporations as Reported and as Adjusted/a

	(1) On Profits As Reported (Percent)	(2) On Profits As Adjusted (Percent)
1965	42.2	41.1
1966	42.4	41.4
1967	42.4	41.2
1968	46.7	46.6
1969	48.7	50.2
1970	49.5	53.0
1971	47.2	50.9
1972	44.1	46.5
1973	42.7	54.8
1974	41.5	71.8
1975	40.1	52.7
1976	40.7	52.3
1977	41.1	51.8
1978	41.0	54.8

a/ Column (2) of Table 3 as percentage of Columns (1) and (5), respectively.

It is obvious at a glance that effective tax rates on real profits have moved away from those on reported profits. In 1974 the rate reached 72 percent. For 1978 it was 55 percent.

V. WHAT DOES IT MEAN?

It is clear that American business has not yet learned how to protect itself against inflation. Overall, it has been unable to maintain normal margins even in the overstated profits of conventional accounting. In terms of real profits, the shrinkage has been drastic./1

It is difficult in many situations to protect even nominal profit margins in the face of inflation. The difficulty arises when price-setting takes place in advance of cost incurment. Under prevailing practice this is a fairly common phenomenon. There may be long-term fixed-price sales contracts outstanding; catalogs may be issued only annually or semi-annually; seasonal merchandise may be priced months in advance of delivery; long-cycle production may be quoted before work is started; etc. Unless such

1/ See Corporate Earning Power in the Seventies: A Disaster, MAPI, August 1977.

advance pricing is based on the costs that will be incurred later (as distinguished from those prevailing at the time of quotation), even historical-cost profit margins will be squeezed.

Overall, however, the protection of nominal margins is a minor problem compared with the protection of real margins. The lead of price determination over cost incurment varies widely from one industry to another. In many it is negligible, in some even negative. But the lead of cost incurment over receipts from sales, though likewise variable, not only averages far longer, but is almost universal. Correction for both leads is accomplished by pricing on replacement costs anticipated as of the time of sale. This is done by basing prices and prospective profit margins on those costs.

It must be acknowledged of course that such a pricing policy may be impracticable for an individual company in a market where the competition is pricing on understated costs. The real remedy lies in the reform of policy across the board. If all competitors are targeting their prices on fully stated costs, there is a better chance that they can make them stick.

Let us add in closing that the present situation is bad not only for business, but for the nation as a whole. Despite the suspicion and disfavor that attach to profits in the eyes of many politicians and of a considerable part of the public, it is vital that they be large enough not only to motivate the expansion of productive investment, but to finance a substantial part of it. It is frightening from the public-policy standpoint that the reinvestment of corporate earnings, realistically measured, has become almost negligible. If this continues it will cost the country dearly.

Let us add further that the Alice-in-Wonderland accounting of costs and profits that now passes for orthodoxy is a problem not only for business management, but for the accounting profession, the regulatory agencies of the government, and, not least, for the tax authorities. It is high time for concerted action by all concerned.

It is gratifying in this connection that both the accounting profession and governments appear at last to be grappling with the problem. The Securities and Exchange Commission has required large companies to file supplemental statements on the current-cost inventory and fixed-asset consumption. There is much activity on the subject among accounting bodies here and abroad, and in several countries by government commissions.

These are first steps, to be sure, but we may hope that others will follow. We may hope also, and even more fervently, that the tax authorities will not be far behind. For the evils of undercosting are compounded by the present practice of taxing capital consumption as income. No reform of costing procedures can be more than partially successful so long as this practice continues./1

1/ See Inflation and the Taxation of Business Income, MAPI, January 1976.

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"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, and April 1978

"The Sad Story of Corporate Profits," by George Terborgh, March 1976

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Statement of the National Crushed Stone Association
On The
CAPITAL COST RECOVERY ACT OF 1979
Submitted To The
Senate Finance Committee

The National Crushed Stone Association (NCSA) is an international trade association representing companies which extract rock and process it into numerous crushed stone products and companies which supply the industry equipment and services. NCSA's membership accounts for approximately seventy percent of the construction aggregate production in the United States. In 1978 that production totalled 1.06 billion tons, valued at $2.82 billion--according to the U.S. Bureau of Mines' latest figures. Aggregates are one of the most basic building materials and are expected to be in demand at a rate of some two billion tons annually by the year 2000. Stone production is integral to the many industries which comprise the national construction economy.

Economic Assumptions

As the United States notes the 50th anniversary of the Wall Street Crash and the Great Depression, it is nothing less than prudent to take what lessons we can from that time. If we can learn nothing else from the Depression Era, we ought to realize that our economic problems today will not magically disappear, just as they did not disappear in 1929. The U.S. cannot "ride out" the current economic situation anymore than it could then.

The problem now is much different from the problem in the Depression Era. In 1929 the economy suffered from depression, whereas today it is suffering from inflation. The problem then was demand, or rather lack of demand and its consequence in depressed output. The problem today is certainly not demand, but rather a supply that cannot keep pace with demand and its consequence in inflation.

In 1929, clenching fists on government spending, raising taxes, and balancing the federal budget as quickly as possible were the keys in President Hoover's plan to dispell depression. Now in 1979, the Carter Administration and others in the Congress are advocating in effect the same approach to the battle against inflation. Yet working toward a balanced budget by cutting back government outlays and allowing taxes to rise--a de facto result of inflation--cannot in itself solve the inflation problem in our advanced, complex industrial society, anymore than such an economically orthodox approach was able to cure depression fifty years ago.

Indeed the most treacherous effect of the present call to tighten money and spending is that it represents a veil for massive, inflation-caused tax increases. Inflation cannot be used to fight inflation. That practice will only result in further eroding of productivity, investment, and overall industrial wealth. It will result in unemployment, depressed output, and reduced purchasing power--in recession.

Without question, a balanced budget is a necessary objective. But achieving that by deliberately slowing economic growth, or worse, by manipulating recession, won't cure the inflationary tendency of our modern economy. It will only stunt the growth of inflation to the same extent that it will thwart all other growth in the economy. And recession, used as a means to combat inflation, places the heaviest weight on those who are least able to bear it. Recession causes great misery and can only lead to further uncertainty about the national leadership and the stability of our economy and society.

NCSA holds the position that the supply side of the U.S. economy must be substantially shored up before the nation can begin to move effectively toward a balanced budget and a reasonable balance of trade payments. Greater efficiency and increased productivity, in line with national and international demand, are the keys to fighting inflation as well as to the renewel of stability and confidence in our social and economic

structures. It may be, as we all hope, that a depression like the Wall Street Crash of 1929 can never happen again. At the same time, however, it is important for governmental policy and action to acknowledge the fundamental similarities of depression and inflation: both are extreme economic conditions, manifestations of an inbalance between supply and demand in a free economy, and ultimately both can have the same radically adverse effects on the overall economy.

The present inadequacies on the supply side of the U.S. economy do not stem from a lack of "good old American know-how," as some commentators might suggest. To the contrary, the weakness of the supply side is the result of rising production costs and declining productivity. The American businessman simply cannot raise the capital he needs for new plants and equipment, to create new jobs, and to increase productivity. He is working with plants that need modernizing and equipment that needs replacing.

Yet he is faced with a "no-win" situation. Equity capital is not nearly as available to him as it once was. Interest rates on borrowed funds have increased to the extent that equity capital can no longer be relied on as a principal source of investment capital. Meanwhile, interest on bonds is barely sufficient to keep pace with run-away inflation. Industry, especially capital intensive industry, is unable to generate the necessary investment capital from profits. Inflation erodes the value of constant production, and inflation erodes the value of money returned on depreciation of investments. What's more, while the value of return on investment is decreasing, the cost of replacing worn out equipment is increasing.

Our antiquated depreciation system is overwhelmingly complex and slows return on investment to the point where real investment value cannot be reasonably recovered.

It makes investment planning all but impossible and, at bottom, strikes deep at business' primary source of investment capital. If left unchanged, this situation with investment depreciation will further weaken the supply side of the economy, resulting in even more inflation, less productivity, loss of jobs, and a lower standard of living.

Positive Effects of CCRA on the Crushed Stone Industry

The Capital Cost Recovery Act of 1979 (CCRA), H.R. 4646, is the most sound remedy that Congress has thus far offered for the capital formation and capital recovery crisis in American business today. The crushed stone industry is extremely capital intensive. Under current depreciation rules, there is a "useful life" for each piece of equipment that an operation owns. The CCRA would essentially place all that equipment under a single category--for quarrying operations, Class II of the CCRA--with a five-year write-off. This would greatly simplify record-keeping by eliminating the Asset Depreciation Range (ADR) and other complicated methods of calculating depreciation. In addition, the Capital Cost Recovery Allowance would help to eliminate the understatement of depreciation which is caused by the interaction of long write-off periods and inflation.

Current practice requires maintenance of detailed records of the ADR's multitude of asset categories and its variety of permitted "lives." This administrative complexity prevents many small operators from taking advantage of the ADR system, which might enable them to obtain a greater capital return from depreciation, and ties them to the "useful life" concept and straight-line depreciation.

Furthermore, the majority of the quarry operations in the nation's crushed stone industry are relatively small businesses. Some of them, in fact, are so-called

"mom and pop" operations. It is these small businesses in particular which suffer the greatest drain of capital, since they are neither able to generate large amounts of investment capital nor to avail themselves of the ADR system.

Virtually all assets in the crushed stone industry would fall under the CCRA's five-year life provision, which permits depreciation on property under construction. Such a provision is particularly necessary for the crushed stone industry because it would correlate the tax benefit of depreciation with the actual investment in tangible property whether or not the property is placed in service at the time of investment. The implications of eliminating the placed-in-service concept are important for the opening of new operations, especially where there may be a considerable time between investment in property and the actual placement of that property in service. Moreover, by eliminating the placed-in-service concept, the CCRA would bring depreciation rules in line with the "qualified progress expenditure" concept (January, 1975) of the investment credit law and the energy tax law.

The present concept of investment tax credit (ITC) recapture requires a businessman to pay back substantial dollars or, in some cases, all of the ITC, if he liquidates an asset prematurely. Under the CCRA proposal, however, a standardized table would be utilized to determine what percentage of the investment in an asset should be re-paid, based upon the actual time that asset was held. This provision would make it possible for businessmen to base their re-investment decisions on economic and market factors, rather than solely on tax considerations.

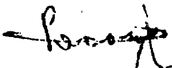
In the same sense, the CCRA's elimination of salvage value assumptions from depreciation calculations and its elimination of the guess work involved in the salvage

value concept would have important implications for the crushed stone industry, especially with respect to new investments and upgrading of existing property under CCRA Class III.

By simplifying record-keeping and administration, by reducing to three the number of depreciation categories, by making possible faster write-offs, by eliminating guess work and assumptions about useful life, placement in service, and salvage value of assets, the CCRA would make it possible for American businessmen to plan for, and on the basis of, recovery of investments. It is this essential ability to plan that facilitates the re-investment of capital and the decision-making involved in principal investments.

Finally, to the extent that a tax benefit would be received under the Capital Cost Recovery Allowance in excess of that available under current depreciation rules, the CCRA provides that the excess should be taxed as ordinary income on disposal of the property. But more importantly, NCSA believes that a substantial, long-term increase in capital investment and re-investment, and consequently a substantial increase in productivity, would be possible if the CCRA were enacted. Such economic vitality would be more than sufficient to maintain Treasury revenues and, by restoring the balance between supply and demand, would attack the very core of the economy's inflationary tendency. Without a doubt, enactment of the CCRA would help to restore the nation's economy to stability and would net national and international confidence in the U.S. economic system.

November 8, 1979



ALUMINUM COMPANY OF AMERICA
ALCOA BUILDING, PITTSBURGH, PENNSYLVANIA 15219
JAMES S. PASMAN, JR. Executive Vice President-Finance

1979 November 09

Senator Harry F. Byrd, Jr.
Chairman of the Subcommittee
on Taxation and Debt Management
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Byrd:

RE: S.1435 - CAPITAL COST RECOVERY ACT OF 1979

We believe that S.1435 - Capital Cost Recovery Act of 1979 ("10-5-3") is a reasonable approach by Congress to initiate changes in the depreciation area which would provide assistance toward solving the capital formation problems facing American business today.

This proposal realistically and effectively provides the mechanics to achieve the goals of capital formation, i.e. slowing inflation, increasing international competitiveness, providing energy independence, creating jobs in the private sector, providing adequate housing, and maintaining a high standard of living.

More specifically we see this system as highly flexible, and its simple uniform application is a much welcomed relief from the present costly burdensome reporting requirements of the Asset Depreciation Range Class Life System (ADR). We believe that this new approach for adequate depreciation will enable the business community to more readily adapt to changing situations and reduce the risk connected with recovery of investment. It should receive a larger usage than ADR and stimulate investment in productive facilities and in research and development which also leads to new, more efficient, equipment to further increase productivity.

With respect to Alcoa in particular and the aluminum industry in general the present depreciation system does not provide adequate capital for expansion purposes. For example Alcoa's capital spending projections for 1979 are about $400 million. Approximately 70% of this will have been expended for productivity, capacity sustaining and environmental programs with only 30% for the expansion of facilities. Because of the long lives associated with our industry and the exorbitant cost of new facilities, present depreciation methods only provide 20% to 25% of Alcoa's capital spending requirements.

Since aluminum is such an energy saving material its future demand will far outstrip production capabilities. Unless new incentives are provided to generate additional capital we fear aluminum imports will increase which effectively means exporting jobs and continuing inflation.

In summary we fully support S.1435 as a realistic method of capital recovery to replace our present outmoded system and respectfully request that this letter be made a part of a record of the hearings held by your committee on 1979 October 22.

Sincerely,

James S. Pasman, Jr.
Executive Vice President - Finance

JSP/cjb

FINANCIAL EXECUTIVES INSTITUTE
633 THIRD AVENUE, NEW YORK, N.Y. 10017 · 212 953-0500

November 6, 1979

Honorable Harry F. Byrd, Jr.
Chairman, Finance Subcommittee on
Taxation and Debt Management
United States Senate
Washington, D.C.

Dear Senator Byrd:

This letter is written in response to the invitation from your Committee to submit statements on S.1435, the Capital Cost Recovery Act of 1979, sponsored by Senators Nelson, Bentsen, Packwood and Chafee.

Financial Executives Institute represents 11,000 senior financial officers of both small and large businesses. We welcome this opportunity to express our strong support for this much needed legislation.

As you are well aware, current depreciation allowances for Federal income tax purposes are totally inadequate in an inflationary economy. Historical costs underestimate the true cost of replacing buildings, machinery and equipment which are used in production. This understatement of costs is converted into overstated taxable income, thus, artificially and substantially increasing the effective tax rate on corporate profits.

American business, therefore, is being taxed on "phantom" profits, with the result that badly needed funds for reinvestment in more productive plant and equipment are being drained away. The long-term result could be continuation of the decline

in United States productivity that has taken place in the last twelve years. This decline has played a large role in overall supply falling so far behind demand that inflation is the result.

We also view the shift from the current inadequate Asset Depreciation Range (ADR) system to the capital cost recovery system proposed in S.1435 as essential to maintaining the competitive position of U.S. business in an increasingly interdependent world economy. The United States has long lagged behind its industrial competitors in tax provisions that encourage capital formation rather than consumption. The time has come for the United States to reverse the order of its tax priorities and give higher priority to investment.

The Capital Cost Recovery Act of 1979 properly, in our view, provides for a gradual rather than an abrupt transfer from the present outmoded system. Moreover, there is a strong likelihood that the long-term impetus given to capital spending would, in turn, generate added revenues as the new system matures -- thus, offsetting much or all of any temporary revenue shortfall. For this reason, we believe that prompt passage of the Nelson bill would not be inconsistent with any short-term need for fiscal responsibility. In fact, prompt enactment would also be responsive to the long-term need for expanded and more efficient productive facilities to bring down the rate of inflation.

We very much appreciate your invitation to express our views

on S.1435. Attached for your further consideration is a more detailed statement of our position on this important legislation.

Respectfully submitted,

Donald K. Frick

Donald K. Frick
Chairman, Committee on Taxation
Financial Executives Institute

Att.
cc: Michael Stern, Staff Director
Senate Committee on Finance
(with 5 additional copies)

Committee on Finance - U.S. Senate
Hearings on Miscellaneous Tax Bills
by the
Finance Subcommittee on Taxation and Debt Management

Statement Submitted by
Financial Executives Institute
on
Capital Cost Recovery Act of 1979 (S.1435)

Introduction

Despite a large dollar investment in capital facilities by U.S. companies in recent years, the record shows that the rate of capital investment in the United States lags behind that of other major industrial countries. For example, Japan spends over 20 percent of its gross national product on capital investments and Germany over 15 percent, while in the United States the percentage has been running at only 10 to 11 percent.

Clearly, the United States cannot long maintain a position of leadership in the world economy when its rate of capital investment is so much lower than that of other competing countries. Reduced capital investments will inevitably lead to a lower level of productivity. This is borne out by data showing that the 2.6 percent average annual growth in productivity (output per hour) during the 1960 through 1977 period in the United States was less than in other major industrial countries - Canada, 4 percent; Japan, 8.8 percent; West Germany, 5.5. percent; and the United Kingdom, 3.4 percent. Further, since 1967, there has been a significant slowdown in the rate of U.S. economic growth. From 1967 through 1977, yearly productivity increases averaged only 1.6 percent, falling to 0.3 percent in 1978. During the first half of 1979, productivity in the private

sector actually decreased at an annual rate of 3.3 percent. These figures indicate that high productivity growth rates have a close correlation with high investment rates. They also underscore the vital importance of capital investment to economic growth. Given these circumstances, it is clear that U.S. economic policies must be reexamined to determine what is needed to stimulate the added investment required to raise U.S. productivity. Those industries which currently have high productivity because of high investment rates, should be encouraged to continue to invest, while those with lagging productivity should have an incentive and the means to increase their investments and productivity.

Increased Investment to Contain Inflation

There is no conflict between policies designed to restrain inflation and those intended to stimulate investment. On the contrary, the only long-term answer to inflation is increased production.

An increase in productive capacity is essential if we are to solve the present problem of high inflation and maintain an acceptable level of employment. To increase productive capacity, the tax system must provide improved incentives for capital investment. Under the existing tax depreciation rules, historical costs underestimate the true cost of replacing buildings, machinery and equipment that are used in production. As a result, part of what books show as net revenues subject to taxation represents the understatement of companies' costs. In this way, inflation converts understated capital costs into overstated taxable income, thus, artificially and substantially increasing the effective tax rate on corporate profits and reducing a principal source of capital funds

for new plant and equipment.

This position is supported by a recent study of the Joint Economic Committee of Congress which said:

> "To the extent that our tax system does not allow the depreciation allowance to cover the cost of replacing capital equipment at inflated prices, inflation will reduce the rate of return to investment and cause profits to be overstated and will, therefore, increase business tax liability."

Accordingly, one of the most significant areas where the Federal Government can play an important role in increasing private investment and reducing inflation is tax policy. The impact of Federal taxes must be taken into account in every business transaction -- particularly in the case of long-term capital spending programs whose economic feasibility hinges importantly on the after-tax rate of return.

Capital Cost Recovery Act of 1979

Senator Nelson, together with Senators Bentsen, Packwood and Chafee, recognized the need for a change in Federal Taxes to encourage investment. Accordingly, last June they introduced S.1435, entitled the Capital Cost Recovery Act of 1979. In recognition of the importance of this measure, S.1435 now has 36 senators as sponsors. A companion House bill, HR 4646, introduced by Representatives James R. Jones and Barber B. Conable of the Ways and Means Committee, now has about 250 sponsors from both parties. Accordingly, there is substantial Congressional support for the provisions of S.1435, the Capital Cost Recovery Act of 1979, now before this Subcommittee.

Financial Executives Institute Position

Financial Executives Institute has long urged Congress to change the tax laws to encourage rather than discourage investment.

Such a change is of particular importance today because existing tax depreciation allowances based on historical costs have been seriously eroded by inflation. Financial Executives Institute believes that the time has come to adopt a flexible capital cost recovery allowance system, since these depreciation charges based on historical cost have become so seriously eroded by inflation that they are inadequate to provide the funds required to replace existing assets. Several independent studies have been made which indicate a serious lag in depreciation for tax purposes which results in the taxation of so-called "phantom" profits, i.e., those representing earnings resulting from the understatement of real costs. However, S.1435, the Capital Cost Recovery Act, would provide for more rapid recovery of capital investment in buildings, plant and equipment by divorcing the capital recovery period from the concept of the useful life of assets. Under this system, business taxpayers could write off their capital costs over a short fixed period, such as five or ten years, using accelerated percentages within this period, while retaining the full investment credit. These shorter lives would tend to recognize current rapid changes in costs of fixed assets, much as LIFO accounting for tax purposes helps business keep more current with the rising costs of inventories in an inflationary period.

If S.1435 were enacted, both small and large business firms acquiring capital facilities after 1979 would benefit in two ways. First, the tax rules for a fast write-off of assets are spelled out simply in the bill -- a matter of great significance to small firms which are unable to cope with the complexities of current depreciation rules. Second, over a period of years, business tax liabilities in

relation to their output would be reduced, and, thus, funds would be released more quickly for reinvestment. As a result, real economic growth would be encouraged by stimulating investment in better, more efficient plant and capital equipment. In the long run, it would also create additional employment and make the U.S. more competitive in world markets. Also, this more simplified procedure for capital cost recovery, when compared to present depreciation methods, would relieve taxpayers and the Internal Revenue Service of administrative burdens.

Provisions of Nelson Bill (S.1435)

As introduced by Senator Nelson and others, the Capital Cost Recovery Act of 1979 would meet the objectives for a more rapid recovery of capital investment in productive assets. It would streamline and simplify the depreciation of commercial buildings, plants and capital equipment by replacing the current complex array of depreciation lifetime schedules with a standardized set of cost recovery rates for most capital assets.

Specifically, S.1435 provides that, beginning in 1980, all newly acquired or constructed depreciable assets will be divided into three major classes. Class 1 will cover retail, commercial and industrial structures -- these can be written off in 10 years, as against the much longer period of depreciation for such buildings now required. (Residential buildings will not be eligible for the 10-year life.) Class 2 assets will include tangible property, such as machinery and equipment, and will have a life for tax purposes of five years. Class 3 assets will be the first $100,000 annual investment in automobiles and light trucks for business use, which will have a

tax life of three years. To simplify taxpayers' calculations, within these 10-5-3-year asset class lives, depreciation will be taken on an accelerated basis according to a fixed annual percentage - thus, eliminating any controversy with the Internal Revenue Service as to the depreciation rate. All Class 1 and Class 2 property will be eligible for the full 10 percent investment tax credit, as long as the property is of a character currently eligible for the credit. Class 3 property will be eligible for a 6 percent investment tax credit.

Property will be eligible for depreciation and the investment tax credit when the taxpayer actually pays for the asset, or when the property is placed in service, whichever is earlier.

The proposal contains safeguards to prevent abuse. When a depreciated asset is sold, the previously depreciated amounts will be recaptured as ordinary income. Also, early disposal of an asset will trigger a partial recapture of the investment tax credit. Taxpayers will have the option to claim less than the full depreciation allowance permitted under the proposal and to carry forward the unused allowance to any future year.

The bill also contains a transition rule designed to phase in the new capital cost recovery system over a five-year period in an orderly manner, as a replacement for existing depreciation rules. Thus, the revenue loss in the first year might be as low as $5 billion, rising to possibly $30 billion in the fifth year, without taking into account revenues from increased business activity induced by the bill.

<u>Summary</u>

Financial Executives Institute believes that a substantially increased level of capital investment by business will be required

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over the next decade. This increased investment should be encouraged by making a shift from existing inadequate depreciation for tax purposes to a capital cost recovery system providing faster write-offs for investments in commercial buildings and plant and equipment, as provided in the Nelson bill, S.1435, before the Subcommittee. Action is needed now on this bill, which is both fiscally responsible through the five-year phase-in provision, and necessary as the beginning step to contain inflation through increased productivity.

STATEMENT OF EDISON ELECTRIC INSTITUTE WITH RESPECT TO S. 1435, THE CAPITAL COST RECOVERY ACT - SUBMITTED TO COMMITTEE ON FINANCE, UNITED STATES SENATE, SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

This statement is submitted by the Edison Electric Institute (EEI). EEI is the principal association of investor-owned electric power companies in the United States. Its members comprise 99 percent of the investor-owned segment of the industry and serve 77 percent of all electricity users in the country.

EEI and its member companies have consistently advocated tax legislation which would encourage and facilitate capital investment. Various bills that are currently under consideration, such as the Capital Cost Recovery Act (CCRA), have as their basic purpose the accomplishment of these laudable goals.

The testimony of Mr. Gordon R. Corey, then Vice-Chairman of Commonwealth Edison Company and Chairman of the Policy Committee on Cost of Money and Taxes of EEI, before the Committee on Ways and Means, United States House of Representatives, Subcommittee on Oversight, on March 28, 1979, portrays the enormous projected capital needs of the electric utility industry. His testimony provides that for the period 1978 through 1992:

> ". . . construction expenditures by the U.S. electric power industry, public and private, are estimated at $850 billion while the industry's new money needs will be in the $500 to $600 billion range. These average out to roughly twice current levels -- over $50 billion a year of new electric plant construction and $35 to $40 billion of new electric power industry financing annually. This suggests that the electric utilities will continue to be responsible for at least one-third of all business financing during the next decade and one-half, if they are to provide the expanded facilities needed to fuel our nation's economy and provide jobs and consumer products in the years ahead." Pg. 23 of written testimony.

CCRA provides for the rapid recovery of investment in productive assets and streamlines and simplifies the depreciation of plant and equipment. CCRA conceptually divorces the capital recovery period for tax purposes from the "useful life" of an asset. The problem of inadequate cash flow and the resulting impact on financing capital investment that CCRA is designed to alleviate are particularly acute for the electric utility industry, which is the most capital-intensive industry in our economy.

The electric utility industry supports CCRA. However, we strongly urge the following three modifications, which are essential if the intended results of CCRA are to be realized by our industry:

1. CCRA deductions should be available to electric utility companies only to the extent that utilization of investment tax credit is not diminished. In effect, investment tax credit would be used before the CCRA allowance.

2. If an electric utility company is precluded from the application of CCRA due to regulatory denial of normalization accounting, then depreciation deductions for tax purposes must be based on the lives and the methods used for ratemaking purposes.

3. CCRA deductions based on expenditures for construction work in progress (CWIP) should be available to electric utility companies only to the extent that such expenditures are included in the rate base for ratemaking purposes.

The first modification would amend CCRA to insure that the economic benefits of the investment tax credit will continue to be available to electric utilities and their customers. To the extent that the CCRA would provide capital cost recovery deductions which could reduce the effectiveness of the investment tax credit, we urge that the legislation be amended to provide that the investment tax credit must be fully utilized by an electric utility before deduction be permitted under CCRA. This is necessary to preclude imputations to electric utilities by regulatory agencies of capital cost recovery deductions which otherwise may result if CCRA as now drafted be enacted. If this modification were to be adopted, the revenue loss stemming from CCRA estimated by Treasury for the electric utility industry would be materially reduced.

The second modification provides an alternative deduction for electric utility companies that are denied

normalization accounting by their regulatory agency. Under CCRA, electric public utility property will be eligible for the recovery allowance only if a normalization method of accounting is used. No specific depreciation provisions cover the treatment of such property if a normalization method is not permitted by the regulatory agency. Because the class life asset depreciation range system of depreciation, commonly referred to as ADR, would no longer be available for additions to property accounts, tax lives for depreciation purposes necessarily would be determined on a facts and circumstances basis. This would impose on electric utility taxpayers and on the Internal Revenue Service burdens that both CCRA and ADR are intended to alleviate. By specifying that the lives and methods used for rate-making purposes be used also for tax purposes, our proposed amendment would reduce controversy between the Service and taxpayers relative to depreciable lives and would reduce uncertainty concerning the amount of income taxes properly includible in cost of service for ratemaking purposes.

Our final recommendation is that CCRA be amended to provide that the recovery allowance based on CWIP expenditures by electric public utility companies be available only to the extent that such expenditures are included in rate base for ratemaking purposes. In the majority of regulatory jurisdictions, CWIP is not included in the rate base. Inclusion of CWIP in the capital cost available for recovery under CCRA in instances where it is not included in rate base for ratemaking

purposes would create tax deductions which have no relationship to current revenue. Additionally, such tax deductions would create a tax normalization reserve which could be deducted from rate base for ratemaking purposes even though CWIP is not included in the rate base. This mismatching would result in actually decreasing current revenue and would be inconsistent with the objectives of CCRA. This possibility should be averted by a requirement that CWIP expenditures be recoverable capital costs during the construction period under CCRA only if they are included in the rate base for ratemaking purposes.

Our recommendation of these changes does not indicate any lack of enthusiasm for the concept of CCRA. CCRA in its present form is basically sound and would be instrumental in returning financial vitality to American industry. We support in particular the requirement of normalization accounting by regulated public utilities. We also strongly support the provision for unlimited carryover of unused CCRA deductions, which is particularly important for an industry such as ours that has a high ratio of capital investment to revenue. It is essential to the electric utility industry that both of these features of CCRA be retained.

Mandatory normalization for regulated companies places these entities on the same basis as that required by the accounting profession for non-regulated industries. Normalization, as previously recognized by the Congress in legislation

dealing with accelerated depreciation, is important because it protects the ratepayers' interests by insuring the proper allocation of tax benefits to the ratepayer using the utility service and by giving him the better and less costly service that a financially healthy utility company can provide. Normalization contributes to the financial health of a regulated utility by providing:

1. Improved debt coverage,
2. Improved quality of earnings,
3. Improved cash flow,
4. Reduced external capital requirements, and
5. Lower costs of financing.

These financial benefits have the ultimate effect of reducing cost of service and benefiting all ratepayers.

In conclusion, adoption of CCRA will be an important step in improving the overall financial condition of American industry. The investment stimulus from CCRA is needed and justifiable for business generally and specifically for the electric utility industry. The tax benefits from CCRA would be instrumental in providing more productive, efficient and reliable electric utility systems. Such benefits would clearly be meaningful to the electric utility industry and its customers.

STATEMENT OF

JEROME O. HENDRICKSON, PRESIDENT

THE VALVE MANUFACTURERS ASSOCIATION

McLEAN, VIRGINIA

Mr. Chairman:

I am Jerome O. Hendrickson, President of The Valve Manufacturers Association (VMA), which is headquartered in McLean, Virginia. The Valve Manufacturers Association includes 72 manufacturers accounting for 75 percent of the total United States industrial valve production.

VMA supports the passage of S. 1435, the Capital Cost Recovery Act of 1979. This legislation would replace existing depreciation schedules for business plant, equipment, and rolling stock, and substitute in its place a simplified system of rapid depreciation for such assets. The Bill has been referred to as the "10-5-3" proposal, providing a 10-year write-off for buildings, a 5-year write-off for equipment, and a 3-year write-off for a limited investment in cars and light trucks.

Last year the United States industrial valve industry recorded annual sales of $2 billion and employed over 50,000 people. It is estimated that an equal number are employed in supplying and supporting companies. In 1978, the industry had a return of 5.3 percent on sales and an 8.9 percent return on net worth.

One of the most serious problems facing our members is that of capital formation. Currently annual industry capital expenditures are $104 million, or 5.2 percent of sales. Since outside sources of capital are scarce, growth must be financed internally to a large extent. One way to facilitate this type of activity is by creating a capital cost recovery system which is fair, simple, and competitive with domestic and international competitors.

The present system is not equitable, requiring our industry to write off the original cost of its plant and equipment, on the average, over a period of twelve years. The need for effective capital cost recovery, however, extends well beyond our industry alone. The concept of "useful life" and the asset depreciation range (ADR) work to inhibit investment and capital formation in our nation as a whole. A continued low level of investment in this country has resulted in sagging productivity, sluggish production, and faltering competitiveness in world markets.

The Capital Cost Recovery Act of 1979 is designed to encourage real economic growth by stimulating investment in better, more efficient plant and equipment. By restructuring the method of depreciation to one which places emphasis on capital recovery instead of "useful life," this legislation, if enacted, will stimulate capital investment and make the United States more competitive in world markets. The Bill would also permit U.S. companies to "catch-up" with the more rapid depreciation rates already permitted in many other industrialized nations.

Accordingly, we of The Valve Manufacturers Association urge the Congress to act quickly to approve the Capital Cost Recovery Act of 1979. By encouraging further investment in modern plant and equipment, it will provide major benefits to the U.S. economy and to our industry.

STATEMENT OF THE ALLIANCE OF METALWORKING INDUSTRIES

This statement is submitted on behalf of the Alliance of Metalworking Industries (AMI), a national trade association, the members of which include the American Metal Stamping Association; National Tool, Die & Precision Machining Association; Forging Industry Association.; National Screw Machine Products Association; and Spring Manufacturers Institute. These five industries employ approximately 889,000 people in 18,900 manufacturing plants which register over $32.5 billion in sales annually. The average plant has forty-seven employees.

Although each of the five industries represented may be characterized as a "small business" industry, their total influence on the manufacturing economy is far-reaching.

Metalworking companies are typically independent, contract manufacturers of component parts produced to the specifications of the industrial customers. Some produce end products as well. But most are "sub-contractors" to an enormous variety of larger manufacturers who assemble and market the finished products.

Major customers include the aerospace, appliance, automotive, construction equipment, electronics, farm implements, nuclear and transportation industries.

As small businessmen we consider ourselves the most competitive and the most responsive element of the free enterprise system in the United States today. A majority of all employed Americans work in small companies such as ours. We are, therefore, eminently concerned not only with the development of new products but also with the growth of jobs in our industries. Whether we can continue to grow in these areas depends in no small part on the updating of tax code provisions to ease the burdens on small companies and to stimulate the small business economy.

AMI, as an alliance of five national trade associations, speaks in unison in support of the principle of accelerated depreciation, and we emphatically urge that capital cost recovery legislation be enacted in this Congress. We are greatly encouraged that committees in both legislative bodies are holding hearings and giving much-needed and most serious consideration to depreciation reform.

It is at least equally important that this Congress recognize the unified business voice in favor of the principle of accelerated depreciation as a stimulus to capital formation and renewed productivity in American business today. AMI joins that unified community of American business, both big and small, which espouses this principle as a means to achieve our common national goal.

AMI's present position has evolved from its continuing concern with the effect of American tax policy on American productivity. As the Congress has reviewed, and sought to reform, our numerous tax policies and provisions, AMI has attempted to apprise the committees of Congress of its perspective on these proposed reforms. In early 1978, for example, AMI's representative testified before the House Ways and Means Committee on the Administration's tax reform proposals. The evolution to our present position is clear from that testimony:

> AMI endorses the concept of simplified depreciation because the present provisions are inadequate, outmoded, and in great need of simplification and overhaul.

At the present time, small firms simply do not have the resources to make these provisions work for them. They cannot afford to employ the battery of accountants, attorneys, and tax consultants used by their larger competitors to take full advantage of what is available. ADR is used almost exclusively by large firms. For example, it is so complex that only two percent of the businesses with assets between $500,000 and 1 million dollars make use of it, while 63 percent of those with assets of over 1 billion dollars use it. Additionally, the Senate Small Business Committee has proposed an optional, simple straight-line depreciation system with shorter useful life for investments in new and used equipment and other small business interests have recommended an increase in the dollar amount of additional depreciation which may be taken in the first year of an asset's life.

On balance, however, what is even more important than the specific form of simplified depreciation provisions is that the Congress adopt a tax policy that encourages the replacement of obsolete and inefficient plants, machinery and equipment so that American enterprise will outproduce its rivals, continue to provide jobs, and maintain American leadership in the world marketplace.

At the present time, American business is at a distinct disadvantage with regard to replacing its obsolete machinery and equipment because most of the major industrialized nations offer capital cost recovery allowances superior to those provided in this country. Prompt capital recovery allowances should be designed to encourage modernization and expansion of productive facilities in order to make American industry fully competitive and capable of meeting the added demands of our economy.

Liberal capital cost allowances are especially important to small or new businesses which have difficulty in obtaining capital for long-lived property.

As targeted in this 1978 testimony, simplification of current useful life depreciation laws would be of prime importance to our small business members. Most small firms do not elect to write off their assets under the current Asset Depreciation Range system which was adopted in 1971. ADR contains approximately 130 guideline class lives for assets (excluding

most real property), and imposes a number of formal accounting and reporting requirements.

In the less than two-year period since our prior testimony, the Treasury Department has revised the statistics we cited by estimating 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. Therefore, any capital cost legislation should be simple for small businesses to use from the day of its enactment.

Whether or not American business can keep pace with the productivity gain of our foreign competitors will depend, in no small part, on this Congress' response to the pending legislation for capital cost recovery. We are encouraged by these early hearings on measures which were not even introduced until this past summer. We believe these hearings are indicative of the Congress' evolution of positions on economic issues. In the early 1970's (when ADR was enacted) the pending legislation would have died a slow death in committee. By 1978, however, real strides were made by the highly constructive Revenue Act of 1978, shifting emphasis from the demand side of the economic equation to the supply side by exploring incentives to work, save and invest. AMI was pleased to have been a small part of that evolutionary process and we are pleased to participate again at this point in time to take another step towards resolving our capital formation and productivity problems.

Clearly, some portion of the poor relative productivity performance of the U. S. economy can be attributed to technological catch-up by other countries; similarly, recent enhancements to the investment tax credit have somewhat improved the competitive position of U. S. businesses vis-a-vis their foreign counterparts. However, if the trends in productivity of recent

years should continue into the 1980s, output per worker in France, Germany, Japan, and Canada would all exceed that in the United States by 1985 or shortly thereafter. The most recent data on U. S. productivity growth do not dispel this outlook.

Despite a large dollar investment by U. S. companies in recent years, the United States is still lagging behind other major industrial countries, including West Germany, Japan, and Canada, in the rate of capital investment. The U. S. economy is suffering from spiraling inflation while the rate of capital formation and growth in productivity decline. However, the most important single cause of this productivity slowdown has been the weakness of business fixed investment over the past thirty years.

Many of our principal international competitors have stimulated capital investment and productivity increases by improving their capital recovery allowance systems. Our basic belief, too, is that a more realistic capital recovery policy will stimulate this nation, as it has these other aggressive industrial nations, to a higher level of capital investment and productivity to the benefit of small or large U. S. businesses and, indeed, to the benefit of all U. S. citizens.

STATEMENT OF DR. RUDOLPH OSWALD, DIRECTOR, DEPARTMENT OF RESEARCH AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS SUBMITTED TO THE SENATE FINANCE COMMITTEE, SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY ON THE "CAPITAL COST RECOVERY ACT OF 1979" S. 1435

November 16, 1979

The AFL-CIO is opposed to S. 1435 -- the 10/5/3 tax depreciation proposal.

The measure amounts to a rapid and arbitrary speed-up in depreciation write-offs. Huge revenue losses would result, the corporate contribution to the costs of government would be cut in half and the concept of business income for federal income tax purposes would be rendered meaningless.

In addition to shifting even more of the nation's tax burden away from business and the wealthy, the proposal would substantially distort and change relative tax burdens. Larger, more prosperous capital intensive firms would reap huge benefits while smaller, more labor intensive firms would benefit very little. Healthy, growing corporations would receive unnecessary bonanzas while the competitive position of marginal or faltering firms would be diminished.

As important, because of the across-the-board nature of the proposal, and the capricious manner in which the benefits would be distributed, huge amounts of foregone revenue would flow to corporations subsidizing investments that would take place anyway as well as providing added cash for speculative ventures, corporate takeovers, overseas activities and other investments which do nothing to enhance productivity, stem inflation or promote the national interest.

The bill's proponents correctly point to the critical importance of fighting inflation and heading off recession. Unfortunately, the diagnosis of the causes of the nation's economic problems is wrong and the policy prescription -- huge business tax giveaways -- would worsen the situation. Inflationary pressures would be exacerbated, progress toward economic stability and full employment would be thwarted and the nation's tax structure would become even more inequitable and perverse in its impact on the economy and on investment decision making.

According to the measure's supporters, improving productivity is the key to the nation's economic problems. The federal corporate income tax is considered a major deterrent to enhanced productivity because it over taxes corporate income and thereby discourages productive private investment in the future and encourages current consumer and government spending. The result is a bidding up of the prices of a constantly shrinking supply of goods and services and the answer according to this logic is simply cut corporate taxes. Corporate cash flow would be enhanced, capital investment will then increase, jobs will be created making plants more modern and more efficient, productivity will go up and prices will come down.

Unfortunately, the only certainty in that logic is that corporate cash flow will increase and federal tax revenues will diminish. How much of the additional cash flow will go to productive, economy building investment and how much of the tax cut will be used to buy up other companies, increase dividends, invest overseas, speculate, etc., will be determined behind the closed doors of corporate board rooms. While there is no way of estimating the results of these decisions, it is obvious that the leakage will be large.

We see no justification, particularly in this time of tight public budgets and widely proclaimed need for austerity and sacrifice, to capriciously throw as much as $50 billion a year in federal tax bonanzas to the nation's corporations and their stockholders in the hope that this largess will eventually trickle-down to workers and consumers in the form of jobs and reasonable prices.

The bill would replace the present system of tax depreciation -- generally based on the cost and useful life of the asset -- with an entirely new and dramatically accelerated system which destroys any linkage between the actual cost of

an asset and the annual depreciation-for-tax purposes write-off. By 1984, when its full effects would be felt, the revenue loss would be over $50 billion -- an amount equal to a corporate income tax cut of about 50 percent! Under the proposal, there would be only three classes of capital assets. The annual depreciation write-off would be the <u>same</u> for all items within the class regardless of useful life.

Specifically:

Class I -- Buildings and Structural Components would be written off in <u>10 years</u> -- presently depreciation lives' average 32.6 years.

Class II -- Machinery and Equipment would be written off in <u>5 years</u> -- present average 10.2 years.

Class III -- Auto and Light Duty Trucks -- <u>3 years</u> -- present average is <u>3.5 years</u>.

But even those drastically shortened lives tell only part of the story. In addition, the write-off schedule is so rapidly accelerated that, in the case of non-residential buildings, 70 percent of the cost would be written off in 5 years, and 76 percent of the cost of most machinery and equipment would be deducted in only 3 years.

The measure would also retain the present law "double-dip" which allows companies to ignore the effect of the 10 percent investment credit when calculating annual depreciation write-offs. Thus, a firm buying a piece of equipment which cost $100, receives a $10 dollar-for-dollar tax credit which cuts the actual cost of the equipment to only $90. Nevertheless, the corporation can still write-off the full $100 -- in effect deducting 111 percent of its cost.

Thus, under 10-5-3, a firm will be able to write-off <u>more</u> than the cost of the asset; do it in approximately half the normal time, <u>and</u> front load the deductions so much as to have 84 percent of the actual cost written off in only one-

third of the equipment's actual lifetime. In practice, the tax saving resulting from this proposal would be more valuable than the notorious "immediate expending" loophole available to the oil companies on certain types of drilling costs ventures.

Treasury Secretary Miller, in his October 22, 1979 statement before this committee, opposing the measure noted:

> "The present value of the tax saving from the combination of the investment credit and the accelerated deduction is greater than full, first-year write offs would be. The treatment of equipment under 10-5-3 would be better for the taxpayer than immediate expensing."

Technically, of course, depreciation speed-ups amount to a "deferral" of tax and not an avoidance since the deduction eventually runs out and taxes in later years are correspondingly higher. Thus, excess depreciation amounts to an interest-free loan.

However, since firms routinely and continually invest and reinvest, the "loan" is constantly recycled and never paid off and at prime rates of 15 percent, money doubles in only 5 years. As a result, "deferring" taxes for 5 years is equivalent to paying no taxes at all, and represents a clear-cut and substantial subsidy -- reducing the business' cost of purchasing equipment and increasing everyone else's tax burdens.

The interest free loan aspect plus the present 10 percent tax credit amounts to an interest free loan of 24 percent of the original cost of equipment with a 10 year service life and a 15 percent interest rate under existing law. The proposed five year depreciation schedule would double the interest free loan amount to 49 percent of the equipment's original cost.

This kind of tax proposal would add to the imbalances among industries in addition to an even more inequitable shift of the nation's tax burden away from corporations and onto individuals. Industries using more capital relative to labor would receive a greater tax subsidy. And industries using plants and equipment

with longer service lives would be given a greater advantage over those using shorter lived plants and equipment.

These imbalances are shown in the Treasury Department's estimates of the benefits for various industries. The estimate shows that more than 20 percent of the investment in public utilities would be paid for with the benefits from the proposal, just under 20 percent for the communications industry, 15 percent for primary metals, 8 percent for motor vehicles and 4 percent for the construction industry. Services, agriculture and wholesale and retail trade are among industries that would receive lower than average benefits.

The accelerated depreciation tax proposal would also greatly increase the use of tax shelters advantages. Much greater benefits would be received through leasing of machinery and equipment and investments in buildings as a tax shelter.

The benefits of the tax break would have no relationship to productivity performance or problems of industries.

Moreover there is no justification for any additions to corporate cash flow. Corporate profits have been booming and are still high despite the onset of recession.

Corporate profits as measured by the Commerce Department rose to an annual rate of $140.7 billion in the first half of 1979, more than double the 1975 level and more than triple the 1971 profit of $41.8 billion. Profits climbed 22.8 percent in the first half of 1979 over the same period last year while workers' buying power went down.

Business investment has been very strong showing no weakness in the last two or three years. Investment in non-residential plants and equipment was 10.4 percent of the nation's GNP in 1978, and 10.7 percent in the first nine months of 1979, a rate if continued that will exceed all but one of the last 30 years.

Investment in equipment alone is a better gauge of productive investment than equipment and structures because structures last longer and new equipment can increase output without enlarging the size of the plant. Investment in non-residential equipment in the first nine months of 1979 was 6.8 percent of GNP, the same as in 1978, a rate exceeded in only one of the past 30 years.

Investment for modernization of plants and equipment has not been a problem. Plants and equipment have become increasingly more modern since World War II. The average age of plants and equipment in U.S. manufacturing, according to the Commerce Department has fallen from 9.2 years in 1945 to 6.4 years in 1978, the lowest equipment -- excluding plants -- has varied between 4 and 5.3 years and now stands at 4.5 years. The average age of equipment does fall during times of expansion and rise during recessions. So it was at its lowest in the expansion of the 1940's and 1960's and fell again in the past three years during the recovery from the 1974-75 recession. The McGraw-Hill survey has also found U.S. plants and equipment to be quite modern. Durable goods manufacturers reported that 49 percent of their plants and equipment are less than five years old and non-durable manufacturers reported 39 percent of theirs to be that new.

The proposal to increase depreciation write-offs has been motivated in large part as a means to increase productivity. But it would be misguided to reduce business taxes in an attempt to increase productivity.

The major problem retarding productivity in the 1970's has been the severe recession and slow growth in demand. The unhealthy economic conditions of the 1970's are due primarily to the attempts to fight inflation with recession, high unemployment, and stringent monetary policies.

Productivity slows down during recessions as the following table illustrates:

PRODUCTIVITY CHANGES
PRIVATE BUSINESS ECONOMY
1948 - 1978

Year	Percentage Change in Output per Hour	Year	Percentage Change in Output per Hour
1948	+ 3.8%	1963	+ 3.8%
1949	+ 1.6 (recession)	1964	+ 4.0
1950	+ 7.9	1965	+ 3.8
1951	+ 2.8	1966	+ 3.2
1952	+ 2.4	1967	+ 2.0
1953	+ 3.5	1968	+ 3.3
1954	+ 1.6 (recession)	1969	+ 0.2 (recession)
1955	+ 4.1	1970	+ 0.7 (recession
1956	+ 1.3	1971	+ 3.4
1957	+ 2.8	1972	+ 3.5
1958	+ 2.5	1973	+ 1.9
1959	+ 3.2	1974	- 3.0 (recession)
1960	+ 1.6 (recession)	1975	+ 2.1
1961	+ 3.1	1976	+ 3.5
1962	+ 4.5	1977	+ 1.9
		1978	+ 0.5

A drop or slowdown in consumer demand leaves workers, plants and equipment idle. High overhead costs discourage the investment that can increase productivity. The slower operation of business slows down the introduction of new plants and equipment that embody the latest technology.

Although overall productivity measures show a slowdown, this is not true of the basic manufacturing sector. In fact, since manufactured goods make up a declining share of total output, there is a serious question about the validity of productivity measurement for the total private economy which also includes construction, finance, insurance, real estate and personal and business services.

The reliability of the productivity figures vary widely for different sectors of the economy. Manufacturing is one of the most reliable because there is normally an end product which can be counted or measured. In contrast, productivity measures are rather unreliable for services, construction, and finance, insurance and real estate. The measures for wholesale and retail trade are also less

reliable than for manufacturing. And those sectors in which the measures are less reliable are the big growth areas of the U.S. economy in recent years -- raising questions about the validity of overall U.S. productivity figures. The manufacturing sector, for instance, has declined, until today it accounts for only about 29 percent of the hours worked in the private U.S. economy.

The widely bemoaned "slowdown" in productivity for the 1970s may be largely, if not entirely, produced by the poor measurement of output for most sectors -- and the measurement of output is much more difficult during inflationary periods when the measure of output must be adjusted for price increases.

Manufacturing productivity increased 2.4 percent over the year ending in the first six months of 1979. For all of the 1970s, manufacturing productivity increased an average of 2.3 percent per year -- less than the 3.0 percent average of the 1960s, but almost the same as the 2.4 percent average yearly growth of the 1950s.

The respectable rate of manufacturing productivity growth during the 1970s came despite two back-to-back recessions and an underutilization of plants and equipment during most of the 1970s. The 1973-75 recession was so severe that it caused a 5.2 percent drop in productivity, the largest drop for any year since World War II. The recession of 1970 also caused a drop in productivity.

The decade of the 1950s also had two recessions, but neither was as severe as the 1973-75 recession. The decade of the 1960s was a long period of continuous expansion of output with only a slight slowing of growth in 1967.

Plants, equipment and manpower were seriously underutilized during the 1970s and this lessened the need for expansion, thereby slowing productivity growth. Plant and equipment utilization in manufacturing average only 81 percent in the 1970s compared to 85 percent in the 1960s and 84 percent of the 1950s.

So the recessions and low utilization rates of the 1970s make it remarkable that productivity growth in manufacturing did as well then as in the 1950s. And considering the marked difference in the economic climate, it is even more remarkable that the 1970s growth rate came so close to that of the 1960s.

In the private business sector of the U.S. economy and in the manufacturing sector, productivity growth has been as follows:

Year	Private Business Sector	Manufacturing Sector
1970	0.7%	- .4%
1971	3.4	5.4
1972	3.4	5.1
1973	1.9	2.7
1974	-3.0	-5.2
1975	2.1	4.9
1976	3.5	4.4
1977	1.9	3.1
1978	0.5	0.6
1979 (first half)	-0.2	2.4

The productivity of American workers is still higher than the productivity of workers in other industrial nations. And unit labor costs in the U.S.A. have gone up much less than unit labor costs in other nations.

The American worker produces 24 percent more than the German worker and 32 percent more than the Japanese worker, according to a study by the Dresdner Bank. And from 1967 to 1977, unit labor costs went up much more slowly in the U.S.A. than in such other major industrial nations as England, France, Sweden, Italy, Germany and Japan.

The AFL-CIO supports maintaining and improving our Nation's productivity performance. We recognize that there may be problems in particular areas. However, we are convinced that such problems will not be solved through huge across-the-board business tax giveaways and huge treasury revenue losses. We, therefore, urge rejection of S. 1435.

Productivity Growth by Industry[1]

1949-1977

	Percent Change Per Year		
	1949-59	1959-69	1969-77
Manufacturing	2.4%	3.0%	2.3% (includes 1978)
Transportation	2.9	3.6	2.3
Communication	4.8	5.0	6.2
Agriculture	6.2	5.5	4.9
Electric Gas and Sanitary Services	6.6	4.7	1.7
Services	1.3	1.9	1.2*
Finance, Insurance and Real Estate	1.6	1.2	1.2*
Retail Trade	1.8	3.0	1.3
Construction	3.0	1.9	-1.9*
Mining	4.1	4.3	-3.2
Total Private Business	3.2	3.0	1.6

[1]Data for manufacturing and agriculture are from yearly indexes. All others are from least squares trend lines.

*BLS does not consider these data to be of sufficient quality to be published separately. The data are released only as a means to aid in understanding the movements in productivity measures.

Source: Bureau of Labor Statistics

CHANGES IN UNIT LABOR COSTS
1967-1978
U.S. AND MAJOR INDUSTRIAL NATIONS

Country	Percentage Increase in Unit Labor Costs	
	National Currency Basis	U.S. Dollar Basis
United States	79.9	79.9
Canada	85.7	75.8
Japan	137.1	312.0
Belgium	66.3 (1977)	130.6 (1977)
Denmark	95.7	148.1
France	123.1	143.9
Germany	80.2	258.3
Italy	267.7	170.4
Netherlands	83.1 (1977)	168.7 (1977)
Sweden	143.4	178.2
United Kingdom	257.0	149.0

Source: U.S. Department of Labor, BLS Press Release

Robert N. Flint
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November 14, 1979

The Honorable Harry F. Byrd, Jr.
Chairman, Subcommittee on Taxation and Debt Management Generally
Committee on Finance
United States Senate
Washington, D.C.

Dear Mr. Chairman:

This statement is submitted on behalf of the American Telephone and Telegraph Company and the associated companies of the Bell System, which are listed on the attachment.

We appreciate the opportunity to comment to this Subcommittee on the proposed Capital Cost Recovery Act (CCRA). Most economists today recognize that an increased supply of capital is needed to modernize and refurbish the nation's industrial plant. Such an increase in capital formation would go a long way toward resolving many economic problems now facing the nation. For example, an increase in capital investment would be a major factor in helping to reverse the decline in productivity we have witnessed in the economy as a whole. This decline has been a contributing factor in the upward spiral of inflation. Real increases in wages for American workers can only be generated by increased business productivity, which in turn requires increased capital investment.

Although there are many reasons contributing to the erosion of our capital base, Federal tax policy is certainly an important factor to be considered in the formulation of a policy to encourage savings and investment. Under current tax policy the corporate income tax acts as an investment disincentive. One of the principal disincentives of the tax under current economic conditions is the long period of time over which taxpayers are required to depreciate their property for tax purposes. I would like to illustrate this point with reference to some Bell System statistics.

The communications industry generally is extremely capital intensive. It requires approximately $2.60 of invested capital to produce $1.00 of annual revenue, compared with $.50 of required capital in the case of manufacturing

corporations. During the decade of the 1970s, the Bell System will have invested over $102 billion in new construction - over $40 billion will have occurred over the last three years alone. Our plant investment per telephone was $801 at the end of 1978 compared with $494 ten years earlier. This massive capital spending has been necessary for two primary reasons:

1. To serve the needs of our customers. Bell System telephones in service during this decade have increased from 93 million at the start of 1970 to an estimated 138 million at the end of 1979. We have had to provide for this growth in business and also have made large investments in new telecommunications technology, which have required heavy capital investment on our part.

2. Inflation has driven up the cost of the equipment needed to provide effective telecommunication services. Although we have experienced some measure of inflation in the past, nothing in recent history has compared with the 13% inflation rate we are now experiencing.

Federal income tax law generally allows taxpayers to depreciate the cost of fixed assets over their estimated useful lives. While this has been viewed historically as an accurate reflection of true net income, the high rate of inflation during recent years has distorted depreciation allowances based on useful lives and historical cost. This result is reached because one effect of inflation is to increase the replacement costs of assets well above the depreciation provisions which are made for them. While the introduction of accelerated depreciation in the 1954 Internal Revenue Code was an improvement over the straight-line depreciation prevalent prior to that period, and the introduction of the ADR system in 1971 also helped, these have been insufficient in the face of the persistent high inflation. As an example, even under the liberalized lives of the ADR system, the average tax life of telephone plant (excluding buildings) is about 13 years. Since tax depreciation is based upon historical costs, inflation works to deprive the taxpayer of a true recovery of the cost of his invested capital, because the dollar deducted for depreciation expense 13 years hence is worth considerably less than the dollar of capital invested today.

The Capital Cost Recovery Act would significantly alleviate the problems I have outlined above. By greatly shortening the period over which the taxpayer is allowed to recover his fixed investments, the impact of inflation on this recovery will be greatly diminished. Along with the continuance of the 10% investment tax credit, this measure would significantly reduce the adverse impact of the Federal corporate income tax on capital formation. The Bell System fully supports the adoption of the Capital Cost Recovery Act. The adoption of this act would provide the Bell System and industry in general with increased amounts of internally generated funds available for productive investment.

Some concern has been expressed that the benefits of CCRA would not be directed toward those industries with low productivity records, which industries are presumably most in need of additional capital formation. It has been suggested that the communications industry in particular would be a major beneficiary of CCRA while that same industry already has a high productivity rate.

While it is true that the communications industry has been a leader in productivity, that high rate of productivity is attributable to technological advances which have been made possible by large capital investment in the past.

For example, in recent years the Bell System has initiated a number of innovative projects which have directly led to productivity improvements. Among these are:

- The replacement of electromechanical switching equipment with newer electronic switching systems (ESS), providing faster, more trouble-free telephone service;

- Installation of Common Channel Interoffice Signalling, which, together with ESS, enables long-distance calls to go through in less time than was previously possible;

- Integration of satellite circuits with microwave radio and coaxial cable circuits;

- Electronic Tandem Switching for business customers, which automatically chooses the most economical communications path among the various communications services a customer may have.

Future improvements in productivity likewise will require large commitments of capital. CCRA would play a major role in helping us secure that capital. Two attractive features of CCRA are its simplicity and effectiveness in aiding capital formation. For these aims to be realized, it is essential that CCRA be applied evenhandedly to all industry groups.

In closing I would like to emphasize the importance of one provision of the proposed Act. This is the provision requiring normalization of the tax effect of the CCRA deduction in the case of public utilities. Without such a provision, many regulatory commissions would be inclined to flow through the entire tax deferral in the form of lower rates. Thus it would provide no capital relief to the utility company.

Normalization of the difference between tax and book depreciation is required for most public utilities under current law. Only by continuing the requirement for normalization can CCRA fulfill its objective of aiding capital formation in the case of public utilities. The company will obtain the use of funds to aid in its continuing construction programs while the customer will benefit by the interest-free capital thus provided and by the productivity improvements brought about by the added capital investment. In the absence of

the capital provided by CCRA, the resultant difficulty in financing could mean that construction needed to modernize service might be delayed or not undertaken at all, thus harming productivity and efficiency of service. The capital which was raised would have to come from the capital markets at a high cost, which would be passed along to customers.

In sum, we believe S. 1435 would make a positive contribution toward meeting the problem of capital formation in the American economy and strongly urge its enactment.

[signature]

ATTACHMENT

BELL SYSTEM COMPANIES

American Telephone and Telegraph Company
The Bell Telephone Company of Pennsylvania
The Diamond State Telephone Company
Bell Telephone Laboratories, Incorporated
The Chesapeake and Potomac Telephone Company
The Chesapeake and Potomac Telephone Company of Maryland
The Chesapeake and Potomac Telephone Company of Virginia
The Chesapeake and Potomac Telephone Company of West Virginia
Cincinnati Bell, Inc.
Illinois Bell Telephone Company
Indiana Bell Telephone Company, Incorporated
Michigan Bell Telephone Company
The Mountain States Telephone and Telegraph Company
New England Telephone and Telegraph Company
New Jersey Bell Telephone Company
New York Telephone Company
Northwestern Bell Telephone Company
The Ohio Bell Telephone Company
Pacific Northwest Bell Telephone Company
The Pacific Telephone and Telegraph Company
and Bell Telephone Company of Nevada
South Central Bell Telephone Company
Southern Bell Telephone and Telegraph Company
The Southern New England Telephone Company
Southwestern Bell Telephone Company
Western Electric Company, Incorporated
Wisconsin Telephone Company

STATEMENT OF
THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA
TO THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
SENATE FINANCE COMMITTEE
U.S. SENATE
NOVEMBER 16, 1979
ON THE TOPIC OF
S. 1435, THE CAPITAL COST RECOVERY ACT OF 1979

The Associated General Contractors of America (AGC) represents more than 30,000 firms including 8,000 of America's leading general contracting companies which are responsible for the employment of more than 3,500,000 employees. These member contractors perform more than 80% of America's contract construction of commercial buildings, highways, industrial and municipal-utility facilities. We appreciate this opportunity to submit written testimony regarding the important issue of capital formation generally, and The Capital Cost Recovery Act of 1979, specifically.

The Associated General Contractors of America strongly supports S. 1435, known as The Capital Cost Recovery Act of 1979, and wishes to commend Senators Bentsen, Packwood and Nelson for their creative and imaginative efforts in dealing with America's lagging productivity, high unemployment rates and unacceptably high inflation rate. AGC firmly believes that The Capital Cost Recovery Act of 1979, if enacted, would be a major step toward overcoming these obstacles to a healthy American economy and would greatly help this country regain its once-held productive and economic superiority in the world.

For many years now, our nation's tax laws have encouraged consumption and seriously discouraged saving and investment. Nowhere is this fact more evident than in the area of capital formation. Consider depreciation as an example. Under present depreciation tax laws, the owner of a productive asset, such as plant, equipment or machinery, is allowed to deduct from his tax liability a percentage of the value of that asset until it is worn out. At the end of that time, the asset will presumably be worthless and the owner will have to replace it with a new asset. The theory behind allowing the owner to deduct a percentage of his asset's value over its "life-time" is that the money he saves in reduced taxes will supposedly enable him to purchase a new asset when his old one wears out. In practice, however, the tax savings realized under current law are so inadequate that there is little or no incentive for a business to replace its outmoded plant, machinery and equipment with new assets even though those new assets could greatly increase the productivity of that business' employees. The reason for this inadequate cost recovery is two-fold. First, because of inflation, the money a business receives back in tax deductions is worth less and less in real terms each year. Second, by the time a business has recovered the cost of its investment through depreciation, the replacement equipment it must buy invariably costs far more -- sometimes two to three times more -- again due to inflation. Therefore, depreciation under current law has proved to be an inefficient capital cost recovery tool.

Another capital recovery tool which also proves inadequate under current law is the 10% investment tax credit. Simply stated, it allows the owner of eligible property to reduce his tax liability by an amount equal to 10% of the cost of his capital asset if he holds that asset for at least 7 years. If he keeps it for 5 to 6 years, then he only qualifies for 2/3 of the 10% investment tax credit and if he holds the asset for 3 to 4 years, he is entitled to just 1/3 of the 10% investment tax credit.

The problem with this arrangement is that in order to qualify for the full 10% investment tax credit, a businessman must declare that the "useful life" of his asset is at least 7 years, even though in reality, it may be only 5 years. On the other hand, if he declares that the "useful life" of his asset is 5 years for depreciation purposes, he will automatically lose the full benefit of the investment tax credit. So, the businessman is either forced to choose the full investment tax credit and give up quick depreciation of his asset or opt for more rapid depreciation at the expense of losing the full investment tax credit. To say the least, this conflict greatly minimizes the potential for capital cost recovery.

The Capital Cost Recovery Act of 1979 would eliminate this conflict and would provide many positive investment incentives. But in the meantime, the construction industry has been, and continues to be

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seriously affected by the inadequacy of the present tax laws to promote capital formation. As the Honorable William G. Miller, Secretary of the Treasury, pointed out in his testimony before the Senate Subcommittee on Taxation and Debt Management on October 22, 1979, "... the construction industries have suffered declines in productivity in absolute terms since the late sixties, particularly over the most recent years." AGC believes that much of this decline has resulted from past and current tax laws which have inhibited investment and capital formation. In fact, many experts believe that the current tax laws have created a highly unfavorable investment climate for business in general throughout this country. This, in turn, has contributed to the steady decline in American productivity to the point that this nation now ranks seventh among its trading partners in productivity, non-residential business investment and economic growth. Japan, West Germany, Italy, France, Canada and the United Kingdom are all ahead of the United States in these areas notwithstanding the fact that America led all of them just a few short years ago. Of course, as business and industry have produced less and less over the years due to outdated, aging equipment and machinery, they have been forced to reduce the number of jobs they are able to provide America's work force so that unemployment has risen to unacceptably high levels. At the same time, demand has increased for the smaller number of goods and services available, so that inflation has skyrocketed to incredible double-digit rates.

The greatest cause for concern, however, may be that at this point there seems to be no end in sight to this nation's economic problems unless strong, remedial action is taken immediately. The Associated General Contractors of America firmly believes that The Capital Cost Recovery Act of 1979 (S. 1435) begins to provide such action for the following reasons, to mention only a few:

1) It would accelerate the depreciation of various productive assets thereby enabling business to recover its capital costs in such a way as to permit reinvestment in new, more productive capital assets even in times of high inflation;

2) It would eliminate the impractical and complicated "useful life" concept and Accelerated Depreciation Range (ADR) system and replace them with simplified schedules which all businesses, large and small, could understand and use;

3) S. 1435 would eliminate the "facts and circumstances" test of current depreciation laws which gives rise to uncertainty among taxpayers and replace it with simplified tables that would add certainty to the tax laws for large and small businesses alike;

4) The Capital Cost Recovery Act of 1979 treats the

investment tax credit as an issue separate and apart from the depreciation issue. Therefore, enjoying the benefits of one does not require sacrificing the advantages of the other;

5) Although S. 1435 would cause an initial revenue loss to the Treasury, it is fully expected that investments in capital assets induced by this legislation will raise the nation's productivity. This, in turn, will create new jobs, supply will rise to meet demand and inflation will be curbed. The resulting tax revenues from increased employment will minimize, if not negate, the revenue impact of this proposal.

AGC has carefully studied each provision of S. 1435 and supports every section with only one exception. Namely, we believe the $100,000 limitation on Class III assets should be eliminated. Our chief concern is that once a business has purchased $100,000 worth of light trucks or passenger cars, any truck or car it purchases thereafter is automatically removed from Class III and included with Class II assets so that it becomes subject to 5-year depreciation rather than the quicker 3-year depreciation it would have enjoyed had it remained in Class III. In addition, that truck or car purchased after the $100,000 limitation has been reached is eligible for a one hundred percent (100%) investment tax credit in Class II as compared to the sixty percent (60%) investment tax credit it would have

received had it remained in Class III. We feel that placing similar or identical assets in two separate categories in this manner will create costly and unnecessary administrative and recordkeeping problems, particularly for larger firms that may purchase Class III assets well in excess of the $100,000 limitation. A simple example of two light trucks -- one in Class III and the other in Class II -- each with different depreciation periods and each with different investment tax credit percentages illustrates the point that there really is no sound basis for treating the two identical assets differently. AGC favors the elimination of the $100,000 limitation so that these assets may be treated the same.

Once again, the Associated General Contractors of America wishes to express its appreciation for this opportunity to submit written testimony on capital formation, which is one of the most important issues in the nation today. AGC strongly urges Congress to enact S. 1435, The Capital Cost Recovery Act of 1979, because it would be a major step toward rebuilding this country's capital assets and increasing its productivity and competitiveness in the world.

CHEMICAL MANUFACTURERS ASSOCIATION

November 16, 1979

The Honorable Harry F. Byrd, Jr.
Chairman
Subcommittee on Taxation
and Debt Management Generally
Committee on Finance
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

This statement is submitted on behalf of the Chemical Manufacturers Association (CMA) in connection with hearings held by your Subcommittee on October 22, 1979 with respect to S. 1435, the "Capital Cost Recovery Act of 1979". CMA is a non-profit trade association having 189 United States company members representing more than 90 percent of the production capacity of basic industrial chemicals within this country.

The Capital Cost Recovery Act is a critical part of a long range plan for stemming the tide of inflation by increasing productivity and economic growth. To reach this objective the legislation proposes, in recognition of the impact of the tax system on the growth of capital formation, that accelerated capital recovery deductions be computed without regard to the depreciation-useful life principle, thereby allowing more rapid recovery of capital investments. CMA strongly supports this approach to bolstering our economy.

Effect of an Expanded Industrial Capacity on Inflation

Inflation is generally regarded as the number one threat to our economic stability and well-being. Conventional wisdom calls for combatting inflation by dampening demand. Unfortunately, such a policy can have the short-term effect of fostering a recession. Such a recession is often fought through tax cuts and increased Federal spending, each of which serves to spur demand, perhaps again to inflationary levels. Thus, the foregoing approach is of doubtful utility.

It is, accordingly, time to reorient our thinking. Remedies must focus less on the demand side of the economy where adjustments seem to produce short term cures at best. Instead, emphasis must be shifted to the supply side. By stimulating investment we can increase productivity and economic growth, which will mean more goods produced more cheaply. It will also mean real, not inflationary,

Formerly Manufacturing Chemists Association—Serving the Chemical Industry Since 1872.

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wage increases. Simply put, with greater productivity and growth, a stronger economy can be created in which everybody can benefit. One major benefit is that the lowered cost of goods can be readily translated into increased competitiveness in, and a resultant larger share of, world markets. This, in turn, would mean a diminished trade deficit, which is again counter-inflationary. And, of course, an integral part of the above scenario is increased employment.

Trends in the American Economy

Thirty years ago the American economy was first among industrial nations in Gross National Product, per capita income, and productivity. Today, while we remain preeminent in GNP, our margin has slimmed. In per capita income we have fallen to eighth. And in basic overall productivity (a crucial inverse determinant of inflation), although still first, we have slipped dramatically. This last result stems from our rate of productivity growth decreasing steadily to the point that our average productivity increase over the five-year period 1974-1978 was less than one percent. (Economic Report of the President, 1979, Department of Labor, Bureau of Labor Statistics.)

An often-cited but, regrettably, not yet heeded, Department of Treasury study reveals that from 1960 to 1973 the average annual productivity growth rate of the United States was the lowest of seven major industrial nations, behind even the United Kingdom. In fixed investment as a percentage of GNP over the same period, we also lag behind the United Kingdom:

Real Non-Residential Fixed Investment as a Percent of Real Gross Domestic Product, 1966-1976

Country	% of gross domestic product
Japan	26.4
West Germany	17.4
Canada	17.2
France (1970-1975)	16.7
United Kingdom	14.9
United States	13.5

Source: Economic Report of the President, 1979, Organization for Economic Cooperation and Development

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These figures explain the drop in industrial growth and productivity. Without increased investment there can be no modernization and expansion of plant and equipment; absent that, workers simply cannot be more productive.

Capital Spending by the U.S. Chemical Industry

The U.S. chemical industry has been near the lead among the nation's industries in capital spending. This reflects the basic capital intensive nature of the industry. The estimated chemical industry spending of $8.3 billion for 1979 will be 10.7% of that estimated for all manufacturers. The average annual increase in chemical industry capital expenditures for the ten years 1968-1978 was 9.9%. Although 1978 expenditures were up only 4.0% over 1977, the 1979 estimate indicates a rebound of 17% over 1978.

The foregoing is shown by the following table:

New Plant and Equipment Expenditures

(billions of dollars)

	1977	1978	1979*
Petroleum	$13.87	$15.50	$16.70
Chemicals	6.83	7.10	8.30
Transportation Equipment	5.32	6.40	7.74
Machinery, Non-Electrical	5.76	6.29	7.51

*Estimated

However, the sharp inflation rate in construction costs has significantly decreased real plant and equipment expenditures of the chemical industry, specifically, and the nation, generally. If the above expenditures are adjusted for this factor, they reflect either little real growth or a decline in capital additions:

	1977	1978*	1979*
Petroleum	$13.87	$13.81	$13.33
Chemicals	6.83	6.32	6.62
Transportation Equipment	5.32	5.70	6.18
Machinery, Non-Electrical	5.76	5.60	5.99

*1978 and 1979 figures have been reduced to 1977 dollars by use of the Department of Commerce Composite Construction Index.

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Moreover, it must be remembered that real expenditures on plant and equipment do not necessarily increase productive capacity. For example, the decrease in real expenditures by the chemical industry since 1977 is even more severe than at first indicated by virtue of the following expenditures for facilities constructed to satisfy pollution control requirements:

Chemical Industry Spending on New Plant and Equipment for Pollution Abatement (millions of dollars)

	1977	1978	1979*
Air	$249	$236	$232
Water	414	286	298
Solid Waste	38	42	50
TOTAL	$701	$565	$580
All Plant and Equipment	$6,830	$7,100	$8,300
% Spent on Pollution Abatement	10.3%	8.0%	7.0%

*Estimated

The portion of spending shown above for pollution abatement has adverse repercussions beyond reducing investments in productive new plant. For one thing, the installation of such equipment must be preceded by costly research efforts to achieve new technology. Furthermore, the operating costs of pollution abatement equipment, in addition to capital and research costs, inevitably add significantly to the consumer's product cost.

CMA believes that a strong American economy represents the only proper response to these problems. To achieve that strength, we believe emphasis must now be placed on increasing the productive capacity and, as a result, the productivity of industry.

The Need for Depreciation Reform

At present, as in the past, tax policy in many ways discourages capital investment, with a resulting adverse effect on the supply and cost of products. We believe that reform of the existing depreciation laws is one of the most significant steps that can be taken to redress this problem. Such a policy, when combined with

continued investment credits at at least the prevailing rate, should directly encourage investment in capital goods. Moreover, the burdensome administrative costs associated with the current useful life/salvage value approach would be eliminated under a simplified capital cost recovery scheme. Lastly, the approach is one which would benefit all sectors of the business community.

As the members of this committee well know, tax depreciation is the system by which the cost of business investments is deducted over time from gross income. The amount which can be deducted in a given year is largely based upon the complex and antiquated useful life concept, which results in deductions stretching out over substantial periods of time. As a result, the cost of capital is raised significantly, particularly for capital intensive industries. Deductions for depreciation spread out over a lengthy period of time mean higher total interest charges or foregone earnings on unrecovered capital. Furthermore, these essentially frozen capital dollars mean less new investment in technology and plant, and the capital which finally is recovered is actually worth less due to the eroding effect of inflation. That is to say, the prevailing depreciation concept not only raises the cost of capital and frees less of it for new investment but, combined with inflation, it also decreases the value of recovered dollars. Thus, fewer new assets are purchased. And this means less growth, less productivity, fewer new jobs -- and more inflation.

In addition, current depreciation law results in countless disputes with the Internal Revenue Service. The Asset Depreciation Range (ADR) has permitted some taxpayers a faster recovery of capital investments than was previously available. However, all business taxpayers, whether utilizing ADR or not, are faced with a maze of regulations and complications concerning depreciation. And, the Internal Revenue Service spends too much time resolving disputes and wrestling with interpretations of depreciation rules. These transaction costs are more than a nuisance. They are expensive, and the American people are forced to foot the bill both through higher taxes and higher-priced goods.

Furthermore, the economic impediments caused by existing depreciation laws are not peculiar to any particular segment of American enterprise. All business suffers from those anachronistic laws. All business needs relief.

Investment credits and capital recovery allowances strongly affect capital investment decisions; however, international comparisons of these items alone do not adequately show the competitive shortfall of United States policy toward capital investment. Other major factors include the availability of extended or low cost financing, captive domestic markets, special treatment of exports,

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and favorable tax treatment of personal income from investments. The United States lags seriously behind in all these respects: United States government-backed financing is minimal; the government does not protect local monopolies; export incentives are modest; and personal taxes on investment income are close to confiscatory.

It follows that there is need for United States policy on investment credits and capital recovery to be more than competitive. Actually, it is quite pedestrian. Our investment credits of 10% on equipment (but not buildings) are at the low end of the basic range of 7% to 20% of project capital offered by other industrial nations with relatively open borders. Furthermore, most other nations offer regular or negotiated extra credits in special situations.

United States depreciation on most industrial equipment is limited to a modified, but unindexed, double declining balance schedule, which places this country at the low end of the scale among industrialized nations. While Japanese and West German schedules appear slightly less favorable, they are actually close in value, if not better, when the lesser rates of inflation in those countries are taken into account. At the other end of the spectrum, the United Kingdom and Canada allow one and two year write-offs, while most other European countries not only offer faster statutory capital recovery than the United States, but in addition, some will negotiate special, more rapid write-offs.

Improved capital recovery allowances are virtually certain to have a positive effect on U.S. exports. The resultant improved capital formation will increase manufacturing capacity and efficiency. Thus, more capacity will be available for exports on a more competitive basis. Although no recent definitive study has been published relating export growth to capital formation, there is historical evidence that they go hand in hand. Those industrial countries showing superior growth in manufacturing exports since 1961, i.e., Austria, France, Japan, and Spain, all had high rates of capital formation. Conversely, the laggards in manufacturing export growth, i.e., the United States and the United Kingdom, also lagged in capital formation.

CMA recognizes that the notion that capital assets should be depreciated for tax purposes as real economic depreciation occurs is the foundation of the existing system. This is consistent with the view of many tax theorists who assert the so-called "income" theory that depreciation is a device by which to reflect net income accurately. We choose not to debate that point, but rather to suggest that when American productivity is lagging as at present, to the serious detriment of the American people, the time for slavish adherence to purist theory has long since passed. Congress has on many prior occasions utilized our tax laws to further certain public policy objectives.

We believe that none of those circumstances was any more compelling than that addressed herein.

For all of the foregoing reasons, CMA feels that some form of capital cost recovery system should be the mainspring of the effort to remove the bias against investment from our system of taxation. On the general level it will stimulate investment, supply and exports. It will also afford sorely needed simplification to one of the more mystical areas of our Federal income tax system, thereby benefitting the entire business community and, accordingly, the consenting public.

The Capital Cost Recovery Act

The Capital Cost Recovery Act, first and foremost, would scrap the useful life concept. Capital investments would be recovered rapidly, in accelerated fashion, on the basis of tables describing maximum percentage deductions in a given year. The number of years allowed for full recovery varies with the type of asset. For example, the time limit is 10 years for structures, 3 years for autos and trucks (not to exceed a capital cost of $100,000), and 5 years for all other machinery and equipment. The full 10% investment credit is maintained for 10-year and 5-year assets, while a 6% credit is afforded to 3-year assets. The salvage value concept, like useful life, would be eliminated. The system expands the qualified progress expenditure concept by permitting cost recovery to commence either as costs are paid or as an asset is placed in service, whichever is earlier. Finally, to ease the revenue impact on government, the system would be instituted over a period of years.

This different approach can provide a myriad of benefits. Because capital is recovered so simply and so rapidly, capital investments would become more attractive. As a consequence, the system should result in capital being more readily available for investment. Moreover, the toll taken by inflation on essentially frozen assets would be significantly lessened. Most importantly, rapid capital recovery would work to draw the newly freed, valuable capital into more capital investments, since the present value cost thereof would be decreased.

Although basically the same amount is deducted under either the useful life of capital recovery concept, the more rapidly recovered investment is less expensive in present value terms. The stream of tax deductions has a discounted present value which represents the current sum total of the tax benefits. Obviously, if a business can recover its costs more rapidly, the present value of the tax benefits is greater, and the cost of capital is thereby decreased.

This analysis, of course, assumes, consistent with the approach taken in the Capital Cost Recovery Act, that the existing rate of investment credit will be retained. If the objective of increased

productivity is to be achieved, it is imperative that any efforts to reduce the amount of such credit, or to otherwise blunt the beneficial impact of the Capital Cost Recovery Act through so-called tradeoffs, be resisted.

CMA is cognizant of the concerns of Congress with regard to the Federal tax revenue cost of a capital recovery system such as that under discussion. Those econometric studies thus far done indicate that the impact on Federal tax receipts could be quite large if the program is considered in isolation from its effects on the economy. However, it would be anomalous to consider this proposal on such a static basis when the very reason for such a program is its expected beneficial impact on the economy. When considered on a so-called "feedback" basis, those studies show that the higher GNP induced by the Capital Cost Recovery Act would produce substantial offsetting Federal tax revenues. Moreover, in its 1979 report the Joint Economic Committee concluded that per dollar of revenue loss, liberalization of depreciation allowances would be the most effective stimulant of investment.

Conclusion

Investment patterns are strongly influenced by the cost of capital. As the cost decreases, capital investment increases. Under a capital recovery approach this increased investment would be recovered quickly, and would likely then be reinvested. The result is increased capital formation with all its tangible benefits, the ultimate one of which is a strong, vital and competitive American economy.

Accelerated and simplified capital cost recovery is the best way to stimulate investment and capital formation so as to decrease our trade deficit, increase productivity, create jobs, and as a result, fight inflation. The Chemical Manufacturers Association strongly urges Congress to pursue this approach and enact a capital cost recovery bill such as S. 1435.

Sincerely,

Robert A. Roland
President

STATEMENT SUBMITTED BY

THE PUBLIC BROADCASTING SERVICE

The Public Broadcasting Service (PBS) is pleased to submit this statement in support of S. 1078, the "Artists Tax Equity Act of 1979."

PBS is a private, nonprofit membership organization, owned and governed by 155 independent local public television licensees which operate stations serving 281 communities throughout the United States, Puerto Rico, the Virgin Islands, Guam and American Samoa. PBS distributes approximately 2,000 original hours of television programming per year and provides a variety of support services to its members. Local stations use this programming at their discretion, in combination with local productions and acquisitions, as part of their effort to be responsive to locally-ascertained needs and interests. It is with these community interests in mind that we express our support for S. 1078, and for its potential to help public television stations increase their unique services to their local communities.

As its name implies, S. 1078 would extend tax equity to artists. We believe that artists, like all taxpayers, are entitled to equitable tax treatment. But more importantly, we believe it is appropriate and fitting for the creative elements of our society to be specially fostered by the federal tax structure. By alleviating unfair treatment of artists under current tax laws, S. 1078 would have the desired effect of spurring creative endeavor

within this country, thus contributing to the aesthetic enrichment of us all. Artworks would become increasingly available to the community, leading to an increased sharing of culture and ideas among the various elements of our society. The public television system has been involved in bringing art to the community in the past, and we believe that with favorable consideration of S. 1078, public television stations may play an even greater role in this vital creative exchange.

We are primarily concerned with Section 3 of S. 1078, which would provide a tax credit of 30 percent of the fair market value of artworks to artists who contribute their works to charitable organizations. Until 1969, artists were able to deduct 100% of the fair market value of their donated works from their annual income taxes. Tax changes made during that year, however, limited deductions of this type to only the cost of materials used in the production of the artwork. If this usually negligible deduction were to be expanded to a 30 percent credit of the fair market value, as proposed in S. 1078, artists donating their works to charitable organizations would have restored to them the freedom to make donations without suffering punitive tax losses.

Already, a law passed in California in October 1979 allows a California artist who derives a specified proportion of his

annual income from his artistic creations to deduct the full fair market value of works he contributes to charitable organizations. It is expected that this state law will not only encourage more California artists to participate in public television auctions, but will strengthen the ties between all of California's charitable organizations and the artistic community.

At the federal level, a variety of groups have testified before this Subcommittee about the need for this type of legislation. Like these groups, the public television community could be affected by the way which S. 1078 addresses one of the unique financial dilemmas involved in the taxation of an artist's work. The third section of this legislation, which allows a tax credit for donation of artworks, would affect public television fundraising auctions which depend in part on donations from artists living and working in the community.

Approximately 25 percent of the public television system's non-federal income (which totaled $333.5 million in 1978) is derived from individual stations' on-air fundraising efforts. A portion of this non-federal income is derived from money raised by public television stations when they auction to their viewers artworks which have been donated to them by local artists. Donations of original artworks have been a long-standing source of

income for many of the 76 public television stations that conducted auctions in 1979. These auctions serve as an important outlet for artists who wish to have their works exhibited and sold to benefit their local public television stations.

Moreover, the auctioning of the works of local artists constitutes an important service to the local community. Artists may become better known because of their exposure during a public television auction, resulting in new sales for them and an increased awareness within the community of local art, ideas and heritage. In this way, the art auction benefits not only the public television station, permitting it to provide more and better programming, but also members of the local public.

The irony of the current tax situation is that as an artist becomes more recognized and starts to derive increased income from his work, the tax situation becomes more restrictive. Anyone else donating works of art to a charitable organization may deduct the full fair market value of his donation, yet artists may only deduct the cost of materials. The successful artist, who may be trying to live off the income generated from the sale of his works, is faced with the problem of wanting to donate a work to a nonprofit organization but being unable to afford the tax consequences of his generosity.

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Although some artists have contributed regularly, public television stations are experiencing increased complaints from those who are withholding their donations because of the unfavorable tax situation. This appears to be particularly true of those artists for whom sales of artworks is a primary source of income. Statements such as the following from member stations are becomming commonplace:

-- "One-third of the artists would donate more pieces if tax laws were changed." WTVP/Peoria, IL.

-- "Many donations have been withdrawn when artists are informed of the tax situation." WNET/New York, NY.

-- "Because of the current tax situation...we get very little support from the artists in the community. Of about 400 contacts, we receive 125 donations." KEDT/Corpus Christi, TX.

This pattern manifests itself at both large and small public television stations. WVPT/Harrisonburg, VA reports that only 23 percent of the local working artists participated in the station's 1979 auction. WNED/Buffalo, NY raised $7,552 from the donation of 107 pieces of original art from 80 local artists. But the station heard comments such as the following from a Buffalo artist who decided not to participate in the auction:

> "Many artists who are relatively unknown, and even those with established reputations, are lucky if they break even, much less make a living by their labors. Why should they give away a work, thereby possibly jeopardizing a sale, ... if they can only deduct as a gift materials and framing?"

Boycotts aimed at highlighting the unfavorable tax situation have been held, or narrowly averted, in several public television communities over the past few years. The final result is too often the loss of works of numerous talented artists who decide not to participate in the auction because it is simply not financially wise for them to donate their works. We believe that this is a loss, not only to the public television stations involved, but also to the community at large.

Public television has always felt that one of its responsibilities was to encourage the creative sharing of ideas and culture within the community. The art auctions held by public television stations are a part of this creative exchange. The current tax situation, however, discourages the sharing of artworks with the public and, in the case of public television stations, hampers local fundraising efforts. We believe that S. 1078 would help alleviate this problem and we respectfully recommend that the Subcommittee approve this legislation.

Statement of the
Air Transport Association of America
Submitted to the Subcommittee on Taxation and Debt Management
on Income Tax Proposals

The Air Transport Association of America represents virtually all of the scheduled airlines of the United States. These privately-owned airline companies make up the highly essential U.S. domestic and international air transportation system. The airline industry, which is a major 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, employment and productivity.

To maintain a modern air transportation system, the airline industry must commit to a multi-billion dollar capital investment in the years immediately ahead. Unfortunately, today, serious concern exists about the industry's 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 17.4 percent over 1977. Some 279 million passengers relied on the airlines for business and personal travel in 1978, accounting for more than 84 percent of all public inter-city passenger miles. The airlines also flew a

record 5.7 billion ton miles of air freight service. The airline industry employs more than 325,000 workers and operates approximately 2,300 aircraft which, together with supporting facilities and ground equipment, represents an investment of about $25 billion.

Total airline industry operating revenues in 1978 were approximately $23 billion and the industry reported earnings of $1.2 billion, a profit margin of 5.2%. However, in the face of skyrocketing fuel costs and a declining growth rate of traffic, the industry's earnings for the first nine months of 1979 fell $580 billion below those recorded in 1978. In addition, low profit margins and huge investment needs continue to present significant airline capital formation problems.

Prior to 1979, the airlines significantly 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 1.0 percent for the rest of the business sector of the economy. This high level of industry productivity improvement was in large part due to the tremendous capital investment made by the airlines in new aircraft technological development. It remains apparent that any substantial future productivity improvements are dependent on increased investment in new technology or equipment.

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 historical 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 $10 billion during the 1960's and an estimated $17 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 transportation, it is estimated that the airlines will require $90 billion in capital for aircraft acquisitions between 1979-1989. This is considered 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 for the airlines 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 S. 1435, the "Capital Cost Recovery Act of 1979", which is now before the Subcommittee.

The 10-5-3 Solution

Inherent in S. 1435 are two basic and essential benefits. First, it simplifies the existing depreciation system and second, it significantly shortens the allowable capital recovery period. There is no question that our capital recovery system should be changed. Our current system is unnecessarily complex and burdensome particularly for small businesses.

Consequently, even though they may be eligible for more rapid capital recovery, most small businesses utilize the standard 10 year straight line method of depreciation. Small businessmen cannot contend with the Asset Depreciation Range (ADR) system, which identifies 132 asset classes in 107 pages of regulations. Hence, less than 1 percent of the nation's businesses use the ADR system. The straight forward classifications embodied in the 10-5-3 proposal will eliminate this complexity and confusion by finally dispensing with the "useful life" concept for depreciation.

The bill would allow businesses to depreciate investments in structures over 10 years, equipment and machinery over five years

and vehicles over 3 years. The move to a more simplified method has evolved over several years and the 10-5-3 proposal is the natural culmination of these efforts.

The second benefit and perhaps the most overriding benefit is the shorter capital recovery periods. For years, the United States has neglected its capital investments, while other nations recognized the need for such expenditures and allowed rapid recovery--1 year in Great Britain and 2 years in Canada. Hence, our economy has moved along relying upon its aging industrial infrastructure.

Faced with rampant inflation, and one of the longest capital recovery periods of any industrial nation, there was little incentive to invest in the plant and machinery necessary to offset the staggering rate of inflation, the rising balance of trade deficits and the continuing decline of the dollar. Without cost recovery reform, there was no reason to invest in the equipment which produces increased productivity and increased jobs. Consequently, the growth of U.S. productivity has languished in this environment of impoverished capital recovery.

According to the President's Council of Economic Advisers, between 1948 and 1965 U.S. productivity growth in the private nonfarm sector averaged 2.6 percent per year. From 1965 to 1973, this rate declined to 2.0 percent, and since 1973 productivity growth has averaged less than one percent per year. In 1979, productivity has actually fallen. A major factor in this slowdown has been inadequate private investment.

The more rapid capital cost recovery under the "10-5-3" system will raise the rate of return on investment in fixed assets and encourage more capital formation. With more capital in place, American workers will become more productive, the standard of living in this country will rise, American business will become more competitive in world markets and the soaring inflation rate will be abated.

The Capital Cost Recovery Act of 1979 will streamline and simplify the depreciation of buildings and equipment, by divorcing the recovery period for capital assets from the concept of useful lives and by assigning assets to three classes for amortization over 10, 5, or 3 year periods. This 10-5-3 proposal will provide more rapid capital recovery, and will substantially reduce the burden and expense of tax compliance by eliminating many complex provisions of existing law.

Investment Tax Credit Improvements

While S. 1435 proposes improvements in the Investment Tax Credit Program, such as shorter lives and simplification, one other aspect needs to be considered. Under present tax law the Investment Credit is not as effective as it should be for many small businesses or businesses in the early years of their development. Additionally, all business enterprises during periods of low earnings and high

investment do not benefit to the maximum extent from the Credit. The airlines believe that the Investment Tax Credit Program should be improved in such a way that it is available to all businesses making qualified investments.

Conclusion

The airline industry endorsed The Capital Recovery Act of 1979 realizing full well that it is not a short run solution to a temporary problem, but rather a long term solution to a long ignored problem. With the adoption of S. 1435, the nation can expect increased capital investment, increased productivity and increased jobs.

The time for capital recovery reform is now. Simplification is long overdue and the ADR System has outlived its useful life. Consequently, the airline industry urges the Senate to act quickly and approve The Capital Recovery Act of 1979 so that the benefits to the economy and productivity of the nation will not be postponed.

OWENS-ILLINOIS

Jerome A. Bohland
Vice President-Finance

November 14, 1979

Chairman,
Subcommittee on Taxation and Debt Management
Senate Finance Committee
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Attention: Mr. Michael Stern
Staff Director
Senate Committee on Finance

Statement in Support of Capital Cost Recovery Act of 1979
S. 1435, H.R. 4646

Dear Chairman Harry F. Byrd, Jr. and
Members of the Subcommittee:

Owens-Illinois, Inc. is one of the world's leading and most diversified manufacturers of packaging products. The company produces a broad range of products including glass containers, corrugated boxes, metal and plastic containers, glass tableware and disposable paper products. With annual sales over $3.1 billion, Owens-Illinois, Inc. ranks 93rd on the list of Fortune 500 companies.

Domestically, Owens-Illinois operates more than 100 manufacturing and related facilities in 28 states and employs more than 50,000 persons. In addition, Owens-Illinois, Inc. operates over 85 plants overseas, employing over 33,000 persons in 22 countries.

Approval of the Capital Cost Recovery Act of 1979 would provide needed capital investment in U.S. productive facilities. This would increase American jobs, improve America's ability to compete in the world, and help to control inflation.

Post Office Box 1035 Toledo, Ohio 43666 (419) 247-1181

Chairman,
Subcommittee on Taxation and Debt Management
Page 2
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We ask you to vote in favor for these reasons:

1. The U.S. presently has the lowest rate of capital investment in business enterprises and the lowest rate of growth in labor productivity among the industrial nations of the world. U.S. capital investment in business averaged 13.5% for the years 1966-76 compared to 26.4% for Japan, the leader. (Table 1.)

   In 1979, Owens-Illinois invested $140 million in productive facilities in the U.S. and $90 million overseas, a total of $230 million.

   For 1980 and in the future, its expected investment in U.S. manufacturing facilities will decrease substantially unless an improvement in return on new capital investment can be obtained.

   Owens-Illinois has a substantial number of attractive capital investments that might be made, if tax benefits for new capital investments were improved.

2. The U.S. economy is experiencing serious inflation, which is eroding the rate of capital formation. Inflation is causing business profits to be overstated in computing taxable income.

   Present U.S. tax depreciation is based on historical cost. It was not designed for an inflationary economy. Tax depreciation does not provide sufficient deductions to recover replacement costs. Table 2 indicates that tax depreciation is lagging current cost of replacement by 20%.

Chairman,
Subcommittee on Taxation and Debt Management
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November 14, 1979

The Act would be a step toward adjusting depreciation rates for cost distortions caused by inflation.

3. Over the past 10 years, expenditures for research and development in the U.S. have declined, except in the area of Government sponsored space programs.

   The Act will encourage more research and development expenditures. Better tax benefits for new plants and new equipment will, in turn, encourage more research and development programs in the United States.

4. The 10-5-3 principle for capital cost recovery is an administrative improvement over ADR tax depreciation methods. It will be easier to compute and easier for the Government to audit.

5. The 5 year phase-in period gives adequate protection against serious disruptions in Federal Government tax revenues.

History shows that tax improvements in capital cost recovery, including improvements in investment tax credits, have achieved hoped for economic goals. Capital investments, jobs and labor productivity increased within a relatively short period after new tax benefits were granted.

We believe economic growth and strength is a most important need in America today. The Capital Cost Recovery Act of 1979 will help greatly to achieve this goal.

Very truly yours,

Jerome A. Bohland
Vice President, Finance

nb
Attachments

Table 1

Ratios of Business Capital Investment to Gross Domestic Product and Growth Rates of Labor Productivity

	Investment Ratio[a]		Average Annual Percent Change in Productivity[b]			
	Percent	Rank	1967-72	Rank	1972-77	Rank
Japan	26.4%	1	9.2%	1	3.5%	1
West Germany	17.4	2	4.8	3	3.5	1
France (1970-75)	16.7	4	5.0	2	1.0	4
Canada	17.2	3	4.5	4	3.1	3
U.K	14.9	5	2.8	5	0.8	5
U.S.	13.5	6	1.1	6	0.6	6

Notes

(a) Measured as real nonresidential fixed investment as a percent of real gross domestic product, 1966-76.

(b) Measured by growth in real domestic product per employed civilian, using own country's price weights.

Source: Economic Report of the President, 1979 and Joint Economic Report, 1979.

11/8/79

Table 2

Nonfinancial Corporations
Excess of Current-Cost DDB over Income Tax Depreciation

1965-1978

	(Billions of Dollars)		
	Current Cost DDB(a) (1)	Income Tax Depreciation(b) (2)	Excess of (1) over (2) (3)
1965	$ 35.7	$ 36.4	$ -0.7
1966	39.6	39.5	-0.1
1967	44.2	42.9	1.3
1968	48.5	46.7	1.8
1969	53.8	51.3	2.5
1970	59.5	54.6	4.9
1971	64.5	58.7	5.8
1972	68.8	65.3	3.5
1973	75.7	70.5	5.2
1974	89.3	77.8	11.5
1975	105.8	85.0	20.8
1976	115.1	92.3	22.8
1977	124.7	100.8	23.9
1978	137.0	108.8	28.2

Notes:

(a) Estimated, 75% of Bulletin F lives.

(b) Estimate of depreciation allowed for Federal income tax purposes.

Source: Department of Commerce.

11/8/79

THE AUTOMOTIVE WAREHOUSE DISTRIBUTORS ASSOCIATION, INC. / 1719 WEST 91ST PLACE / KANSAS CITY, MISSOURI 64114 / (816) 444-3500

OFFICERS

DIRECTORS

November 16, 1979

The Honorable Harry F. Byrd, Jr.
Chairman, Taxation Subcommittee
Senate Finance Committee
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Byrd:

The Automotive Warehouse Distributors Association, a trade association composed of 631 warehouse distribution outlets and 246 manufacturer affiliate members engaged in the manufacture and distribution of automotive parts and accessories in the aftermarket, has been following the Capital Cost Recovery Act with keen interest. Since your Subcommittee has just finished a round of hearings on S. 1435, we thought it an appropriate time to let you know what the passage of this legislation would do for our industry.

Traditionally, warehouse distributors buy replacement parts from independent manufacturers and resell the parts to jobbers and wholesalers. Warehousing is an extra link in the distribution chain resulting from the explosion of part numbers and vehicle model proliferation since World War II. In order to prosper, the WD of the future will have to become a large parts distribution center.

But at the very time when WDs need to finance the expansion of their businesses, debilitating inflation has squeezed WDs between higher costs of doing business and interest rates unimaginable just a short time ago. Continued inflation can only make the situation worse for WDs, many of whom run relatively small, family-owned operations.

It is for these reasons that AWDA supports the Capital Cost Recovery Act. Accelerating depreciation on buildings, equipment and vehicles will assist WDs in their struggle to meet new competition and to cope with inflation.

Our 33rd Year!

The Honorable Harry F. Byrd, Jr.
Page 2
November 16, 1979

I might add that the bill would make the tax laws easier to administer by doing away with the confusing and much litigated concept of "useful life" for certain assets.

Thank you for your consideration.

For the Pursuit of Excellence,

MARTIN FROMM
President

MF:gs

STATEMENT

OF THE

ROCHESTER TAX COUNCIL

BEFORE THE

UNITED STATES SENATE COMMITTEE ON FINANCE

TAXATION AND DEBT MANAGEMENT SUBCOMMITTEE

WITH RESPECT TO

S. 1435

The Rochester Tax Council was formed in 1969 as a voluntary organization of companies having strong affiliations with the Rochester, New York, area. The Council membership includes:

- Bausch & Lomb, Inc.
- Champion Products, Inc.
- Corning Glass Works
- Gannett Co., Inc.
- Garlock Inc.
- Gleason Works
- Eastman Kodak Company
- The R. T. French Co.
- Schlegel Corporation
- Security New York State Corp.
- Sybron Corporation
- Xerox Corporation

The members of the Council are engaged in manufacturing and other business activities, most of which are in a wide variety of high technology fields. While these companies have substantial facilities in the Rochester, New York, area, they also have major facilities in over half the states in the United States. Most members of the Council have substantial investments in depreciable property.

The Council strongly urges the passage of S. 1435, the "Capital Cost Recovery Act of 1979." The decade of the 1970's has witnessed an unprecedented decline in the productivity of American business and its consequent ability to compete in world markets. To a large extent, this is the result of an unbalanced federal tax structure which has been emphasizing wealth redistribution and encouraging consumption at the expense of efficiency and savings. The results are today plainly evident in a 13% annual inflation rate and the erosion of American business preeminence.

One of the principal problems faced by American business is the need to generate funds to replace capital assets in a highly inflationary economy. Modern plant and equipment is a sine qua non in enabling domestic business to compete with their foreign counterparts and the United States lags far behind the rest of the developed world in providing the tax climate that will not only encourage modernization but will allow the accumulation of funds to facilitate it.

The enactment of S. 1435 will be instrumental in making available to American business the funds needed to secure the capital improvements so essential to regaining the American competitive position in the world. In addition, the funds generated over the coming years by the faster recovery of capital outlays permitted by S. 1435 will stimulate the expansion of research

and development activities which are an essential compliment to plant modernization.

S. 1435 is not simply a tax reduction program for business. Data Resources, Inc., a Cambridge, Massachusetts research firm which has extensively analyzed the economics of S. 1435, has projected that its passage will generate 1.2 million new jobs in the next five years. S. 1435 thus has the dual attribute of being anti-inflationary by stimulating greater productivity while at the same time being anti-recessionary in generating new jobs.

While there are other business tax reduction proposals under various stages of consideration, the Council believes that S. 1435 is the broadest base proposal available. It will be of great assistance to small business as well as large, and to both incorporated and unincorporated companies. Passage of this legislation is an important signal to the business community that the United States Government is committed to efficiency and greater productivity; to a healthy American business environment which will enable domestic companies to once again compete successfully in world markets.

Stockholders of America, inc.

INVESTORS IN AMERICA

THE VOICE OF 25 MILLION

1625 EYE STREET, N.W. WASHINGTON, D. C. 20006 (202) 783-3430

STATEMENT FOR

THE SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT
OF THE
SENATE COMMITTEE ON FINANCE

96TH CONGRESS

ON

S. 1435

CAPITAL COST RECOVERY ACT OF 1979

BY

MARGARET COX SULLIVAN
PRESIDENT
STOCKHOLDERS OF AMERICA, INC.
WASHINGTON DC

NOVEMBER 20, 1979

A NATIONAL NON-PROFIT NON-PARTISAN ORGANIZATION
ESTABLISHED 1972

MR. CHAIRMAN AND MEMBERS OF THIS DISTINGUISHED COMMITTEE:

I WANT TO THANK YOU FOR THE OPPORTUNITY AND THE PRIVILEGE OF EXPRESSING THE VIEWS OF STOCKHOLDERS OF AMERICA, INC. IN SUPPORT OF THE CAPITAL COST RECOVERY ACT OF 1979 (S. 1435). THIS LEGISLATION WOULD AMEND THE INTERNAL REVENUE CODE OF 1954 TO PROVIDE A SYSTEM OF ACCELERATED CAPITAL RECOVERY FOR INVESTMENT IN PLANT AND EQUIPMENT, ENCOURAGE ECONOMIC GROWTH AND MODERNIZATION THROUGH INCREASED CAPITAL INVESTMENT, AND EXPAND EMPLOYMENT OPPORTUNITIES.

MY NAME IS MARGARET COX SULLIVAN AND I AM PRESIDENT OF THIS SEVEN-YEAR OLD NATIONAL, NONPROFIT, NONPARTISAN ORGANIZATION DEDICATED TO REPRESENTING THE INTERESTS OF THE 25 MILLION STOCKHOLDERS IN PUBLICLY HELD AMERICAN CORPORATIONS. WE ARE GRATEFUL TO THE SPONSORS OF THE CAPITAL COST RECOVERY ACT, THE MANY BIPARTISAN CO-SPONSORS, AND FOR THE READINESS AND WILLINGNESS OF THIS COMMITTEE TO GIVE ITS THOUGHTFUL CONSIDERATION TO THE GREATLY NEEDED OVERHAUL OF THE PRESENT CAPITAL COST RECOVERY SYSTEM FOR FEDERAL TAX PURPOSES.

(S. 1435) IS NOT JUST ANOTHER TAX PROPOSAL BUT IS A CAREFULLY WORKED OUT ANSWER TO OUR NATION'S PROBLEMS OF DECLINING INVESTMENT AND PRODUCTIVITY.

THE JOINT ECONOMIC COMMITTEE'S 1979 REPORT ENTITLED "THE MID-YEAR REVIEW OF THE ECONOMY," A REPORT WHICH WAS UNANIMOUSLY ENDORSED BY THE BIPARTISAN COMMITTEE FOR THE FIRST TIME IN 20 YEARS, ALARMINGLY POINTS OUT THAT THE UNITED STATES RANKS SEVENTH IN PRODUCTIVITY, CAPITAL INVESTMENT, AND ECONOMIC GROWTH AFTER JAPAN, WEST GERMANY, ITALY, FRANCE, CANADA, AND THE UNITED KINGDOM. THE REPORT FURTHER STATES THAT OUR LOW

RATE OF CAPITAL INVESTMENT AND PRODUCTIVITY IS DUE, AT LEAST IN PART, TO OUR COMPLEX, OUTMODED, AND UNREALISTIC CAPITAL RECOVERY SYSTEM, AND IT RECOMMENDS THAT MAJOR IMPROVEMENTS NEED TO BE MADE. WE AGREE.

JEC CHAIRMAN SENATOR LLOYD BENTSEN ALSO STATED THAT ONE OF THE PRIMARY REASONS FOR OUR LAGGING PRODUCTIVITY RATE IS A LACK OF INVESTMENT CAPITAL FOR NEW PLANTS AND EQUIPMENT. WE HAVE THE LOWEST INVESTMENT RATE OF ANY INDUSTRIALIZED NATION IN THE WORLD AND THE PERIOD OF CAPITAL RECOVERY IN THE UNITED STATES IS ONE OF THE LONGEST AMONG ALL INDUSTRIALIZED NATIONS.

THIS IS PARTICULARLY FRIGHTENING AT THIS TIME FOR IT HAS BEEN ESTIMATED THAT OVER THE NEXT 10 YEARS, AMERICAN INDUSTRY WILL NEED $5 TRILLION. WE HAVE ALLOWED OUR GREAT AMERICAN BUSINESS MACHINE TO GET RUSTY; MUCH OF OUR EQUIPMENT HAS BECOME OBSOLETE. WE HAVE TO REALIZE THAT 67% OF ALL METAL WORKING MACHINERY IN THIS COUNTRY IS MORE THAN 13 YEARS OLD WHEREAS IN JAPAN THE FIGURE IS ONLY 30% AND IN GERMANY, 37%. THIS IS TYPICAL OF ALL OUR PLANT AND EQUIPMENT AND SHOWS WHY OUR LONG TERM PRODUCTION ADVANTAGES ARE FADING AND WHY WE ARE LOSING OUR POSITION IN THE INTERNATIONAL MARKET PLACE. WE MUST REBUILD OUR INDUSTRIAL ENGINE, EXPAND OUR ECONOMY, CONTROL INFLATION, AND CREATE JOBS, AND THAT IS WHY WE ARE SUPPORTING (S. 1435).

TRADITIONALLY, CAPITAL NEEDED FOR INVESTMENT HAS COME FROM FOUR SOURCES: INDIVIDUAL SAVINGS INVESTED, BORROWING, RETAINED CORPORATE EARNINGS, AND CAPITAL RECOVERY ALLOWANCES.

IN CONSIDERING INDIVIDUAL EQUITY INVESTMENT, ONE FACT MUST BE NOTED. ALTHOUGH THERE ARE 25 MILLION STOCKHOLDERS WHO CURRENTLY OWN

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STOCK IN 11,000 PUBLICLY OWNED CORPORATIONS (NYSE STATISTIC) AND INDIVIDUALS STILL OWN OVER 60% OF THE STOCKS; THERE HAS BEEN A SHARP DECLINE IN THE STOCKHOLDER POPULATION. ACCORDING TO STATISTICS RELEASED BY THE NEW YORK STOCK EXCHANGE, THE NUMBER OF INDIVIDUAL STOCKHOLDERS DECLINED BY 18% FROM 1970-75. DURING THESE YEARS, THE STOCKHOLDER POPULATION SLID FROM 32 MILLION TO 25 MILLION. FOR THE FIRST TIME SINCE 1952, WHEN SUCH STATISTICS WERE INITIALLY RECORDED, THE NUMBER OF INDIVIDUAL STOCKHOLDERS DID NOT SUBSTANTIALLY INCREASE. THIS IS A VERY SERIOUS TREND, ESPECIALLY SINCE IT WAS PREDICTED YEARS AGO THAT WE WOULD NEED 50 MILLION STOCKHOLDERS BY 1980 TO TAKE CARE OF THE EXPANDING LABOR FORCE AND TO MEET CAPITAL NEEDS. HERE WE ARE IN 1980 WITH HALF AS MANY.

WE ARE NOT OVERLOOKING THE INSTITUTIONAL INVESTORS BUT, OF COURSE, BASICALLY, THEY REPRESENT AN AGGREGATION OF INDIVIDUAL SAVINGS, THE RESULT OF PENSION FUNDS, INSURANCE, ETC. THE INDIVIDUALS, HOWEVER, PLAY AN IMPORTANT, EVEN UNIQUE ROLE AND MUST BE ATTRACTED BACK INTO THE CAPITAL MARKET. THE INDIVIDUALS HAVE ALWAYS BEEN KNOWN AS THE BACKBONE OF OUR CAPITAL RAISING SYSTEM AND HOLD THE KEY TO THE FUTURE OF THE MARKETS. OUR MARKETS WILL NOT WORK WITHOUT THEM; THEY MAKE THE MARKET. THE MILLIONS OF DIFFERING INDIVIDUAL DECISIONS MADE DAILY IN DIVERSIFIED MARKET TRANSACTIONS ARE NEEDED FOR LIQUIDITY, FOR A TRUE AUCTION, AND A MORE REALISTIC VALUE OF STOCKS. FURTHER, AN INDIVIDUAL HAS A DIFFERENT PATTERN OF INVESTING THAN THE LARGE FINANCIAL INSTITUTIONS. FUND MANAGERS, EITHER BECAUSE OF REGULATION OR FIDUCIARY RESPONSIBILITIES, INVEST PRIMARILY IN THE WELL-ESTABLISHED COMPANIES AND FOR THE MOST PART IN A FAVORED FEW. THE INDIVIDUAL, IN HIS OWN FRAME OF IN-

TEREST AND JUDGMENT, WITH HIS OWN CAPITAL MAY MAKE INVESTMENTS IN THE SMALLER, OFTEN MORE VENTURESOME HIGH RISK NEW COMPANIES AND SHARE IN THE OWNERSHIP AND GROWTH OF THEM. THIS IS AN IMPORTANT FACTOR NOW WHEN THE CAPITAL NEEDS FOR RESEARCH AND DEVELOPMENT OF NEW TECHNOLOGIES - ESPECIALLY ENERGY - ARE SO CRUCIAL.

LIBERALIZING CAPITAL RECOVERY ALLOWANCES AS OUTLINED IN THE "10-5-3" PLAN OF (S. 1435) WOULD BE BENEFICIAL TO THE EQUITY INVESTORS AND COULD BE AN INCENTIVE TO ATTRACT THEM BACK TO INVESTING AND REINVESTING. CORPORATIONS WOULD NOT HAVE TO CONTRACT LARGE LOANS OR MAKE DILUTING OFFERS OF EQUITY IN THE FINANCIAL MARKETS. WHEN COMPANIES NEED ADDITIONAL FUNDS AND ARE FORCED TO GO TO THE CAPITAL MARKETS, THEY BORROW AT HIGH INTEREST RATES, RATES THAT ARE PROBABLY GOING EVEN HIGHER, AS WE KNOW. MANY COMPANIES HAVE HAD TO BORROW LARGE SUMS WHICH HAS CAUSED A DANGEROUS INCREASE IN DEBT/EQUITY RATIOS. CLIMBING DEBT RATIOS MAKE BUSINESS HIGHLY VULNERABLE TO BUSINESS CYCLE CHANGES. THE GROWTH OF HIGH DEBT RATIOS IS A VERY UNDESIRABLE DEVELOPMENT WHICH CONTRIBUTES TO BANKRUPTCIES, GENERALLY SUPPRESSES ECONOMIC GROWTH, AND STYMIES THE ABILITY OF BUSINESS TO EXPAND AND MODERNIZE.

THE CAPITAL COST RECOVERY ACT, (S. 1435), WOULD INCREASE THE CASH AVAILABLE FOR EITHER CORPORATE RETENTION OR FOR PAYING DIVIDENDS. DIVIDENDS ARE CERTAINLY AN INCENTIVE FOR STOCKHOLDERS TO INVEST IN AND SHARE IN THE OWNERSHIP OF COMPANIES. IN SOME ENTERPRISES THEY SHARE OWNERSHIP WITH LESS THAN 1000 OTHERS AND IN CERTAIN COMPANIES THEY SHARE OWNERSHIP WITH A MILLION OTHERS.

THE SUCCESS AND STRENGTH OF OUR FREE ENTERPRISE SYSTEM COMES FROM

. . . . 5

THIS LARGE OWNERSHIP BASE. OUR SYSTEM IS OFTEN CALLED PEOPLE'S CAPITALISM AND THAT IS A GOOD DESCRIPTION; BECAUSE THROUGH THIS SYSTEM IT IS POSSIBLE FOR EVERYONE TO BE A CAPITALIST AND INDEED STOCKHOLDERS DO COME FROM ALL WALKS OF LIFE. IT IS THIS SYSTEM WHICH HAS MADE POSSIBLE THE BUILDING OUT OF A WILDERNESS THIS GREAT INDUSTRIALIZED NATION WITH ITS CITIZENS ENJOYING THE HIGHEST STANDARD OF LIVING. WE MUST CONTINUE TO INSURE THE CONSTANT FLOW OF CAPITAL WHICH IS THE FINANCIAL FUEL - THE DRIVING FORCE - TO KEEP THIS SYSTEM GOING AND REGAIN OUR POSITION AS <u>THE GREATEST</u> INDUSTRIALIZED NATION IN THE WORLD.

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Statement of C. Hoke Leggett, President
National Cotton Council of America
to the Senate Committee on Finance
On the Capital Cost Recovery Act of 1979
November 13, 1979

The National Cotton Council is the central organization of the raw cotton industry, representing cotton growers, ginners, warehousemen, merchants, cooperatives, textile manufacturers, and seed crushers from the Carolinas to California.

The cotton industry is deeply concerned over the slowdown in productivity improvement that has occurred in most sectors of our nation in recent years. No longer are productivity increases able to offset rising wage levels and keep unit labor costs level. The result has been rapidly rising labor costs which increase consumer prices and contribute heavily to inflation. Additionally, U.S. products have been made less competitive in foreign markets, thus leading to trade deficits and the reduced value of our dollar. This has further contributed to inflation and retarded employment opportunities in the export sector.

While labor productivity gains have continued unabated in cotton production, the lack of such gains in other sectors has made cotton production costs skyrocket. U.S. Department of Agriculture cost studies show that labor now comprises less than 10% of the cost of growing cotton, so rising costs in other sectors which supply cotton farmers impact very heavily on our production costs.

Other witnesses have undoubtedly cited the slow growth of investment in producers' durable equipment (when adjusted for inflation) as one of the main causes of the lower rates of productivity gains. This is exacerbated by the fact that much of the producer investment in recent years has been forced into equipment required by OSHA, EPA, and other federal regulatory agencies which has contributed little toward improved productivity. A McGraw-Hill survey in May, 1978, indicated EPA- and OSHA-mandated expenditures alone accounted for 10% of producers' durable equipment investments in that year. This means that less of the limited capital available for investment is free to go toward more productive plant and equipment.

We have a very timely example in our industry. A U.S. appeals court has just upheld OSHA's cotton dust standard in most branches of our industry. Our studies show that the investment cost for dust abatement equipment may exceed $2½ billion, most of which will fall on the cotton textile industry. OSHA requires that this be accomplished in four years. The 1977 Census of Manufactures shows that the sectors of the textile industry consuming raw cotton had new capital expenditures of $673.2 million in 1977. If this is a typical rate of investment, then this one standard will require nearly four years of the industry's normal level of capital spending.

Additional investments are required to meet EPA's air and water pollution standards, and possibly an OSHA noise standard.

Companies in the textile industry are faced with two alternatives. The first would be to avoid the expenditures for dust control entirely by abandoning or cutting back on cotton as a raw material in favor of man-made fibers. To the extent this course is chosen, the investment, jobs, and economic activity in the production, processing, and handling of cotton would be impaired to the detriment of the nation's economy. The huge economic stake of our nation in cotton is demonstrated by cotton's annual retail value of some $41 billion -- more than that of any other crop, including corn, wheat, or soybeans. It seems likely that imported cotton products might replace at least a large portion of the market abandoned by domestic mills, thus worsening an already serious trade deficit.

The other alternative would be to attempt to meet the OSHA standard by spending the billions of dollars required for dust control equipment. Even here there are two courses that could be followed. One is to purchase dust collection equipment to fit the textile machinery already in place. This is the $2½ billion cost cited earlier, and is the less expensive route. The other is to spend more money and buy new textile machinery with a lower propensity for dust emissions. The new production line equipment still would have to be equipped with special filtration equipment but it would have the advantage of a higher level of productivity.

If capital is available, mills most likely will choose the new machinery over retrofitting old equipment because of its improved production efficiency.

In either case, without the fast tax write-off proposed in the Capital Cost Recovery Act, obtaining this huge amount of capital may be virtually impossible under today's conditions. Without it mills -- rather than spending tremendous sums of money to retrofit old equipment that will give no productivity gain -- are likely to decide to reduce cotton consumption or eliminate it altogether. This would inevitably be accompanied by the huge loss of economic activity mentioned earlier.

The Capital Cost Recovery Act may make it possible to reduce dust levels in the expensive fashion dictated by OSHA, greatly increase our productivity, and continue processing of cotton in this country.

We strongly urge adoption of a measure like the Capital Cost Recovery Act to help control inflation and improve competitiveness in world trade.

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STATEMENT BY
NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY
COMMITTEE ON FINANCE
UNITED STATES SENATE
OCTOBER 22, 1979

The National Machine Tool Builders' Association (NMTBA) is a national trade association comprised of about 370 companies accounting for some 90% of the United States machine tool production. Over 70% of these companies have less than 250 employees, while the entire industry has approximately 100,000 employees.

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 a resounding effect on this capital-intensive industry.

At the outset, we commend to this Subcommittee the concept of accelerated depreciation as an engine 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 pending depreciation reform legislation (S. 1435), we would first like to briefly comment on the very substantial effect that capital cost recovery and depreciation tax policies will have upon economic growth and prosperity in America and upon our balance (or more correctly, imbalance) of trade.

In our 1978 testimony on the Tax Reduction Act, we reported to you that NMTBA had conducted a study of 16 major metalworking companies' annual reports. Without question the companies we 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.

Chart 1 shows the reported book value of the fixed assets of the 16 metalworking companies. With published results in current dollars, it is no wonder that many people think that business and industry are healthy.

But look what happens when the inflation influence is removed and constant dollars become the measure of value. From 1960 to 1967, when the annual inflation rate averaged about 2%, the real value of these 16 corporations was steadily growing. Then at the turn of the decade, when the inflation rate was averaging nearly 4½%, real growth came to a halt. And then, during the last few disastrous years with inflation averaging over 6%, the real asset value of our sample companies declined substantially. In short, since 1970 America's metal-working industry has been in unconscious and involuntary liquidation. And the same probably holds true for almost all of America's manufacturing industries.

Let us see what would have been required to avoid involuntary liquidation by our 16 company sample. In other words, how much investment would have been needed just to hold the real asset value at the same level that was achieved during the 1967-1971 period when assets were on a plateau.

Chart 2 shows what the 16 companies actually spent in current dollars -- and what they would have had to spend just to maintain the real value of their fixed assets since 1971. Over the entire 6-year period the capital spending required to just stay even was twice the actual capital spending for these companies. But given our depreciation policy in the United States, capital spending at those levels was impossible! Not even these 16 Blue Chip companies could obtain that much money.

The effect of these years of underinvestment in America's manufacturing plant are dramatically illustrated by the average ages of machine tools in use in the industrialized nations. The United States of America has the lowest proportion of machine tools less than ten years old -- and the highest proportion that are more than 20 years old, of any of the seven nations shown in the table below:

MACHINE TOOLS IN USE IN SEVEN INDUSTRIAL NATIONS

Country	Percent of Total	
	Under 10 Years	Over 20 Years
United States	31%	34%
West Germany	37	26
United Kingdom	39	24
Japan	61	18
France	37	30
Italy	42	28
Canada	47	18

Our fierce international competitors from Japan have the opposite standing. Nearly two-thirds of their machine tools are new, modern and ultra-efficient, while only 18% of their machine tools are candidates for resale at an antique shop.

When you consider the dramatic technological improvements that have occurred in machine tool technology during the past ten years, with the application of computer control to virtually every type of machine tool, is it any wonder that Japanese manufacturers are overruning some segments of our manufacturing economy.

To illustrate the importance of maintaining a stock of the latest, most technologically advanced manufacturing facilities, let us cite the average age of the plant and equipment of two well-known companies. The first, Texas Instruments Inc., is reknowned for its innovative ability and its success in meeting foreign competition head on in the area of technology where overseas manufacturers have been most successful -- electronics. The average age of Texas Instruments' plant and equipment is only three years, and 14% of their sales income goes for plant and equipment depreciation.

Now let's look at another company, one that is being beset with foreign competition, the United States Steel Corporation. The average age of their plants is seventeen years and depreciation is a scant 3.3% of sales.

That, Mr. Chairman, is a dramatic difference. And, as we all know, these two companies have had dramatically different levels of success in meeting import competition. So the message is clear, if we are going to meet foreign competition and stem the tide of imports that are washing our trade balances in red ink, America must invest, and invest heavily, in new plant and equipment.

We would also assert that for our manufacturing capacity to efficiently produce it must be expanded. For many years a major portion of our nation's capital investment has been devoted to what has been picturesquely called "capital repair". In other words the repair of old, worn out

equipment. Chart 3 shows how net investment has actually been declining in constant dollar terms while total investment has been rising. The difference between total investment and net investment is the capital that is being spent to repair our facilities.

The net investment is the capital that is being used to meet government-mandated expenditures for clean air, clean water, and safer working conditions, plus the capital that is being invested in new, efficient, capacity improving plant and equipment. We think that it is obvious that, when the mandated expenditures are removed, real investment for new capacity has to have been declining precipitously.

We have all recently been faced with a dramatic example of what happens to any industry that does not have enough capacity to meet the demands of its customers for the types of products they want, when they want them, and at a price they can afford. Have you tried to purchase a fuel efficient, compact American-made automobile in the last few months?

In spite of the efforts of Detroit automakers, and absolutely staggering capital expenditures by them for new production facilities, small cars are in short supply. And the result has been a dramatic surge in the demand for foreign imports -- at almost any price.

When situations like this are permitted to occur -- is it any wonder that American industry is being eaten alive by foreign imports? Today, we assert that, unless America's

depreciation policy is changed -- unless we substantially shorten the period of time over which American industry (both big and small) is permitted to recoup its investments -- the trend toward involuntary capacity repair instead of capacity expansion, liquidation, unsatisfactory levels of productivity, and non-competitiveness with our more productive foreign trading partners will continue.

In other words, as Americans demand more and more manufactured products in the years ahead, we must have sufficient modern, competitive manufacturing capability to meet this demand. If we don't the sea of red ink on our balance of payments accounts will drown us. Our foreign competitors will increasingly satisfy our needs for new products.

If American industry is to maintain its technological leadership and improve its competitive position in foreign and domestic markets manufacturing capacity must be increased, and 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.

Shortening depreciable life spans will permit business to generate the funds to be appropriated for capital spending

out of its own operations. Improving the cash flow of industry through these changes 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 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.

When we testified before this Subcommittee on June 18th we produced evidence that, in order to effectively control price increases, we must increase productivity faster than total wages. Depreciation reform will accomplish both an increase in manufacturing capacity and a substantial increase in productivity. Thus, depreciation reform must be viewed not as a tax incentive nor as a "tax expenditure" -- but as a weapon in the war on inflation.

We commend Senators Nelson, Bentsen, Chafee and Packwood for their far-sighted leadership in sponsoring S. 1435, the "Capital Cost Recovery Act of 1979". Under their proposal, the current ADR system would be replaced by a capital cost recovery system calling for accelerated amortization of:

- Buildings over a ten-year period;
- Machine tools and other long-life equipment over a five-year period; and
- The first $100,000 worth of rolling stock over a three-year period.

Adoption of this system would abolish salvage value requirements. Additionally, the 10% investment tax credit (ITC) would continue to apply to equipment with a 6% ITC for rolling stock. Furthermore, S. 1435 is devised to be phased-in over a period of years to minimize revenue loss to the Treasury.

As an association predominately representing small business, we strongly oppose suggestions, which some have made, to put a "cap" on the amount of annual investment in plants and equipment eligible for the faster amortization provisions of S. 1435. In a misguided (albeit, well-meaning) effort to assist small business, these suggestions will do very little to upgrade America's store of new plants and equipment; they will not help the thousands of small businesses who supply equipment and construction services to larger companies; and they will do next to nothing in providing for the critically necessary improvements in our nation's lagging rate of productivity. Their adoption would reduce the effectiveness of S. 1435 as a weapon in the war on inflation from a cannon to a pop gun.

So let us summarize the tremendous impact which passage of S. 1435 will have on America in the 1980's:

1. The desire of the American people for an improved standard of living will require large increases in capital investment in America. We must modernize our plants so that our present products can compete in a world where manufacturing efficiency is of paramount importance. And we must also build new plants

and equip them with totally new equipment to efficiently build the new products and new designs that are already being demanded by Americans.

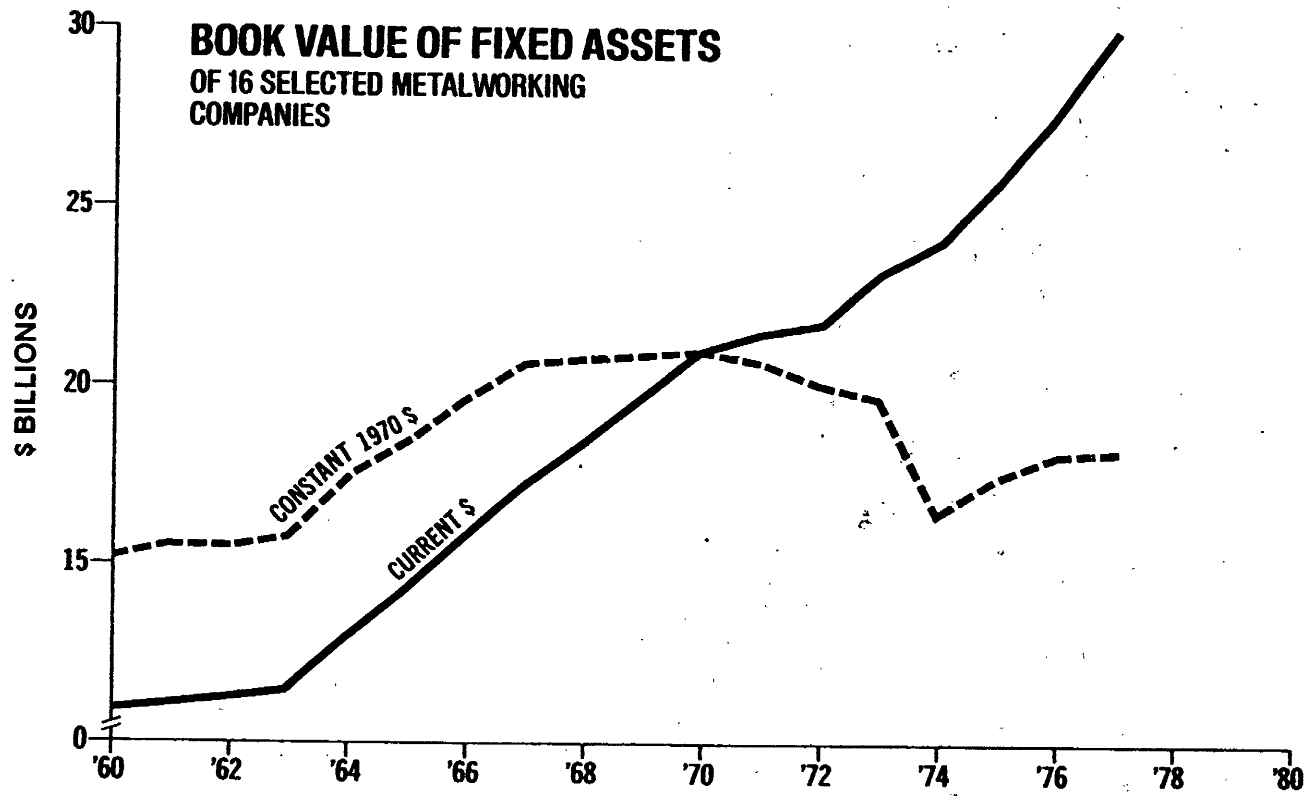
2. If we fail to generate sufficient capital investment in America, our foreign competitors are more than ready to make the investments needed so that they can supply the goods and services that Americans want from overseas plants. The result will be a greater dependence upon imports, more red ink in the balance of payments accounts, and prices that are determined in a foreign land and dramatically influenced by the vagaries of international money markets.

3. As evidenced by the age of our equipment and our current rates of investment, American industry -- both big and small -- is unable to afford the massive increases in manufacturing capacity and modern equipment needed to meet the challenge of the 1980's.

4. Depreciation reform is vital to the improvement in cash flow and capital accumulation necessary to increased American manufacturing capacity and productivity.

NMTBA urges the adoption of S. 1435. We appreciate this opportunity to again present our views to this Subcommittee.

Chart 1



Prepared by NATIONAL MACHINE TOOL BUILDERS ASSOCIATION

SOURCES: COMPANY ANNUAL REPORTS
NMTBA
U S DEPT. OF COMMERCE (B.E.A.)

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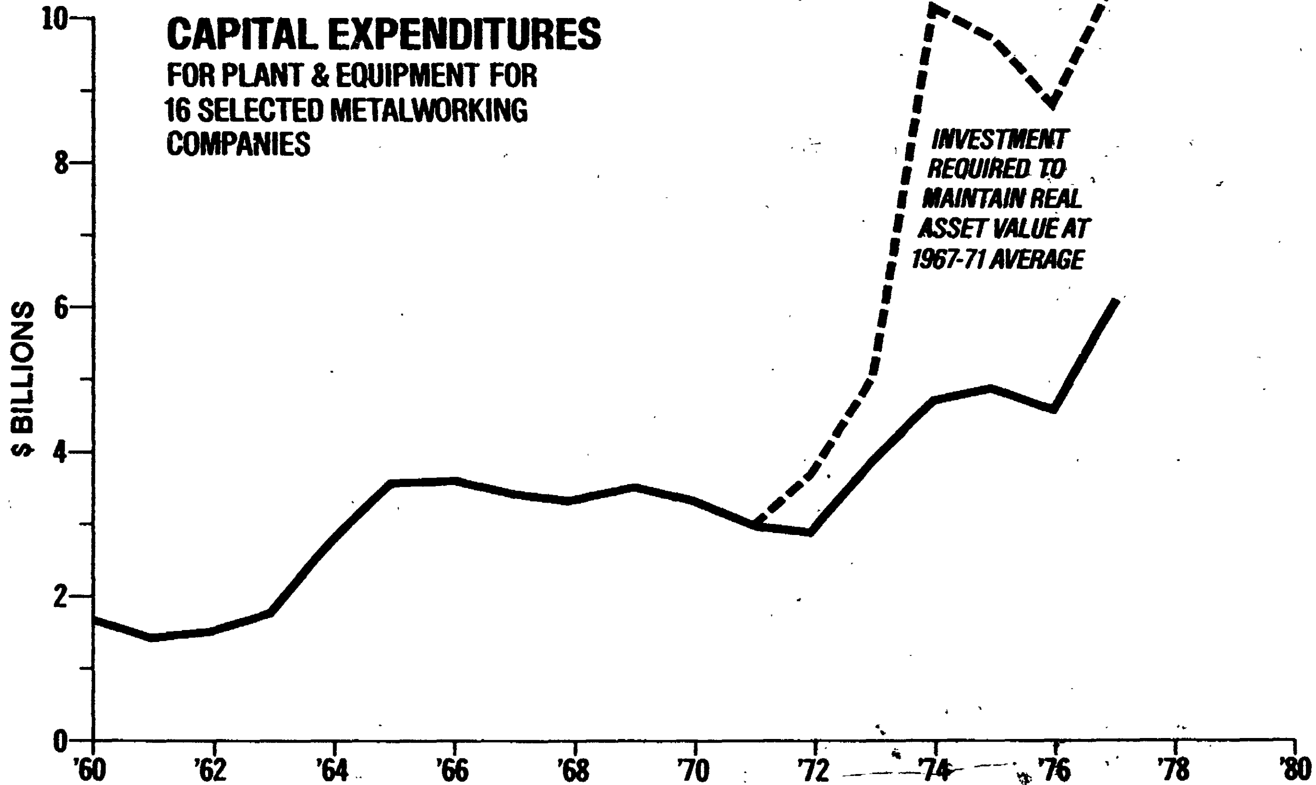
Chart 2



Prepared by NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION

SOURCES: COMPANY ANNUAL REPORTS
NMTBA
U.S. DEPT. OF COMMERCE (B.E.A.)

Chart 3

CAPITAL EQUIPMENT INVESTMENT

(FIXED, NON-RESIDENTIAL, PRODUCERS DURABLE EQUIPMENT)

CONSTANT (1972) DOLLARS—BILLIONS

100
80
60
40
20
0

50 52 54 56 58 60 62 64 66 68 70 72 74 76 78 80

7% CREDIT
CREDIT SUSPENDED
7% CREDIT
CREDIT REPEALED
ADR & 7% CREDIT
10% CREDIT

TOTAL INVESTMENT

NET INVESTMENT

Prepared by NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION—3/79

SOURCE: BUREAU OF ECONOMIC ANALYSIS

STATEMENT OF THE
NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS
Before The
Subcommittee on Miscellaneous Tax Bills
Senate Committee on Finance
On The
Capital Cost Recovery Act, S.1435
October 23, 1979

I am William C. McCamant, Vice Chairman of the Board, of the National Association of Wholesaler-Distributors (NAW). NAW is a federation of 114 national commodity-line associations (list attached) composed of over 45,000 merchant wholesaler-distributor establishments located throughout the 50 states. Wholesaler-distributors are responsible for a large share of our nation's economic activity. Their sales for 1979, as estimated by the Commerce Department, will exceed $825 billion. The firms represented by NAW account for approximately 60% of total industry sales, and 60% of the 3.5 million individuals employed in wholesale trade. Our industry is preponderantly composed of small-to-medium size businesses, is highly competitive, and operates on very slim profit margins, averaging 1.9% after taxes.

We welcome and appreciate this opportunity to present the views of our industry on the Capital Cost Recovery Act, S.1435.

CAPITAL'S FUNDAMENTAL ROLE

There is widespread and growing recognition that the rate of capital formation in this country has been inadequate in recent years. This is, in large measure, attributable to existing tax policy, and failure to effectively deal with our growing capital needs will have profound implications for the economy as a whole.

Our nation's economic strength derives from our productivity and competitiveness. These in turn depend on our generation and reinvestment of capital.

The complex and fundamental role of capital is not fully understood by the public, but support for substantive capital recovery measures is gaining broader public support. There is increased awareness that the public does suffer the effects of inadequate capital formation: i.e., inflation; eroded real purchasing power and unemployment. The public expects government to respond by embracing tax policies which will restore our economic vigor.

Treasury Secretary Miller underscored the importance of capital formation in our industrial society when he stated in testimony before this Subcommittee on October 22, 1979:

> "The stimulation and improvement of productivity performance must be among the foremost objectives of economic policy."

The Capital Cost Recovery Act is designed to promote and encourage capital investment. The long and persistent inflation has indicated beyond any reasonable analysis that the former "useful life" concept for establishing the period of capital recovery does not provide business a fair chance to replace worn-out machinery and equipment, industrial and commercial structures, or the capital for modernization and expansion. The 10-5-3 concept for establishing the period for capital recovery will directly and immediately affect business decisions to upgrade

productivity, thereby making the labor of millions of workers more profitable to their employers and to themselves.

This Subcommittee has received considerable evidence of the slowdown in productivity improvement of American industry, along with alarming comparisons of other industrial countries. Distribution is an integral part of the economy, and increased productivity in distribution is just as important in reducing costs of products and services as in other industries.

The Capital Cost Recovery Act provides for three groups of depreciable assets:

Class I - Non-residential buildings and structures with a capital recovery period of 10 years;

Class II - Machinery and equipment with a capital recovery period of 5 years;

Class III - Cars and light duty trucks with a capital recovery period of 3 years (up to $100,000).

To the extent that such assets now qualify for the ten percent investment credit, assets in Class I and II would continue to be eligible. Assets in Class III would be eligible for a six percent investment credit. We also endorse the concept that used equipment be afforded the full investment credit. The only reason that businesses purchase used equipment is because that equipment is an upgrade with respect to their particular business operations. Further, a steady market in used equipment paves the way for those companies which choose to upgrade their facilities with new equipment.

An examination of the Statistics of Income, 1974 Corporation Tax Returns (the latest available), published by the Internal Revenue Service, indicates the following financial and tax statistics on Wholesale Trade:

Item	Total Wholesale Trade
Number of returns, total	214,975
With Net Income	158,842
Total Assets	159,566,514
Depreciable Assets	33,038,626
Less: Accumulated Depreciation	14,664,750
Total Liabilities	159,566,514
Accounts Payable	37,638,012
Total Receipts	499,287,522
Business Receipts	491,668,543
Depreciation	2,927,425
Income Subject to Tax	11,716,450
Investment Credit	165,599

The table indicates that Wholesale Trade reported approximately $33 billion in depreciable assets. It also reports that less than $3 billion of depreciation was claimed, or one-eleventh per year. This figure clearly indicates that buildings constitute a highly significant part of a wholesaler's depreciable assets. Permitting these businesses to recapture within 10 years the cost of new buildings or extensive modernization of current structures, particularly warehouses would create a significant incentive for modern warehouse construction leading to productivity improvement.

We are encouraged to note that Secretary Miller early in his statement recognized that "investment in nonresident structures has shown a persistent downward trend since 1966." Attention to the

tax policy toward structures is particularly important to our industry as a rather large segment of depreciable assets used by our industry is in structures.

Attention is also called to the reported total assets of $159.5 billion and income subject to tax of $11.7 billion or a return on assets of 7.3 percent. Again, the year was 1974, when inflation was over 10% and the Federal Government was paying 9% on Treasury bills.

I would also like to note that the income on sales amounted to 2.3 percent in a year when inventory replenishment costs went up over 10%.

One of the basic reasons NAW is supporting the Capital Cost Recovery Act is because we believe all of U. S. businesses, our own industry, our suppliers and our customers must be modernized and better equipped. Wholesaler-distributors have faced year after year with rising inventory replacement costs, and forecasts for the future are not encouraging. What limited depreciation is still available is providing a fraction of replacement costs, forcing businesses to adopt a "make-do" practice with respect to use of current capital assets.

We can only conclude that far too many wholesaler-distributors have not kept current with the need for capital investment and, indeed, will not be able to do so until inflation is brought to a much lower figure and tax policies are revised to provide for a shorter period of capital recovery.

Certainly one of the major advantages that will flow from a shorter period of capital recovery is a savings in interest costs. Business loans for financing structures are being made at unprecedented interest rates. A shorter recovery period will increase the capital return, reducing the loan requirements and saving considerably on the cost of the funds borrowed.

The wholesale distribution industry is currently suffering from high interest rates because they must borrow funds simply to maintain the same volume of inventory. Therefore, the industry views the shorter 10-5-3 capital cost recovery periods as very desirable tax policy.

Our association urges the Congress to give early approval to S.1435, the Capital Cost Recovery Act. We appreciate the opportunity to submit these views to the Subcommittee.

National Wholesaler-Distributor Organizations
Affiliated with the National Association of Wholesaler-Distributors

Air-conditioning & Refrigeration Wholesalers
American Dental Trade Association
American Jewelry Distributors Association
American Machine Tool Distributors' Association
American Supply Association
American Surgical Trade Association
American Traffic Services Association
American Veterinary Distributors Association
Appliance Parts Distributors Association, Inc.
Associated Equipment Distributors
Association of Footwear Distributors
Association of Steel Distributors
Automotive Service Industry Association
Aviation Distributors & Manufacturers Association

Bearing Specialists Association
Beauty & Barber Supply Institute, Inc.
Bicycle Wholesale Distributors Association, Inc.
Biscuit & Cracker Distributors Association

Ceramics Distributors of America
Ceramic Tile Distributors Association
Copper & Brass Servicenter Association
Council for Periodical Distributors Association
Council of Wholesale-Distributors
American Institute of Kitchen Dealers

Distributors Council, Inc.
Door & Hardware Institute
Drug Wholesalers Association

Electrical-Electronics Materials Distributors Assn.
Explosive Distributors Association, Inc.

Farm Equipment Wholesalers Association
Fireplace Institute
Flat Glass Marketing Association
Fluid Power Distributors Association, Inc.
Food Industries Suppliers Association
Foodservice Equipment Distributors Association
Foodservice Organization of Distributors

General Merchandise Distributors Council

Hobby Industry Association

The Irrigation Association

Laundry & Cleaners Allied Trades Association

Machinery Dealers National Association
Mass Merchandising Distributors Association
Material Handling Equipment Distribution Association
Monument Builders of North America - Wholesale Div.
Motorcycle Trades Association
Music Distributors Association

National-American Wholesale Grocers' Association
National Appliance Parts Suppliers Association
National Association of Aluminum Distributors
National Association of Brick Distributors
National Association of Chemical Distributors
National Association of Container Distributors
National Association of Decorative Fabric Distributors
National Association of Electrical Distributors
National Association of Fire Equipment Distributors
National Association of Floor Covering Distributors
National Association of Marine Services, Inc.
National Association of Meat Purveyors
National Association of Plastics Distributors
National Association of Recording Merchandisers, Inc.
National Association of Service Merchandising
National Association of Sporting Goods Wholesalers
National Association of Textile & Apparel Wholesalers
National Association of Tobacco Distributors
National Association of Writing Instrument Distributors
National Beer Wholesalers Association
National Building Material Distributors Association
National Business Forms Association
National Candy Wholesalers Association
National Ceramic Association, Inc.
National Commercial Refrigeration Sales Association
National Electronic Distributors Association
National Fastener Distributors Association
National Food Distributors Association
National Frozen Food Association
National Independent Bank Equipment Suppliers Assn.
National Industrial Belting Association
National Industrial Glove Distributors Association
National Lawn & Garden Distributors Association
National Locksmiths' Suppliers Association
National Marine Distributors Association
National Notions Wholesaler Distributor Association, Inc.
National Paint Distributors, Inc.
National Paper Trade Association, Inc.
National Plastercraft Association
National Sash & Door Jobbers Association
National School Supply & Equipment Association
National Solid Waste Management Association
National & Southern Industrial Distributors Associations
National Swimming Pool Institute
National Truck Equipment Association
National Welding Supply Association
National Wheel & Rim Association
National Wholesale Druggists' Association
National Wholesale Furniture Association
National Wholesale Hardware Association
Northamerican Heating & Airconditioning Wholesalers
North American Wholesale Lumber Association, Inc.

Optical Laboratories Association

Pet Industry Distributors Association
Power Transmission Distributors Association, Inc.

Safety Equipment Distributors Association, Inc.
Scaffold Industry Association
Shoe Service Institute of America
Specialty Tools & Fasteners Distributors Association
Steel Service Center Institute

Toy Wholesalers' Association of America

United Pesticide Formulators & Distributors Association

Wallcovering Wholesalers Association
Warehouse Distributors Association for
Leisure & Mobile Products
Watch Materials & Jewelry Distributors Association
Wholesale Florists & Florist Suppliers of America
Wholesale Stationers' Association
Wine & Spirits Wholesalers of America, Inc.
Woodworking Machinery Distributors Association

1000 East Main Street
Plainfield, IN 46168

November 20, 1979

Mr. Michael Stern, Staff Director
Senate Finance Committee
Rm 2227 Dirksen Senate Office Bldg.
Washington D.C. 20510

Dear Sir:

Public Service Indiana, a major investor-owned electric utility operating in sixty-nine counties in Indiana, submits the following comments to the proposed Senate Bill 1543, which would defer taxation on dividends reinvested in new issue stock.

The utility industry is a capital intensive industry which must continually offer new issue stock to finance the large construction programs required to meet anticipated peak energy loads. Public Service Indiana, whose construction budget for 1980 alone approaches a half billion dollars has adopted a Dividend Reinvestment Plan and presently has over 20% of all common shares participating in such plan. However, many shareholders are discouraged from reinvesting dividends because of the present tax laws relative to such reinvested dividends.

Under the new tax proposal, participation in the reinvestment plan would be greatly encouraged because immediate taxation would be avoided, and the long-term capital gains treatment could be used if the shares were held for a period of at least one year. Thus, new low cost capital for the Company would be created. This is especially attractive since large public offerings in the marketplace are becoming more difficult to complete and are becoming more expensive. Also, by increasing the participation in the reinvestment plan, the Company will be able to reduce its capital issuance costs and thereby pass the savings on the the consumer.

During the first three quarters of 1979, the Company obtained $9,865,000 of equity financing as a result of the Company's shareholders reinvesting their dividends in new issue common stock. Many additional shareholders would, most likely, have taken advantage of this plan, if the burden of taxation of these dividends was deferred.

Mr. Michael Stern, Staff Director
November 20, 1979
Page 2

In addition to the above advantages, the proposed law could also be anti-inflationary if the dividends are reinvested in stock and not used in the consumer goods markets.

Public Service Indiana strongly supports Senate Bill 1543 and urges all Congressmen to seriously consider the bill's favorable effect upon the economy and support the adoption of the act.

Very truly yours,

James H. Pennington,
Vice President

JHP:rd

cc: Herbert B. Cohn, Chairman
Committee for Capital Formation
Through Dividend Reinvestment