TAX CUT PROPOSALS

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TAX CUT PROPOSALS

THURSDAY, JULY 24, 1980

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

The committee met, pursuant to recess, at 10:05 a.m., in room 2221, Dirksen Senate Office Building, Hon. Russell B. Long (chairman of the committee) presiding.

Members present: Senators Long, Byrd, Nelson, Gravel, Bentsen, Matsunaga, Moynihan, Bradley, Dole, Packwood, Danforth, Chafee, Wallop, and Durenberger.

The CHAIRMAN. Let me say, for the benefit of the witnesses and the audience, that I am advised that all but two Senators on this committee are expected to be here during the course of today's hearing. I am sure they have other important matters to keep them away at the moment, but they will all want to study the testimony of the witnesses here today, who can give us some very informed advice.

First, we will call a panel of outstanding economists, each of whom has served as Chairman of the Council of Economic Advisers: Mr. Alan Greenspan, Mr. Walter Heller, and Mr. Leon Keyserling.

I think that we will just go alphabetically, Mr. Greenspan. Is that all right with you?

Mr. GREENSPAN. It is fine with me, Mr. Chairman.

STATEMENT OF ALAN GREENSPAN, FORMER CHAIRMAN OF THE COUNCIL OF ECONOMIC ADVISERS

Mr. GREENSPAN. In the last several weeks I have been having some very serious concerns about economic policy and the problems that have surfaced in this country. I am sure, as you recall, Mr. Chairman, for many years I have been up here testifying for restraint in deficit spending, and for very significant reductions in budget deficits. I have been a very strong supporter of balanced budgets over the years.

I have seen the significant swing in this body, and in the House in that direction, toward what I think is critical for this country; namely, an anti-deficit, non-inflationary fiscal policy.

I have been distressed in recent weeks however, as I watched the individual budget figures move, by the fact that even though the budget in a longer-term sense is perhaps moving toward balance, it is doing so from the receipt side. I have suddenly become fearful of this. It never bothered me terribly much in the past—I always considered that the good judgment of the Congress would never allow receipts to rise inordinately; that tax cuts would become the

order of the day whenever receipts became onerous to the American taxpayers.

What has been happening, subtly and I suspect perhaps without full awareness, is that we have been allowing not only bracket creep—that elegant new phrase we have seemed to construct—to occur, but a number of other subsidiary taxes to move into our fiscal system, so that the drag on the overall economic system from the tax side is threatening to become onerous.

As a consequence, it is important for us all to step back and to recognize certain fundamentals with respect to the question of taxes, budget balance, expenditures, and to remember that although budget balance is very important, and certainly anti-inflationary policies are critical, they are so because they are seen to create a vital and productive economy.

Let's never forget what the ultimate end of economic policy. It is not to balance the budget, or to reduce inflation. It is to create a vital economy.

What I feel we may very well be trying to do at this point is to balance the budget without any acute awareness of the ultimate purpose. If we do so in the context of increasing taxation, and remember that the existing revisions of the budget in recent days now still suggest total revenues rising $86 billion from fiscal 1980 to fiscal 1981, we are confronted with a potentially huge increase in the tax burden on the American public.

If we allow this type of thing to go on, we will dampen the incentives that we require in this system, and we will ultimately find that we may well succeed in balancing the budget, but only because we allowed taxes to rise inordinately. We will have achieved that secondary goal but find that we have undercut the productivity of the American economy, and have unleashed inflationary forces, which can occur even in the context of strict on-budget balance, if other elements in the system are not in place. We will have found that economic policy has failed.

As a consequence of that, we have to move to recognize what the various priorities are in this country, and find a means to appropriately evaluate them, fit them into the structure of our fiscal system, and enact those types of policies which will successfully create the most beneficent type of outcome.

I think that it is the will of the Congress, and I am sure backed by the American people, that we must somehow augment our defense capabilities. This suggests a rather significant increase in the Defense budget. My judgment is that we will end up with a Defense budget higher, certainly on budget authorities, and on outlays to a lesser extent, than the existing long-term budget proposed by the administration.

Yet, we must also create a set of tax policies which will reduce the gradual up-creep in taxation, and still keep in the back of our mind that if we are, in fact, running excessive deficits over a long period of time, we will engender inflation and lose the whole ballgame.

It turns out very fortunately that this country has not as yet arrived at a set of relationships which makes it impossible over the next 5 years to achieve an adequate pattern of Defense outlays, and an appropriate set of tax cuts to remove the growing tax

burden on the American people, and to achieve a set of budgetary policies which are ultimately disinflationary.

It does mean, of course, that we maintain a significant restraint on new program addition and new program expansion on the non-Defense side of the budget. At this stage, it does not yet require any significant curtailment of existing programs. In other words, if we are successful in living with the current services budget, adjusted for the so-called discretionary inflation increments, we basically are in a position, even with the Republican-sponsored set of initiatives led by the Roth-Kemp bill, to create a level of budget receipts and expenditures which either approaches or achieves budget surplus by 1985.

Senator PACKWOOD. Did you say 1985?

Mr. GREENSPAN. Yes.

I have not gone through the full details of a number of different alternatives as yet.

Senator DOLE. Could we hear that again?

Mr. GREENSPAN. Yes. If we start with the current services budget, adjusted for the inflation increments which are not imbedded in law such as the increases in Federal compensation, the increases that are occurring in the Defense budget the Roth-Kemp bill, some version of accelerated depreciation initiatives which a number of people have been raising, we still are either close to balance, or can under certain economic assumptions create a surplus in fiscal 1985.

Senator PACKWOOD. But not before?

Mr. GREENSPAN. I don't know that, Senator. It might be possible, depending on the configuration of both taxation and receipts. What I am saying is this; the preliminary work that I have done suggests that the arguments that you cannot do any of this forgets the fact that we start with a current services surplus for fiscal 1985 which is well in excess of $150 billion, and probably considerably more.

I am not embodying in this type of analysis any exotic so-called reflow. There is obviously some because it is automatic in our system, but it is not a level of so-called income reflow or tax reflow which is out of line with any recent experience.

Senator PACKWOOD. Mr. Chairman, may I pursue that for just a moment?

Alan, may I rephrase it this way. If we pass Roth-Kemp, and it includes some form of substantially increased depreciation, and substantially increased defense, given the average economic assumption, we are not likely to balance the budget before 1985, assuming current services on all other programs.

Mr. GREENSPAN. It depends on the size of the defense expenditure increase and on the accelerated depreciation. I will say this, Senator: It is close. Remember we are starting from a budget deficit level which is likely to be at minimum several billion dollars higher than is currently being estimated by the Office of Management and Budget.

I think the $61 billion deficit for fiscal 1980 is a low number. The possibilities of something as small as the $30 billion deficit for fiscal 1981 has got to be remote. My judgment is that it is going to be far closer to $50 billion than it will be to $30 billion. So we start fiscal 1981 with a very large deficit, and the mere momentum of

carrying it down to zero by fiscal 1984 is not easy, although it is not unachievable. I can create a scenario that will get us there.

Remember, in all of these contexts what is essential is that the Congress do not, as it seems to invariably do, add bits and pieces to existing domestic programs by seemingly minor augmentations of entitlement programs, and a number of other seemingly small bills which over a full legislative year add up to significant amounts of money.

Senator PACKWOOD. Let me ask the question another way, then.

Let's assume the changes that you are thinking about, on the human resources end, the service end, and a modest increase in Defense spending. If we pass Roth-Kemp and its full implications of the a 30-percent cut over the 3 years, one, is it likely to widen the deficit next year; two, is it likely to make it more or less likely that we will achieve the balance you are hoping for by 1985?

Mr. GREENSPAN. The passage of any tax cut legislation will widen that for fiscal 1981. There is no way that I can envisage avoiding that. It is possible that the passage of Roth-Kemp in its full form may marginally increase the probability of achieving a balanced budget in fiscal 1985, but very honestly, Senator, I am not sure we want to get there that way as I indicated in my very early remarks.

Namely, if we achieve a balanced budget by allowing taxes to increase as they tend to in an inflation environment such as we have been living through, then the achievement of that balanced budget will turn to ashes. A balanced budget over the longer run is a necessary condition to a vital economy. But it is not a sufficient condition, because if we do it by allowing taxes to increase and so stifle the incentive structure of American business and the American people generally, then we may well achieve our balanced budget and find that our real ultimate purpose, a vital economy, is lost.

The CHAIRMAN. Let me just suggest that we let each witness make his presentation before we get to the questioning. We had originally planned for each witness on the panel to speak for 10 minutes, and then to interrogate the witnesses. I know everyone here wants to know what each of these witnesses is going to present.

So I would hope that we would not interrogate the witnesses until they have made their statement in chief, and then they can be asked questions afterwards.

Mr. GREENSPAN. Mr. Chairman, I have completed my statement.

The CHAIRMAN. Next we will hear from Mr. Heller.

STATEMENT OF WALTER HELLER, FORMER CHAIRMAN OF THE COUNCIL OF ECONOMIC ADVISERS

Mr. HELLER. Mr. Chairman, to economize on the committee's time, I have prepared a statement that I hope is before you, and I would like to speak from that statement. I am going to devote about half of it to the economic background, and then I cannot resist making a few suggestions on the tax cut itself.

I think the case for a tax cut is compelling. Not as an antirecession weapon, it is probably too late for that, but as a prorecovery, progrowth, and anti-inflation measure.

A tax cut could restore a little color to the economy's cheeks without any risk that it would turn into the flush of inflationary fever. Given last year's slowdown, and this year's recession, and next year's modest recovery prospects, the economy is operating so far below par that the injection of, say, a $30 billion tax cut by January 1 would have only tonic, not toxic effects.

One can cite a number of numbers on that: Unemployment at 8 percent almost now, and rising to a peak of about 9. We have to remember that the capacity utilization and manufacturing which hit a peak of 87 percent early in 1979 has been sliding ever since. In some ways, the expansion stopped in early 1979, even though the recession did not start until early 1980. There was kind of a hiatus there. So now we are only operating at 76 percent of capacity.

On page 2 of the statement I take a broader look at it by trying to see what, on the basis of a very conservative assumption; you all know me as very conservative. Suppose that the economy had grown at just 2 percent a year, instead of sliding, what kind of a gap would have opened up in production, and how much production have we given up by this slowdown, recession, and slow recovery before us.

Racking up that 2 percent growth in potential output against the actual growth of only 1 percent last year, and an estimated drop of 4 percent this year during a recession, and then a rather optimistic 4 percent rise next year. This is against 2.6 percent that the Council of Economic Advisers and the White House have been using. Here are the striking, if not to say startling, results.

In the current quarter, had we had no slowdown or recession, we would be producing about $150 billion more of GNP a year, at today's prices, than we actually are. This is just arithmetic of the 2 percent growth versus the actual.

Now this shortfall grows to $180 billion by the end of 1980, and then gradually shrinks to about $130 billion by the end of 1981. So there is just all kinds of headroom for expansion. With a tax cut of $30 billion, you would not come within a country mile of pressing against the economy's productive ceilings.

By the way, those numbers tell us something else that startled me as I spelled out the arithmetic. If the economy had been growing at 2 percent in 1979–81 instead of having this slowdown, recession, and sluggist recovery, it would have produced a total of $300 billion more at today's prices than it actually will produce over the 3 years.

So if you are talking about slowdown and recession as a means of fighting inflation, it is costing us $300 billion of output.

Now, how much inflation reduction are we buying for this huge loss in output and jobs? On the surface the answer seems impressive. The CPI has dropped from that high of 18 percent to, I would estimate, around 6 percent. I might say that this is an estimate I have been making since January. Most of this drop is simply a case of letting the air out of the CPI bubble that is represented, as I am sure this committee knows, by high mortgage interest rates and housing prices.

Last month's jump in Consumer Price Index, you noticed, was four-fifth, still simply the rise in mortage interest rates and hous-

ing prices, which operates with a lag. I would be willing to predict that by next month we will see a sharp drop in the CPI index. That is the good news.

The bad news. The hard core or bed-rock inflation rate that lies just beneath the surface will yield very little to the pressures of economic slowdown and recession. Most of this recession will be reflected in a loss of jobs and output, not in lower wage and price increases.

Catchup is still the name of the game in wages. As to prices, there is some price cutting, and some discounting, but there is also discouraging evidence of widespread price hikes in the teeth of recession, where GM boosts the price of its average car $135, as it was described, in an "undaunted effort to pass on to consumers a large chunk of its increased production costs" even in the face of the weakest auto markets since 1960, this morning's paper tells us. One is moved to ask. "Recession, where is thy anti-inflationary sting?"

When you hear a major manufacturer quoted as saying, "We had to raise prices to make up for the loss of volume," whatever happened to the rigos of the marketplace?

Recession and slack in the economy will surely have some moderating effect. But even at that, just to summarize the next paragraph to the top of page 5, I think that we are going to come out of this recession with about an 8 or 9 percent basic inflation rate, and we will take off from there during the next round of prosperity.

So we will come out of the inflation with the inflationary gases vented, but the glowing bed-rock of inflation will recede little, if at all, and will threaten to errupt again when the recovery is in full swing.

Now the budget background. In considering a tax cut, one has to confront the fact that we now face a $61 billion deficit, and a $30 billion deficit for starters for fiscal 1981.

By the way, let me say, although my good friend Alan Greenspan and I agree on many things, I could not disagree with him more about the impact of Roth-Kemp. These deficits would be chicken feed compared with the deficits that would be generated by Roth-Kemp. My rough estimates show not so much for the first year, but by 1983 my estimates show a deficit add on of about $60 billion from Roth-Kemp, an add on to whatever else it would have been.

I don't see how you can bring that back into balance by 1985 unless you touch off a whopping inflationary growth in GNP that pours inflationary revenues into the Treasury.

Senator DANFORTH. That is the full 3-year Roth-Kemp you are talking about?

Mr. HELLER. That is the whole 3-year Roth-Kemp, which by the way I think the estimates are that it would cost you $135 billion by 1983 fiscal year, and about $288 billion by 1985. This is adding the 10-5-3, and the indexing. Those are not small numbers.

I should note, by the way, that even this $61 billion deficit, in terms of the total size of the economy, does not come close to the 1976 deficit. This one will be 2.5 percent of the GNP, and that one was 4.1 percent. In other words, if we were running as high a deficit in terms of the overall numbers of the economy, we would be running almost a $100 billion deficit to equal that $66 billion

deficit in fiscal 76. The last year that was affected by Mr. Greenspan's administration.

In looking at these large deficits, by the way, one should not ignore the fact that the budget process did produce a budget this year that would have balanced under the assumptions that the Budget Committees were using, and would have a good, hefty surplus at reasonable, full employment.

What I am saying by this is that these deficits, while disappointing and disturbing, threaten no inflationary thrust, or crowding out of private borrowing. The Treasury's borrowing needs will be largely a mirror image of the shrunken private borrowing requirements. That is, the Federal borrowing will not displace private borrowing, but instead will use funds that are idled by the recession. As a result, the deficits will not boost inflation or interest rates, and should not act as a barrier to moderate tax cuts.

There is a fact that is not widely recognized that even with the defense buildup, the 1981 budget outlays will be somewhat smaller in real terms than the 1980 outlays. If you comb out the defense spending, the cutback in civilian spending, in real terms, is about 3 percent in 1981 over 1980. This is not the general public perception, surely, of what is happening here in the Halls of Congress.

Then if you take an even broader perspective, and take those huge tax increases that Mr. Greenspan was citing, take those into account plus some holdback in expenditures, you will find that we are making a tremendous swing in a restrictive direction in the budget. I use a 6-percent high unemployment rate, and you get an $85 billion swing toward restrictions, and most of that is still ahead of us.

About $60 billion of a restrictive swing in the midst of recession. It is an unprecedented policy circumstance to have this tremendous back pressure on the economy when it is in recession.

Now the case for an early tax cut, page 7, to summarize. There is plenty of slack in the economy to absorb a cut.

Second, the tax overburden has been steadily growing. Personal income taxes were 21 percent of personal income in 1978, and they were 22 percent this year. They are heading for 23 percent next year. The total taxes relative to GNP are moving toward a new high of 21 percent of GNP in 1981—this is taxes. Most of this has been tax increases that have been stealthly legislated by inflation, by pushing income into higher brackets.

Third, $18 billion of new payroll taxes, and I show the breakdown of that, and the mounting tide of oil profits taxes coming on stream.

Fourth, primarily as a result of these huge tax increases, we have this tremendous swing toward restriction.

Fifth, properly structure, a tax cut program will ot only remove some of that fiscal overburden, but can serve as an important weapon in the battle for higher productivity and lower inflationary.

In light of these realities, we could stand a tax cut tomorrow if it were possible to wave a magic wand and produce a balanced progrowth and anti-inflationary tax program overnight. I am inclined to agree with the administration that under the election year pressure cooker, and given the limits of the legislative calendar, it

is not a high probability. But the better part of wisdom is to hammer out a carefully designed tax cut that will advance rather than retard the basic economic objectives.

But if this committee, Mr. Chairman, working against the calendar, and working against the odds, is able to produce a balanced tax cut by September, I see no economic reason for postponing congressional action after the election.

What it boils down to is this: We should not deny ourselves a prompt tax cut that makes good economic sense because it would be considered political. That would surely stand election-year economics on its head.

Although I fully agree with the desire to fend off a big, across-the-board tax cut that might win votes but lose the war against inflation—the proposal for a $36 billion downpayment on a tax cut of $288 billion by 1985 comes to mind—I hope the White House would not reject a carefully designed cut that would strengthen the economy.

If Congress, through a Herculean effort, produces such a bill before the election, I hope President Carter will sign it.

The challenge to Congress, then, is to confound the skeptics, take the raw meat of tax cut proposals, cook it to a turn, and serve up a dish that would be nourishing to the economy.

If the Secretary of the Treasury can use that figure of speech, then I guess that I can turn it around a little.

It is too late in the day for a tax cut that would apply to 1980, but I think that we ought to move for one for 1981. I would just quickly summarize the kind of composition that I would like to see in such a tax cut to serve the economic objectives.

First, offset that scheduled increase in social security payroll tax liabilities, preferably by action to cancel such increases, but if it cannot be done because of sensitivity about the soundness of the social security system, then do it by the Gephardt approach at least for a couple of years by offset payroll tax liabilities against income taxes.

Then, devote $5 to $10 billion to the first-year costs of a program of accelerated depreciation. I think one that would increase productivity and help the economy is not the 10-5-3 plan. I don't see any point in giving 10-year writeoffs to shopping centers and commercial buildings, and so forth.

I imagine that this is the toughest issue that you have got to face in doing a quick and sensible tax cut, it is to choose among 10-5-3—you will hear from Mr. Jorgensen later about the full capital recovery which economists like, but I don't know whether Congressmen and Senators do. The third is what I call the 20 categories, instead of the 10-5-3. The fourth is what I call the booby plan, in which you would try to simplify grouping, and maybe set aside—I think Congressman Ullman has a plan something like this—buildings, trucks, and so forth, and then have a group rate for the rest of the industry, and adjust that for speed up.

Then, finally, I would set aside another $5 billion or so for a contingency fund on real wage insurance. I am just afraid, Mr. Chairman, the next time around in prosperity if we run into double-digit inflation, we are running directly into mandatory con-

trols. Anything we can do in the tax system to help moderate wage and price increases, I think we ought to do.

I see the red-light is on, and I would just like to read my last two paragraphs, if I may.

The question may be raised. Why so modest a tax cut in the light of the compelling case for such cuts? The answer is to be found in the facts of fiscal life. The built-in civilian spending increases plus the defense buildup require us to keep our tax power dry. I understand that cold turkey estimates of the budget show it rising to 23 percent of GNP in the next 2 years, an alltime high.

The conservative and prudent course is to hold the tax cut to roughly $30 billion, and retain the rest of the revenue-raising power of our tax system to restore budget balance quickly, and enable you to have a somewhat more reasonable money policy.

This is in sharp contrast to the tax cut program of the fiscal radicals who advocate a $36 billion first installment on a tax cut that would cost over $200 billion by 1985, and at the time that they advocate a $100 billion increase in defense expenditures. That might be smart politics, but I doubt even that in the light of the public mood in America today, but it surely would be upside down economics.

The CHAIRMAN. Now let's hear from Mr. Leon Keyserling.

STATEMENT OF LEON KEYSERLING, FORMER CHAIRMAN OF THE COUNCIL OF ECONOMIC ADVISERS

Mr. KEYSERLING. Mr. Chairman and members of the committee, I am under a particular difficulty because I did not know that I was going to inflict myself upon you until Monday, and then I had so many commitments that I could give very little time to this, which is a liability to me but undoubtedly a benefit to you.

I have a prepared statement of a 1½ pages supplemented by a lot of documentary charts. I am going to follow the order of that. In the interest of brevity and because I am inspired by what the members of the committee have already said, and what my colleagues here have said, I am going to deviate somewhat from it.

I want to say just two things about the approach to this recession. The main approach of most economists, and of Government in the main, judged by its actions and not by words, reminds me of a fire company that is standing in front of a blaze, and it is debating how long it is going to last if they do nothing, and whether it is going to be shorter than the last blaze, or whether it is going to be longer than the next blaze, instead of pouring some water on it.

Or, to take a better analogy because the fire company did not start the fire, but this Government has been committed to deliberate policies of recession, articulated in economic reports and budget messages, it is more like a doctor who is looking at a patient who has had some kind of heart attack, and the doctor wants to cure it without considering that he has had five before, and what we can learn from them, and whether the five don't add up to more than the one, and what he is really being hurt by. I will not accept the superficial answer that, all right, he has got the fifth one. Now we have got to deal with that before we think of the others.

I have been kicked around here for 47 years, and I have seen what is happening, from saying, "Well, we can't think of any of the

fundamental problems, or take a long-range view, or do anything basic because we have got to get over where we are today." This is childish for a great Nation that is now being outdone by every important country in the world in growth of production and standards of living, in the invasion of our markets and while we are unable to afford the higher security program which I have always felt we needed even during the Korean war—I will not go into that.

Therefore, we have got to look at what has been happening to us progressively since 1953, and especially in the last 10 years, if we are going to be mature. What has been happening, in brief, is that we have been in a chronic recession, a chronic recession from full employment, a chronic recession from high plant use, a chronic recession from high productivity growth, a chronic recession from everything.

What have been the causes of that? The first basic cause is that there has been no sense in national policy of relative importances. Now, I am going to advance the simple proposition that the thing that counts first, and here I could not agree more with my friend Walter Heller, everything in the final analysis depends upon how much you produce of goods and services, and how intelligently you distribute it. That is what people eat. That is what they wear. That is what they ride in. That is what they defend themselves with. That is what they build plants with.

I hope nobody is saying, I am soft on inflation. The President who listened to me made a better record on controlling inflation under more difficult circumstances than anybody since, and he did not do it primarily with controls. He did it primarily by calling forth the great weapon of our ability to produce.

The best thing that has been said on this subject—I want to read the magnificent foreword to the report of the Joint Economic Committee in 1979, I guess, prepared by the chairman who is sitting to the right of the chairman of this committee.

> Policies which produce slow growth will not also produce price stability. A slow growth scenario for the 1980s implies a concomitant rapid rise in the cost of living. The fight against inflation can be won only by policies which increase production. A stagnating economy means double-digit inflation. It means protracted and rising unemployment. It means a reduced standard of living. Policies which lead to slow growth will lead to many and unnecessary cruel hardship for disadvantaged Americans.

I have been trying, as the chairman of this committee knows, to throw that idea before the committee, in publications and in testimony, since 1954. When we first projected the horrible idea that the way to stop inflation—there wasn't any inflation, incidentally. The inflation did not begin until we tried to stop it that way—was to cause unemployment of manpower and of machines, and of business skills, and of everything that makes the American economy, and that supports it.

The curious thing is that now that this doctrine of the tradeoff has been repudiated so eloquently, the President, the Congress, and the administration are still doing it. They are still trying to slow down the economy, not by higher taxes but by lower spending, and still worrying about speeding up the economy by a tax reduction because it may cause more inflation.

This is empirically so absolutely ridiculous that one does not need to argue the relative merits of getting a little less inflation,

and getting tremendously less production and employment which have inflicted the costs of $7.7 trillion of 1979 dollars upon the American tax economy since this thing got started in 1953 and 80 million years of unnecessary civilian unemployment conservatively measured against an optimum economic growth rate of only about 4.4 percent as against what we have actually done.

This is the first thing that we have got to do.

The second thing we have to consider is supply economics. I don't want to rumple any feelings. I don't understand what is meant by "supply economics" as against "demand economics." Obviously, we want supply economics that keep production of goods and services in line with our maximum capability to properly stimulate it.

Obviously, we want demand to markets that clears the markets, because otherwise the plants are going to be idle, and the people are going to be idle.

So the real problem is to examine what relationships in the flows of income as affected by tax policy, and by money policy, which I will say a word about, and how other national policies affect those flows. We have developed no concept of those balanced relationships as we proceed with a tax reduction here, and a spending action there, and something else somewhere else.

We have no goals as a guide to policies, and I know because we had them. We rationalized them, and we put them together when the policies were successful. We don't have them now at all.

So in the name of supply economics, as misused although I am for it as properly used, we are going to proceed, it seems, in a tax reduction pattern, making exactly the same mistakes that we have made repeatedly—I don't want to say, since 1964, Walter. I had something to say about it then.

The great Arthur Oaken, who unfortunately we have lost, confessed in an economic report to the President 2 years later that we should have put more strength upon consumption.

The chairman of the Joint Economic Committee said last year, again brilliantly, that the reason the economy was not going entirely to hell in 1979, it was growing only 0.8 percent and that was terrible, was because consumption was holding up moderately well, and investment would be all right so long as that continued, and that the great danger to investment was that consumption would fall behind in 1980.

Now, I have a statement from Business Week of a week or two ago, which I have not had the time to read, which says that the key to the whole thing is whether the demand will support the supply. It is not doing so any more.

Therefore, I propose that instead of using a gaudy name to say that we are doing something new, while making old mistakes, we ask what kind of balance we should give in the forms of the tax reduction. I am going to throw out an idea to be a little more specific.

Consumption is six times investment, roughly speaking. Even if you want to stimulate growth, and growth obviously is far too low when the economy is in a recession, you would be dollar wise to get the same percentage stimulus as applied to each, have about six times as much stimulus on the consumption side as on the investment side. I think a pattern of tax reduction should be geared that

way, roughly. I think it would produce a better balance in the economy.

Instead of just having talk about how we have been consuming too much, and need to sacrifice. And that demand economics has failed. Demand economics has not failed, it has not even be tried. I have been saying for 10 years that we had this miserable economic performance, and that we were not getting adequate demand, and we weren't.

The gist of what Walter is saying right now, if I understand it properly, among other things, is that we are not getting adequate demand. Let's put the two together, and let's carve out a tax reduction program that uses the two in balanced proportion, and that relates the tax reductions for investment purposes to some consideration of where the need for more investment is, some kind of quid pro quo.

I did object to the kind of tax reduction that we have had over the last 10 years. I objected only because I said, you know they are not short of funds. They are not short of ability to borrow. When they sit around the table to decide whether they are going to invest more, they look at what they are going to be able to sell. This is commonsense economics, and we have buried it, as we buried King Tut. We had better bring about some kind of reincarnation of ordinary commonsense in this whole proposition. So I would approach it that way.

The next thing. You cannot build a great nation forever with more and more tax reductions to solve every problem. We are not even asking ourselves any more what part of the job of stimulating the economy on a long-range basis, what part of our great national needs in mass transportation, in energy, in environment, in rescue of our cities, and some kind of modicum of decent treatment of our farm population. Depend upon more public spending, not more tax reduction. Can every part of it be met by handing money to people to spend, and no part of it be attempted by well-guided public investment.

You can make mistakes in public investments. You can also make mistakes in tax reductions. But I will state it as basic an axiom of anything in the law of economics that a nation that commits itself increasingly since 1964 to nothing but tax reduction whenever they think of a problem, it will solve inflation, and it will solve deflation, it will meet the problems, and commits itself to more and more tax reduction instead of reliance upon pointed public investment is moving the wrong road.

There is not a country in the world that is outdoing us in many respects that duplicates in any respect what I regard as the nonsense of this proposition.

Third, we have to look at the magnitudes, and Walter certainly said that. Looking at the size of the economy, looking at the size of the deficits, I think we need a Federal tax and spending $48 billion stimulus this year, lifted to about $60 billion or $20 billion more next year, and the net including whatever is done about the social security tax.

In other words, if you are going to have any social security tax increase, instead of needing $48 billion you will need $48 billion plus enough to counteract such social security increase. I don't hear

that talked about. That is the size thing we need if we are going to do the job on a long-range basis.

Then we have to consider how we divide the stimulus. I would suggest that in view of the political realities—I would say more if not for that—maybe something like half between investment, and half between tax reduction, with the tax reduction governed by the principles that I have suggested, and thus running up to about $24 billion in the first year and $30 billion in the second.

Thank you. I see my time is up.

The CHAIRMAN. Thank you very much.

As the members of this committee know, we go by what is known as the early bird rule—the first Senator who gets in the room gets to ask the first question, and that is me. I was the first Senator here today, so I get to ask the first question.

I would like to ask that each Senator be confined to 5 minutes, if there is no objection, in interrogating this panel. If they need more time we can come back to them after the first round of questions.

Do I take it from the testimony I have heard here that all three of you agree that we should have a tax cut at this time?

Do you agree with that, Mr. Keyserling?

Mr. KEYSERLING. Yes, sir.

The CHAIRMAN. Do you agree with that, Mr. Heller?

Mr. HELLER. Indeed.

The CHAIRMAN. Do you agree with that, Mr. Greenspan?

Mr. GREENSPAN. Yes, sir.

The CHAIRMAN. All three of you have had experience as the Chairman of the Council of Economic Advisers with a great variety of problems, and you know what these things are about. Having looked at this, you gentlemen having served under Democratic administrations and Republican administrations, all of you agree that we ought to have a tax cut.

May I say, having seen how each of you work, and do good work for the country, it seems to me that it is enormously impressive.

I cannot buy the argument that I heard yesterday that we should not have a tax cut, even though the economy requires it—that, I think, was conceded—just because somebody might offer an amendment to the bill.

I have seen amendments offered before, and my impression about that is that no one likes to have an amendment offered, unless he agrees with it. If you disagree with it, you wish that the person would withhold it. But on any major revenue bill, you have to let people have the opportunity to offer their amendments.

What impresses me about the problem is that if the effective date is to be January 1, 1981, how would businessmen be better advised to make decisions: with a law that they can look at and guide themselves by passed before January 1, or making decisions not knowing what the law is going to be, a law passed next year that would have to go into effect retroactively.

Is there any doubt in any of your minds that the business people would be better advised if they had a law before them, than to have to act hoping the law will be changed in the future?

Mr. KEYSERLING. Mr. Chairman, if the argument of the administration be valid, the Congress cannot act responsibly on a tax cut until after an election, then by the same token the administration

should suspend all of its primary activities until after the election on the ground that people cannot act responsibly before an election.

You could not be more right that the Congress on the tax cut is going to act not too differently before or after the election. They are going to have to listen to pressures. They are going to have to bargain. They are going to have to resolve competing views.

This is one of the silliest arguments I have ever heard.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

The CHAIRMAN. By the way, gentlemen, there is a vote on now. Those of you who want to can go vote and come back.

Senator CHAFEE. Mr. Chairman, I would like to address my first question to Mr. Greenspan.

I was impressed with your testimony that the drag in the system from the tax size is threatening to become onerous. I would like to have you go into a little detail on the exact type of tax cut that you would recommend. Could you outline that for us?

In other words, all right, we are going to have a tax cut. What kind of a tax cut would you recommend?

Mr. GREENSPAN. There are several potential versions, Senator. I would first subscribe to the initiative that was offered by the Republicans of this body, joined by Governor Reagan a couple of weeks ago, for the first phase of Roth-Kemp.

Senator CHAFEE. Just the 10 percent?

Mr. GREENSPAN. Yes, and let me suggest why.

We have, and I think quite correctly, been focusing on sophisticated techniques to create incentives in our system, and there is no question that that is an extraordinarily high priority with respect to tax policy.

Regrettably, what we have in place at this stage is a series of disincentives being created. In my judgment, what must occur first is to eliminate the disincentives. The best way to do that is merely to roughly adjust, as best we can, the inflation impact on our system.

Remember that there are no tax cuts recommended anywhere that I can find, which even remotely resemble the aggregate amount of tax increases that are now confronting the American people. In most cases, we are talking not about tax cuts, but about reducing the rate of increase.

Senator CHAFEE. I think you said in your testimony, or Mr. Heller did, $86 billion of new taxes in 1981.

Mr. GREENSPAN. That is the official estimate of the Office of Management and Budget as of 2 days ago. The figure has not significantly changed from recent estimates, and it is unlikely to do so.

Mr. HELLER. May I interrupt just to say that it is worth noting that that is the total increase in collections, because of inflation, and so forth, some of that is different from the actual new taxes going into effect, which are somewhere between $50 and $60 billion.

Senator CHAFEE. You mean the social security increase?

Mr. HELLER. The social security, the bracket creep, and the oil profits tax, they add up to somewhere between $50 and $60 billion

of new taxes in the sense of higher rates and higher base, not in the sense of the actual generation of a higher GNP in money terms.

Mr. GREENSPAN. In any event, Senator, what I would recommend at this stage is that we first get to the issue of removing the disincentives. In my judgment, the package offered by the Republican side of this body strikes me as the most appropriate at this stage.

Senator CHAFEE. You only addressed the first part, the 10 percent personal cut. What about on the accelerated depreciation, the 10-5-3. Could you address how you think we should proceed on that.

Mr. GREENSPAN. I would think, Senator, that first any of the tax bills that have been offered with respect to accelerating depreciation is far superior to what we have. I trust that we do not, in the process of wrangling over different versions, essentially come up with none.

The 10-5-3 has many positive, and some negative aspects to it, as indeed does every other initiative. What I would suggest is that this body have a special session on all of these various technical versions. I myself would tend to support 10-5-3, but it is only a marginal choice. I would support, for example, as I think Professor Heller has indicated, Professor Jorgensen's particular view, but I think that it is probably front-loading the revenue far more than what I think Congress would want to do.

In any event, the important issue is to recognize that any bill in this area is better than none.

Senator CHAFEE. I agree with that, but the administration argues that the 10-5-3 is very expensive in the out years. So they have come forward suggesting yesterday, Mr. Miller did, that the 10 part does not help your industrialization at all. You are not helping by building new buildings, necessarily, as much as you are sticking with the 5-year writeoff for machinery and equipment.

Could you expand briefly on that?

Mr. GREENSPAN. I disagree with that. What we have seen in the last 10 or 15 years is a gradual decline in the average life of capital investments being made by American business. That is substantially the result of accelerated inflation premiums, and gradual contraction of the average life of what we are investing in.

This is one of the reasons why productivity has slowed in this country. I would suggest that anything that we can do to reinvigorate long-term investment is helpful.

I do not deny that any version of an accelerated depreciation bill will favor one industry versus another, and I would defy anyone not to be able to find some exotic example, which looks terrible in the light of what the purpose of the bill is. But if we allow that sort of analysis to deter us from moving ahead, I think we would be making a bad mistake.

Senator CHAFEE. Thank you, Mr. Chairman.

Senator NELSON. We are on the second bell of a rollcall. We will recess for 10 minutes.

Senator DOLE. Let me just ask a couple of questions because I have to go to a meeting in Senator Byrd's office.

I want to follow up on what Senator Long said, because I think as is customary he has his finger on the pulse. I agree with what Mr. Heller said. I hate to think that this is going to be a tax cut in a political year. It would be unheard of, wouldn't it? Is there any precedent for that?

Mr. HELLER. Yes; there are some precedents for that.

Senator DOLE. Yes.

Mr. HELLER. 1964 comes to mind, and 1972 comes to mind.

Senator DOLE. Plus a lot of other years.

Mr. HELLER. 1964, of course, was the greatest tax cut ever announced. [Laughter.]

Senator DOLE. I am not as familiar with that as you are, but you may be absolutely correct.

I think that we may be misleading the American people when we talk about a tax cut. I am not certain that we are going to have a tax cut. I think we are just trying to lessen the increase.

Is there another name that we could use, instead of trying to lead people to believe that we are going to have a big tax cut? As I look at the $80 and $90 billion in new taxes in fiscal 1981, are we being honest with the American people when we talk about a tax cut?

Mr. HELLER. It is a longer word, but you could call it a tax abatement, which is really what it is. You are abating some of the impact of the tax increases that would otherwise go into effect. It is not a very catchy term.

Senator DOLE. I don't think tax cut is either. We have just finished a survey in my State, where only 9 percent of the people were convinced that we were really talking about a tax cut, and most were concerned about other matters.

I really believe that the reluctance on the part of the American people with reference to tax cut is based on the fact that they know that it is not a tax cut. They know that it may be, as you indicated, an abatement.

If it's satisfactory to the witnesses, we will have a brief 5- or 10-minute recess while we all run over and vote.

Thank you.

[Recess.]

Senator PACKWOOD. The committee will come to order.

I will use my time now to ask questions while the members are voting.

I wonder if I might start following up where Chairman Long left off. All three of you are in favor of a tax cut.

Dr. Heller, I have tried to add up your figures, You have got roughly an $18 billion social security reduction, and if you count the self-employed, that gives about half to individuals and half to businesses.

Mr. HELLER. Right.

Senator PACKWOOD. You have a $5 to $10 billion depreciation cut in some form or another, and a $5 billion wage insurance contingency, which may or may not have to be used.

Is it fair to say that you are tilting your tax cut roughly 50-50 business/individual?

Mr. HELLER. That is correct.

Senator PACKWOOD. The individual part is the social security tax reductions.

Mr. HELLER. That is correct.

Senator PACKWOOD. Alan, you are in favor of a tax cut, but I sense from reading your past statements that you would also tilt it rather strongly toward business tax cuts, or maybe roughly the same 50-50 proportion that Dr. Heller recommended. Is that a fair statement?

Mr. GREENSPAN. That is correct.

Senator PACKWOOD. On the Roth-Kemp figures, the initial one, of course, was just a straight across-the-board 10 percent tax cut for individuals over 3 years, or 30 percent.

Would you both think that type of tax cut would be a wise one?

Mr. GREENSPAN. I think it would.

I have a certain problem in the sense that I would like to see much larger tax cuts throughout this period, and certainly far greater emphasis on incentives for business investment. But as I indicated in my opening remarks, I have now become so concerned about the problem of just slowing down, at least as a first shot, this extraordinary momentum on the tax receipt side that I cannot see how at this particular stage we could put into place a tax cut bill, which I would feel optimum.

If somehow we could wave a wand, and knock $100 billion off the expenditure side, I could think of some tax bills which in my judgment would be very effective. Regrettably, we have in the last several years spent a good chunk of our potential tax cuts. Therefore, I am being forced into a numerical position of picking and choosing, and as a consequence granted the choices available, the least worst in the sense of not having all of the various choices in front of us, is to go with the Roth-Kemp and some early version, or some starting version of accelerated depreciation.

Senator PACKWOOD. The Republicans are stumbling over the Democrats, and vice-versa, to get to the starting gate to claim credit for this. If you could not get anything else, would you take Roth-Kemp?

Mr. GREENSPAN. Yes, indeed.

Senator PACKWOOD. You would like to have some depreciation, or something else added. But if that is impossible, you would take the across-the-board 10 percent.

Mr. GREENSPAN. Yes, largely because what Roth-Kemp does is substitute effectively for indexing, and at this stage what I think is most important to eliminate is bracket creep and the tendency to press excessive burdens on the structure of the individual tax system.

That creates the type of negative incentives which we should avoid very strenuously.

Senator PACKWOOD. Dr. Heller, what about you? What if our option is almost a total individual tax cut, maybe Roth-Kemp or some close variation of it, would you prefer that to nothing?

Mr. HELLER. That is a tough question. I hope we are not confronted with that kind of an alternative. I find myself here to the right of Mr. Greenspan—I don't mean just physically, but policywise—and that is an unusual position for me to find myself.

I think structurally we ought to adapt that tax cut in such a way, as you have just summarized. You ought to get some of that cost push payroll tax off of business, and some of that take-home pay decreasing burden off of labor, so that you have some chance of moderating wage/price increases. Overall, my proposal would give somewhat more advantage to business than his.

Second, as you look further into the future, I simply cannot see enough room for a $127 billion tax cut by 1983. There is no way that the Federal budget is going to be cut that much. Out of that $127 billion, you are only going to get a feedback, by all of the numbers that we know as to the stimulative impact of tax cuts, of $40 to $50 billion. That is an add on, I said conservatively, of $60 billion, and closer to $80 billion, to the deficit in 1983 minus whatever expenditure cutbacks you can make.

I don't think that with a $100 billion increase in Defense expenditures that you are going to have that cut back in expenditures. So I think that you ought to take the cautious, conservative course.

Senator PACKWOOD. Let me ask one last question of both of you.

I don't know if we are going to come out on a tax cut, but if it heavily tilts toward an individual tax cut, and relatively slightly toward business, you both agree that it will widen the deficit, and maybe substantially widen it in 1981, and will be further inflationary?

Mr. HELLER. No. You can substantially widen the deficit in 1981 from the currently projected $30 billion. Let me say that it may be actually, cold turkey, $35 billion, or something like that. You could substantially expand that to about $50 or $60, and you don't come anywhere near crowding out private borrowing because it is the reduction in private activity and private borrowing that makes the room for that public borrowing.

I think that a modest tax cut under those circumstances is going to be, if you structure it right, anti-inflationary, and not proinflationary. I really, honestly, I think that the Roth-Kemp, or Kemp-Roth plan is the radical plan. I had the opportunity to say to Congressman Kemp, about 3 weeks ago, that I thought I was the fiscal conservative, and he was the fiscal radical. He said, "It is the first time I have been called a radical, and I rather like that. 'I am glad that he accepts that definition because I think he deserves it.

Senator PACKWOOD. I have some questions for Dr. Keyserling, but my time has run out.

Alan, would you answer that last question. It will widen the deficit. Will it in any way worsen inflation?

Mr. GREENSPAN. First let me just say that if we institute a set of depreciation rules while in the first year, you will have an abnormal individual to business tax tradeoff. As the years go on, it will shift more toward business, and that is as it should be, because a business tax cut now will not create incentives because capital investment takes probably 2 years before it becomes profitable and taxable.

I do not think that the institution of Kemp-Roth at this stage, or any reasonable tax cut will, provided that it is appropriately structured, be any more inflationary than the policies that are now going on.

Mr. HELLER. I cannot resist just one add-on. I disagree with that. We ought to front-load, and not back-load the stimulus for business, because if we have that stimulus growing just at the time when the economy is reaching something like full employment, then it is just going to blow the top off of inflation.

The time to give the stimulus to business is early in the game, so that we can reap the benefits without pumping too much juice into the economy.

Mr. KEYSERLING. May I make a little comment on this discussion, because it relates to what I am talking about.

Mr. GREENSPAN. Would you yield for just 2 seconds.

What I am saying is that a depreciation tax cut, which is set in place now, to accelerate in later years has its maximum incentive on capital appropriations now, and not later.

Mr. KEYSERLING. I think that the questions that have been asked characterize the basic reasons for the terrible mistakes that we have made all along. I judge mistakes only by results, not by ideological propositions or whether what I say is pleasing to business or to labor.

I have been studying very carefully and very constantly, and if you look at the supporting materials that I have in my testimony, I have made for recent periods an analysis of what has been happening to business investment, and what has been happening to what I call ultimate demand; namely, consumption plus Government demand.

I have shown that before each recession, and including 1979, which I would call a recession, although we had an 0.8-percent growth, the investment was growing four or five times as fast as the ultimate demand. That is not probusiness, or prolabor, or pro-what-have-you. That is what has been happening. That was happening before each of the preceding recessions. Therefore, I say, you have to consider what you want to stimulate and in what proportions.

The question was asked, if you don't have a choice, or if you have to choose between A and B, would you rather take A than nothing. You know that is what has been happening. When we need a stimulus for the economy, we say what the hell does it matter where we throw all the money. Let's just throw it anywhere.

I say that this is like a guy driving up to a gas station, and the attendant says, "Shall I put the water into the gas tank, and put the gas into the cylinders?" The driver says, "What difference does it make? Haven't you ever heard of "Lord Keynes." Just fill her up." It makes all the difference in the world where you put it.

Now let us even assume that you want to stimulate investment more than consumption. Taking the consumption alone, without adding in the factor of Government demand which is demand not because of Government investment, but the Government is buying things. It is not producing plants. It is public demand and private demand, and private investment, and it is the private investment that increases the capacity.

Even if you wanted to stimulate them equally, or even if you wanted to give a greater benefit to investment, you have to consider that according to the last economic indicators, and it is a good,

rough rule, the nonresidential fixed investment is running at about one-sixth of consumption.

Now, if you admit that both are very much too low in the kind of economy we have. If you add $10 billion—I am taking rough figures—to investment, and $10 billion to consumption, you are adding six times as much percentagewise to investment, because consumption is six times as big.

Therefore, if you want to give any proportional or rational stimuli to the two, you have to take some account of the respective size as factors in the economy. I don't know what you are coming out with, but I certainly think that you have to take that into account.

I don't quite follow the argument that somebody said here, I don't remember the exact figures, that we cannot reduce taxes by $217 billion a year over the next *x* years, and that the exact figures don't matter, because we can't reduce spending that much.

What kind of economics am I hearing? If the economy has been suffering from a congenital and chronic retreat from full utilization of its resources, and if the whole mixture is wrong, what the hell sense does it make to say that we are going to put tax reductions on one side of the cart, and reduced government spending on the other side of the cart, and have them pull in opposite directions?

If you accept the formulation and the nature of our economy and its need for growth, to equate tax reduction with reduction in expenditures is nonsense. It is utter and complete nonsense. From any consideration of national priorities, which is what a decent society is all about, it is worse than nonsense, and it is inequitable as hell, and it is what has been going on.

Besides, it does not even relate to the question of balancing the budget by cutting the taxes, and cutting the spending by the same amount. But I have not had time to say, but I show it in one of my charts, and I have shown it repeatedly, the deficits do not come from spending, or taxes, or tax cuts. It has come from the fact that you can't squeeze the blood of adequate revenues out of the turnip of a starved economy.

How can a government that a year or two ago was swearing that it was going to balance the budget this year, and is coming up with a $60 billion deficit, still come up with the drivel that the way to balance the budget is to continue to do what they are doing in their effort to balance it.

The Truman administration in which I served ran a net surplus average for 7 years in a row, although the Korean war was a large part of the national economy than any international nonproductive burden since. How, because you had a full turnip, and you reach the needs, and balance the budget.

Now the same people who said that they would get us a surplus this year, that this was the top priority, and who are going to run a $60 billion deficit, now say that the deficit is only going to be $29 billion or $32 billion next year.

Take their own projections, which are always too optimistic, that you are going to have 9 percent unemployment by the beginning of 1982, and a 4.5-percent decline in the economy this year if the 9 percent converts to zero, or something like so that you average 4.5,

how are they going to have only a $28 or $30 billion deficit next year? The deficit next year is going to be as big as this year.

What I am trying to say, and it pains me, the whole scheme of approach, the economic analysis and the economic policy have departed not from radicals moorings, but from what was always regarded as the very basis of economics. You could never have had any basic economics years ago that said that the important thing really is reduction in production and employment, and the important thing is balancing the budget, and not having inflation, because production and employment are the source of all wealth.

But to continue to try that after 25-odd years when trying to do it that way has also increased the deficit, and has also increased the inflation, I just can't follow it. I think you can understand how it upsets me a little bit.

The CHAIRMAN. Senator Bentsen is next.

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

Let me first thank you, Dr. Keyserling for your generous comments concerning the report we made at the Joint Economic Committee last year, and that was prophetic, I believe.

I feel very strongly that the way we have to beat inflation is by production lines, and not by unemployment lines. We have seen long-term capital investment for a worker going down, and it is time that we turn that around, I believe.

I am not sure that a tax cut is good politics. In years past it certainly was. I have read these polls that say, "Are you for a tax cut?" People keep telling me that the answer is, "No, I am not because of inflation." I totally agree with them if it causes inflation. But we sure don't have to have that kind of a tax cut.

I don't know if it is good politics, but I do know that it is good economics, and I am convinced that we have to do it. The problem we have, if we look at the realities of it, we have a short term in which to accomplish this tax cut. But if we wait until next year, then we have to organize a new Congress, committee assignments, then start hearings again. We would not have a tax cut until probably July. I think that that is a serious mistake.

When we hear the estimates of what the drag is on the economy, we have estimates all the way from new taxes of $47 billion, and I have heard as much as $80 billion. But obviously there is room in there for this tax cut.

One thing concerns me, one of the arguments that I hear against it. I must say that it does not concern me very much because I question the validity of it. I am told, if we start talking about a tax cut, we are going to get an increase in interest rates right away because that is the way the financial markets are going to perceive it.

I would like one of you to tell me, do you think we run a serious danger in doing a tax cut, insofar as reversing the long-term interest rates if we try to target the tax cut very carefully?

Mr. HELLER. Senator Bentsen, and Mr. Chairman, I would not agree more with the implication of your question, in an economy that is so far below its productive potential, and given a tax cut that is clearly carefully structured to be anti-inflationary in the supply side sense, if there is no demand side risk, and you have a plus on the supply side, so to speak, and with Federal borrowing

merely replacing private borrowing that is not taking place because of the recession and the slowdown, there is just no reason why Volcker and his associates at the Federal Reserve should either induce or permit an interest rate increase in those circumstances, because I don't think that it would spring naturally out of the economic developments in the financial markets.

So I do not think that we risk that interest rate increase, although eventually, as the economy revvs up in 1982-83, of course interest rates will increase again as part and parcel of the natural cyclical process. The tax cut will not do it.

Senator BENTSEN. Alan, do you wish to respond?

Mr. GREENSPAN. Yes, Senator.

I have been puzzled by the response in the money markets, and as best I can judge it is not taxes that is concerning people, it is the acceleration on the expenditure side. I don't believe that if we were to cut taxes that that would have a significant impact one way or the other on the overall inflation premiums in the money markets, which is essentially what we are talking about.

I do, however, believe that unless we turn the rate of increase in Federal outlays back down to where it has been for quite a while that that might create problems. In an odd way, the tax cut may actually facilitate the coming to grips with the expenditure side, especially if we put a tax cut in place which is not only a 1-year tax cut, but one which is programed for a series of years, so that we know what revenues are available, and can address that issue in the Budget Committees and elsewhere in the Congress.

Senator BENTSEN. Mr. Chairman, I think that I got a fast clock.

The CHAIRMAN. You have one more question.

Senator BENTSEN. I have listened to the different estimates on what Kemp-Roth would do. I listened to Dr. Schultze yesterday say, $100 billion deficit in 1983. I have listened to Dr. Heller say, a $60 billion add-on in 1983, which might be $100 or might be more. I have listened to Dr. Greenspan say that it might be a surplus by 1985.

Dr. Greenspan, I did not get the assumptions that you made in arriving at those kinds of estimates. For the record, I would appreciate it if you would give us the assumptions that you are talking about that go into your estimate. This would give us a better opportunity to evaluate it.

Mr. GREENSPAN. First, that the current services budget for nondefense is in place with only the so-called discretionary inflation adjustments such as Federal pay increases. That there are no addons of either major new programs, or in the existing entitlement program structure.

Two, that there is a significant, but as yet undetermined add-on to budget authorities in the military over and above what is currently in the long-term budget.

Three, that Roth-Kemp goes in place as it now exists, and that some version of an accelerated depreciation bill goes through, perhaps not 10-5-3, but some reasonable version thereof.

Under those conditions, and under moderate reflow estimates of revenues, starting with the Congressional Budget Office's current $160 billion-plus current services surplus by fiscal 1985, you end up with either a very small deficit, or a very small surplus.

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

The CHAIRMAN. Senator Danforth.

Senator DANFORTH. This question may have been answered in response to Senator Packwood, but I don't think so. I would like you each to answer it in turn.

Let's assume that we pass a tax cut bill effective January 1 in the amount of about $30 billion. Always in a tax cut there is a split between the individual component and the corporate component. I would like to ask you each your views on, first, the appropriate ratio, or the most desirable ratio between the individual and the corporate components of a tax cut.

Second, with respect to the individual component, what form should it take? There are a variety of possibilities. One would be a rate reduction. One would be some sort of social security offset, and there, too, there are options: One is the tax credit proposal, the other would be to fund medicare out of general revenues. A third possible approach would be indexing. A fourth possible approach would be some sort of savings specific type of tax cut. For example, further cut of capital gain rates, or universal IRA's, or exclusions for interest and dividends, and that kind of thing.

Generally, with respect to the individual portion of the tax cut, how much should there be and what form should it take?

Mr. KEYSERLING. In answer to this question, I have to say that what I fear is that when I try to picture what kind of tax action, what kind of budget actions emerging from the joint actions of the President and the Congress, and the economists who advise them, and the general mainstream economists——

When I visualize what is happening under that, I see nothing new; I see nothing different. I see that we are facing the prospect of exactly what we have run through for at least 10 years: Some stimulation to the economy for a little while. As soon as it begins to move up, and it gets halfway where it ought to be, then priority No. 1 is something else.

So we deliberately announce in the official reports that we are going to drive the economy down again. We go through that timeless roller coaster seesaw of a long-range policy. Now, let's apply my answer to your question to that, and then I want to say just one word about the Federal Reserve.

I will not argue for the moment whether the greater weakness in the economy on any real analysis is in consumption or in investment. I realize that investment adds to productivity.

Senator DANFORTH. Yes, sir. I understand the point that you have been making. I was just asking——

Mr. KEYSERLING. You were asking me how I would divide it.

Senator DANFORTH. Yes.

Mr. KEYSERLING. I would not divide it by saying how many dollars you give to each, but how much percentage you add in one case to the disposable income, and in the other case to the funds available to the business.

Therefore, if you divide it half-and-half on a dollar basis, nonresidential fixed investment is one-sixth as big as consumption, you are giving six times as big a stimulus to one as to the other. I say that that is not defensible in terms of any of the evidence.

Therefore, I would divide it roughly—abandoning my point that the weakness is more on one side than the other, I would divide it roughly in accord with the relative size of the two factors in the functioning of the economy. That is my answer to your question.

Senator DANFORTH. What would that division be, approximately?

Mr. KEYSERLING. That goes to the question of whether we are going to do over and over again what we have always done, just at random say, "Well, a $10 billion package looks good. A $20 billion package looks good." You have to follow forward from what Walter said, "What is the size of the deficit in the economy? Where do you want to go? What size growth rate do you want?" On a long-range basis, taking all factors into account, what is the size of the stimulus that is meaningful, and not just a placibo, or a political gesture, or doing the same inadequate thing over and over again.

I gave my figure on that. I said, it looks to me that you would have to have Federal tax and spending stimulus of $48 billion in the first year lifted to $60 billion in the second, which is very small compared to the size of the economy, that would be about the size, and that would have to be met taking into account what you do on social security, and taking into account what you do on everything else, because if we allow one tax to rise as much as the other taxes fall there is no net stimulus. Altogether, I recommend a $48 billion stimulus the first year, half in increased public investment and half in net tax reduction, with the $24 billion in the tax reduction going about five-sixths to consumption and about one-sixth to investment.

Those are the sizes that I would suggest.

Mr. HELLER. Senator Danforth, just very quickly. I was proposing about $18 billion of payroll tax cuts. I would prefer, as a direct payroll tax cut, a shift of the hospital insurance over to the general revenues. I think that it has more punch if it is in the form of a payroll. It has more punch in cutting back business costs.

The Gephardt approach of a deduction against income tax is not quite as punchy in that respect because it hits the corporate income tax. But if you had an $18 or $20 billion gross payroll tax cut, that would be $10 billion/$10 billion to individuals and corporations. But since the corporate one would be deductible from the corporate income tax, it would come out about $8 billion. So that is $8 billion net for corporations, and $10 billion for individuals.

Depreciation would be about $7 billion for corporations, and about $1 billion for individuals. Then I would have a backup of wage/price guidelines by wage insurance, which sets aside about $5 billion for individuals. So I come out with about $16 billion for individuals with a contingency, and $15 or $16 billion for business.

Senator DANFORTH. It would be about 50-50.

Mr. HELLER. Yes.

Senator DANFORTH. Your preference for the type of those various possibilities would be payroll, but you would prefer the medicare option.

Mr. HELLER. Yes, and I will add one other thing.

When labor looks at this, it ought to bear in mind that even though a big chunk of this cut is given to corporations in the form of that payroll tax cut, eventually most of that accrues to the

benefit of consumers, and those consumers are members of the labor force.

Senator BYRD. Did you say that you preferred a medicare transfer to a payroll transfer.

Mr. HELLER. I would prefer a direct cut in payroll taxes of about $20 billion, which is the approximate cost of hospitalization insurance under medicare, as I understand it, in the social security system. I would like to transfer that to the general revenues because it seems to me that health or hospitalization does not have much relationship to wage payments, and it ought to be financed out of the general, progressive, overall tax revenues.

So I would like a direct cut in the form of simply suspending all increases for 1981 and going a little bit beyond that to $20 billion. But if you could not get that because fears of the soundness of the social security system, and I think those fears are misplaced, but the public is scared, then I would do it in the form of the Gephardt bill, in which you took $18 or $20 billion in payroll taxes as a deduction against your corporate and individual income tax.

Senator DANFORTH. Alan?

Mr. GREENSPAN. Senator, I have a series of priorities, all on the issue of first removing the disincentives which the growing tax burden is creating on the American economy. I would, therefore, in order of priority list indexing as first. The reason I support Roth-Kemp is that it is a proxy for indexing.

Second, I would support most strongly a 5-year scheduled reduction in the corporate income tax. The purpose of that being to backload the tax cut, but announce it now to gain the maximum current capital investment impact.

The various forms of accelerated depreciation which have obviously far greater political support at this stage, create most of that effect, in my judgment, not exactly the same. It is slightly inferior.

Nonetheless, because there is such significant support for these depreciation programs, rather than choose between corporate tax cut and depreciation, and lose both, I do strongly support depreciation.

Senator DANFORTH. Mr. Chairman, if I could just repeat the original question.

The question was, What portion of the total, let us say $30 billion in 1981, would be allocated to the individual, and with respect to the individual portion what would be the best form for it to take?

The best form for it to take, in your view, for individuals would be indexing. You believe that the Roth-Kemp is a rough offset for indexing, and you can accomplish the same objective as indexing by rate cuts, although over a limited period of time.

How about the split?

Mr. GREENSPAN. The reason that I hesitated answering the split is that the split is a function of what time period you have in mind. Obviously, in the very first year, fiscal 1981, it is very heavily individual, and small business. But that changes over the years.

But if we are thinking in terms, as I think we should, of not the absolute amount of change in revenues at the Treasury, but the differential degree of incentives created, even though the revenue losses are very modest in the first year, the impact on capital investment incentives is rather large because if we put in place

particular long-term accelerated depreciation statute, since capital investment is made over these longer lives, the impact is very strong initially because the investment will be paying taxes over a longer period.

So if you look at it strictly in terms of a balancing of revenue losses, we miss the incentive balance issue. Even though the revenue loss in the type of program I would suggest is sharply skewed in terms of individuals, and very modestly in favor of business, the actual impact on the economy is quite a good deal different from that.

Senator DANFORTH. Thank you.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Thank you, Mr. Chairman.

I would like to ask each of you the same question. We are engaged in a discussion of tax cuts. On the business side, we have begun to face the tax cut as a productivity tax cut. Productivity, as I understand it, is an infinitely complex matter, and perhaps oversimplifying it a little bit, but assuming that there is a relationship between the amount of investment in society, and the level of productivity, when you take the comparative levels of investment in the United States, West Germany, and Japan as a percent of GNP—roughly, we are at 10, West Germany at 15, and Japan at 20. Do you agree that we must increase our size of investment as a percent of GNP? If so, where will that investment come from?

Who will lose if we increase the amount of investment, or can we get that amount of investment from growth in general in the present environment?

Mr. GREENSPAN. Nobody loses when we get increased investment. It is clearly in the affirmative. We obviously have to create more investment in our economy, and one of the reasons I am so strongly in favor of removing the excessive increase in overall tax which is now beginning to emerge is that we are putting roadblocks in front of the investment process merely by allowing the aggregate amount of tax burden to rise.

It is certainly the case that it matters where those taxes are. But let's remember that tax incidence, that is where the ultimate tax burden falls, as distinct from the person or group on whom it is imposed, is not easy to determine.

The aggregate burden should be addressed in the sense that even though we may say that a specific tax on business hits business, ultimately the consumer and the individual will feel it as well. Therefore, I would argue that we not exclusively focus on just where that additional tax burden is, and think in terms of bringing all taxes back down.

So I would conclude that, first, we have to remove the aggregative growth in the tax burden, and second, focus on the expenditure side, and hold the aggregate of credit creation processes of the Federal system in check. We have to reduce inflation, and defuse the inflation biases in the capital investment process.

A combination of both of those would, in my judgment, create the type of dynamic capital goods market which would strongly increase the productivity potential of this country, and enable us to compete far more effectively with other countries in the world.

Mr. HELLER. Senator Bradley, four or five points.

No. 1, I agree entirely with one of Mr. Greenspan's points, that we need to have some tax stimulus to capital investment because that is an important element in the increase in productivity.

No. 2, we should recognize that there are a lot of other elements. Capital investment per se is about four-tenths of the explanation of productivity increase. We ought to be very careful also to nurture more research and development, technological advance, and so forth. I have some sympathy, even, for some tax breaks for research and development, although they are very tough to factor, especially since we already allow 100 percent deduction of research and development expenditures against income for tax purposes.

Senator BRADLEY. What percent of GNP should be investment?

Mr. HELLER. That is a tough question. We have found that it has been 10 percent more or less for a long, long time, and 16 percent if you take all kinds of investments, housing, and so forth, into account. It has been a terribly stable number. It is awfully tough to boost it.

I think that we not only should focus on that number, but the competition. We have had 10 percent investment in the past 3 years, but too much of it has been to short-term stuff.

Alan is quite right, there has been a discrimination against long-term investment through inflation, and the inflation premiums. So we should be working on moving the composition, and that is equally important to moving the total amount.

I think that if we could step it up to 11 or 12 percent, it would be fine. We have to remember that Germany and Japan are still trying to catch up in spite of what Mr. Keyserling said. I have a lot of respect for his numbers. A careful appraisal of the standards of living in various countries, which has been made by the University of Pennsylvania Wharton School, in terms of actual purchasing power, what will a dollar's worth buy, still shows us way ahead of the world.

France and Germany have two-thirds of our standard of living in terms of per capita command for goods and services. Let's not poor line ourselves so much as we are inclined to do. We have tremendous problems, but we have tremendous strength to come with those problems.

Next, with respect to the aggregate tax burden. It is 33 percent of GNP in this country, and it is 40 percent in Germany. So you can't explain the level of investment simply in terms of aggregate tax burden. There is a percentage of GNP.

Finally, let's always remember that the level of investment is a function, not just of the rate of return on investment which we are talking about when we are talking about accelerated depreciation. It is a function of the level of production in the economy. We are losing $300 billion of production in 1979 to 1981 in the fight against inflation slowing the economy down, and having a recession. In that process, we are losing a whale of a lot of investment.

So we have to strike—don't ask me precisely how—we have to strike the right balance between the level of activity, and the percentage rate of return. That is a mighty, mighty tough policy assignment.

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Mr. KEYSERLING. On this matter of productivity, I have got to say again that I would rather get back to some figures that were revealed by a study of what has been happening.

Generalities are very good. I can't extract these generalities, whether they are right or wrong. I am not going to engage in a debate as to the relative progress of various countries. I think that I could show that there are one or two anyway that have a higher standard of living than us, but that is not the big point I made.

They are outracing us. Who would have dreamed a few years ago that Japan would be producing 10 million automobiles a year, or become the dominant automobile producer in the world, with record markets. Who would have dreamed that Russia would be producing more steel than us. I could go on ad infinitum.

They are outracing us. They are meeting their potential, and we are not. All their policies are geared primarily to the increase in the production of goods and services.

Just look for a minute at this chart 11 that I have here. I have been stressing this for over 30 years. What you see is that the main factor in productivity growth is not the variations in the level of investment, but the variations in the level of demand and the utilization of available resources.

This chart shows all through for 1947 to 1979 that the productivity growth rate is more than anything else a function of whether you have full employment and full utilization. Let me illustrate that mathematically, and then I will give the example.

If you are operating at 92 percent capacity, and you go down to 80 percent, you will have, roughly speaking, a 14-percent reduction in plant use. Fortunately, you don't fire 14 percent of the labor force. You fire 6 percent. So you have a 94-percent index in labor force use, and an 86-percent index of plant use, and the productivity figure that we see is not technology growth at all, which is advancing at an alarming rate. It is a figure that you get by dividing the labor force input index in the plant into the output index.

Therefore, the greatest incentive to higher productivity growth is to get the economy moving.

Let me give an example here that is a vivid example of why it is not primarily the rate of investment. Look here at the short period from the fourth of 1975 to the first quarter of 1976, when the economy began to advance at a real criminal rate of 10.7 percent. You had a sudden bursting forth of productivity growth of 7.6 percent.

Then as the economy languished again, the productivity growth rate slowed. When you got down to the 0.8 percent growth rate for the fourth quarter of 1978, and the fourth quarter of 1979, the productivity growth rate was minus 2.1 percent.

I read a book put out by Brookings—I don't want to say anything about my friends here—as to the reasons for the decline in productivity growth rate, and it is because you have regulations that prevent people from breathing in lung dust, it is because labor is asking for too much wages, when the real wages have lagged behind everything for as long back as you long.

It is everything but the fact that almost all of our difficulties, the budget deficit, the productivity languishment, the inflation, they

all stem primarily from the fact that we have forgotten, and don't care any more about how the economy is moving in terms of the creation of real wealth.

If you look at my other chart, you see the terrible figures of what has happened to the real economic growth rate. Just look. Every economist almost was saying that the least we needed to do was about 4.4 percent, and that was conservative. That was a standard figure. The Rockefeller brothers came out with 5 percent. The Eisenhower report came out with 5 percent.

Now we are reducing our goals. All we are doing is saying the achievable growth rate is lower and lower. The unemployment rate is higher and higher. America is going up on everything it should go down on, and down on everything that it should up on. We are never going to really get any different because we are going to keep on doing the same thing.

Anybody who talks, not about doing something radical and new, but trying to learn something from experience of the great laboratory of the American economy over a period of 45 years, all of which is traced through in here, is just as if it had never happened. Either it is all being done by the Arabs, or it is all because the program is different that economists are puzzled. Or, Samuelson says that we can't any more blame economists for the terrible errors they make, any more than we can blame doctors because they have not discovered the cure for cancer. It is a rotten analogy.

During a period like World War II when we needed remedial measures, we found them. We cured the rubber shortage. We brought the production up to what we needed to do. We reduced the unemployment to what it ought to be. There is none of that within the framework of what we are talking about.

On this first chart that you asked about, here we are. If you look at the average annual economic growth, taking the 4-percent figure that the economists were using, look what a glorious record Walter Heller made. From 1961 to 1966, we hit 5.4 percent average, and he did not even start from a recession base. He just said that we were not doing well enough.

Then we sink down during 1969 to 1976, to 3.2 percent. The 10 years from 1969 to 1979, 2.9. The 2 years from 1977 to 1979, 3.3. The last year, 0.8. Now the Government is projecting a decline of 4 or 5 percent for this year, and it says we are going to get to a reasonable price stability by 1988.

Imagine going before the American people and telling them that the great Government of the United States, the best we can do is to have what we would have regarded as high-price inflation by 1988. They are still adhering to the idea that they are going to get the unemployment down to 4 percent by 1985, but they say that it is going to be up to 9 percent by early 1982.

So how are they going to get it from 9 to 4 in 3 years, when they just got through saying at the beginning of this year or last year that they could not get it from 6 to 4 in 4 years. When you start looking at what is being said, and what is being done, it makes you sick if you care anything about the country.

So that is what has been happening to the economic growth rate. That is where the productivity problem is. I have not said anywhere here that the investment figure is not a big factor in the

growth of productivity. The only question that I am raising is how you are going to get the investment.

Every model that I have made for the economy of the future to get back to where we want to go shows a need for a higher growth rate in investment than in other parts of the economy. It sets a higher growth rate for investment than I ever set for economic growth. I say, where are you going to get it, and why is it going down?

Investment in General Motors is not because of low productivity growth, and it is not because of the Arabs. It is due to other intrinsic domestic factors, wrong policies that have put the economy in such a chaos. What is happening to housing is the same thing. What is happening to steel is mainly the same thing, although I don't have to go into it.

We have to start looking at those things. I want to get the investment up. I am merely saying that the big industries, if you take the chart on the economic change here, chart No. 5, which shows that from the fourth quarter of 1978 to the fourth quarter of 1979, the rate of investment in plant and equipment in real terms was growing at an annual rate of 6.1 percent. Consumption plus government demand was growing 1.0 percent.

How do we derive from that the fact that it is investment that is the mortal sufferer? How do we derive it from looking at the relevant trends in profits, and wages and other consumer incomes.

Let me finally say one word about the Federal Reserve, in which the chairman and I once had a great mutual interest.

I said a little while ago that we cannot become a one-shot economy with one kind of gun. We have got to think about tax reductions. We have also got to think about investment. We have got to think about both. We cannot get anywhere on any of these things if the Congress lets the Federal Reserve go the way it has been going increasingly since 1952. It is the most miserable mistake in the economic policy. I am amazed.

You are worried about the Federal deficit. The chart shows $40 billion have been added to the Federal spending by the interest rate increases alone coming to more than the total size of the deficit in the year which it was computed for, coming to two or three times the size of programs on education and health, and manpower, and other things that I think we need something of.

A trillion dollars has been transferred from borrowers to lenders since 1953 by the rising interest rate. Does anybody think that that is a economically viable or socially desirable transfer of income. That money is going to be investment, when there is nobody to buy but 87 percent of the existing plants.

We have not made great progress because the interest rate has come down from 20-percent prime, 12-percent prime, or whatever it is, it changes every day, and the housing rate has come down from 15 percent to 10-12 percent.

I have a chart from one of my recent studies that we need a 6-percent housing rate. During my time in the Government we averaged a 4.5-percent housing interest rate, and we brought housing ownership to the people rather than to the banks, and people can pay for their mortgages. The 10-12 percent rate now is just as prohibitive as a 15-percent rate.

The prime rate, now, it is down to 11 percent, or 12 percent. Two years ago it was 7 percent. When it was really working well it was 3 or 4 percent. The cities can't live with it. The Federal Government cannot live with it. The American families can't live with the. The credit is expanding enormously at supercharged interest rates.

What is the Fed doing? While the economic is moving, they bring the prime rate up to 20 percent, and they bring the mortgage rate up to 15 percent. Then, they get redfaced and embarrassed at the evil things they have done and they reduce it a little bit. They bring on what may well now turn out to be the worst recession we have had since the Great Depression.

How long is it going to stay reduced? Even the 10-percent mortgage rate or the 12-percent prime note. What is Mr. Volcker now saying? What is going to happen when we start to recover a little bit? If the past be any guide, just as unemployment at the trough of each recession has been higher than the trough of the last one, and the peak of each recovery has been higher than the last year. So the interest rate, just as it has been the case for 20 years, will be higher.

When we get halfway to a decent recovery, as it was the last time, then the prime rate will go to 20 percent. Then the housing mortgage rate will go to 15 percent. So where are we. We have got to get a hold of this thing. It is draining everything that we might do by the tax reductions, and the other things.

The CHAIRMAN. Senator Byrd.

Senator BYRD. Let me ask the panel this question.

Nearly every Member of the Senate is recorded as favoring a reduction in taxes, and for the legislation to be enacted this year to be effective in 1981. Every Republican is recorded in favor of it, and virtually every Democrat has signed a resolution to that effect.

I might say that the leading candidate for President is advocating a reduction in taxes.

If this is not accomplished this year by the Congress, would that have a chilling effect on the economy, or not?

Mr. GREENSPAN. No; it will not have a chilling effect, Senator. It is certainly desirable to move in the direction of lowering the tax burden, as I indicated in my opening remarks, curbing the growth in expenditures as well.

However, if we allow the inflation tax collection, so to speak, to proceed for a series of years, I think that that would be severely deleterious to our system. A 1-year delay, I would not be able to argue is a major problem, but I see no purpose in delaying. There is no advantage which is created since the sooner we get to a slowdown in the rise in the tax burden, the better it is for the economy.

Mr. HELLER. Senator, my response would be very simple. It would not have a killing effect, but it would have chilling effect on the recovery in 1981 if we did not inject roughly $30 billion or so of purchasing power into the economy.

I don't happen to prefer the Kemp-Roth approach, but one way or another it would cool down the recovery.

Senator BYRD. Mr. Keyserling, do you want to respond to that?

Mr. KEYSERLING. I can't measure the differences between chilling, thrilling, and paralyzing, and killing. I think that it would have a seriously deleterious and fearful effect. I think we need a tax reduction. I think we need a stimulus, subject, of course, to my broader view that it is not the only thing we need. We have to get some balance, and things, instead of having one remedy for every problem. You don't create a civilization just with tax reductions.

Senator BYRD. Let me ask this, if I may.

If the tax reduction is delayed. If legislation is not enacted this year, particularly in the business side of tax reduction—the accelerated depreciation, would that tend to delay activity on the part of business until such time as a tax reduction is enacted which brings about a liberalization of the depreciation schedules?

Mr. GREENSPAN. Yes, Senator. Anticipation of tax changes has very little effect on business investments, since the nature of the tax enactments are critical to the types of investments in the particular programs that are introduced.

So the mere discussion, or the mere discussion of the delay would, in effect, slow the capital investment process. Even if they knew that the Congress would enact a bill, let us say, late in 1981, they would have to know exactly what the bill was, and be assured of its enactment in order to prevent a delay in projects which would go forth if actual tax enactment took place.

Mr. HELLER. I would put myself pretty much in the same camp. I would simply say that if business becomes convinced that there is going to be an easing of depreciation allowances, but that easing is then postponed for some months—I think that you can postpone it for about 3 months without having a whole lot of effect on the actual investment decision, but if it is postponed for quite a number of months, then there is kind of an air pocket because they hold their breath waiting for the better breaks on the investments that they then make.

So I do believe that delay in this case can be expensive in terms of investment decisions.

Senator BYRD. One of the leading businessmen of this Nation was in my office this morning on another matter, it was not in regard to this, and I brought this up to him, and he took the view that he and his directors could not authorize or proceed with a modernization program, for example, or sign contracts for new orders, if a new depreciation schedule was imminent but had not been enacted.

He felt that they might be subject to stockholder criticism for proceeding under the old depreciation rates with some likelihood that new depreciation rates, or more liberalized rates could be enacted at a later date. I suppose that that is somewhat logical, isn't it?

Dr. Greenspan, as I listened to your testimony, you mentioned, I believe, the need to get spending under control. It seems to me that that is a key, very key matter. I think that if we can get spending under control, we can take care of the tax problems with some ease, certainly much greater ease. But the problem is that, for example, the increase in spending of $85 billion in this fiscal year, a 17 percent increase, is the largest increase in the history of the Nation.

We will have this year the second largest deficit in the history of the Nation. So I was impressed with your comment earlier. I will preface it by saying, with the public becoming more concerned, as I believe it is, about deficit spending, as I recollect you indicated that a tax reduction might actually help reduce spending by making less money available. Was that your point?

Mr. GREENSPAN. Yes, sir. Let me first say that if you add off-budget items, the off-budget entities to the deficit, fiscal 1980 then becomes the alltime record deficit because the off-budget items in the previous peak year, fiscal 1976, were significantly less than they are in fiscal 1980. The combined total makes fiscal 1980 the alltime record deficit.

Senator BYRD. So if you use the off-budget deficit, you not only have this year the largest increase in spending in the history of the Nation, but you also have the largest deficit in the history of the Nation. Is that correct?

Mr. GREENSPAN. That is correct, Senator.

Senator BYRD. Thank you, gentlemen.

The CHAIRMAN. Thank you very much, gentlemen. You have brought us very important information, and we appreciate it very much. It will be very helpful to the committee in seeking to arrive at our conclusion. We appreciate having you here today.

[The prepared statements of the preceding panel follow:]

Statement by

Walter W. Heller
University of Minnesota

before the

Senate Finance Committee
Washington, D.C.
July 23, 1980

The case for a tax cut is compelling. Not as an anti-recession weapon -- it's probably too late for that -- but as a pro-recovery, pro-growth, and anti-inflation measure.

A tax cut could restore a little color to the economy's cheeks without any risk that it would turn into the flush of inflationary fever. Given last year's slowdown, this year's recession, and next year's modest recovery prospects, the economy is operating so far below par that the injection of a $30 billion tax cut by January 1 would have only tonic, not toxic effects.

The Economic Background

Let me begin by citing a few numbers showing how much room the economy has for absorbing the stimulus of a tax cut without coming close to overstimulating it. The most obvious evidence consists of unemployment -- now at nearly 8% and heading for a peak of about 9% around the turn of the year -- and capacity utilization in manufacturing -- which has fallen from 87% early in 1979 to 76% today and is still falling.

To take a broader cut at it, let's look at it in a three year perspective embracing not just the recession in 1980, but the slowdown in 1979 and the restrained recovery in 1981.

Looking back: for a year before the recession started last January, expansion had already slowed to a crawl: Real GNP grew only 1% during the preceding year (from the fourth quarter of 1978 to the fourth quarter of 1979).

Looking ahead: even under the moderate assumption of a 4% drop in real GNP during this year's recession (between the fourth quarters of 1979 and 1980) and under the optimistic assumption of a 4% rise in real GNP next year (and that's pretty optimistic relative to the White House estimate of 2.6% growth and the CBO estimate of 3.5%), the U.S. economy will not achieve its late-1978 levels of output until late-1981. In a determined effort to retard inflation, we will have given up three years of economic growth.

How much growth have we forgone, and how much room do we have for expanding output before the economy starts bumping against its productive capacity or potential? Let me give you the results of some arithmetic that I have done on this. I make the modest , the downright conservative, assumption that the U.S. economy's capacity to produce is growing only 2% a year in the 1979-81 period (the 2% consisting of 1.5% real growth in the labor force plus a measly 0.5% in the trend growth in productivity per year). I am purposely pitching the growth rate below the Council of Economic Adviser's projection of a 2.5% growth rate for 1979-81. (It is also worth recalling that the 2% rate is just half of the 4% rate of growth n potential that prevailed in the

mid-1960s).

Racking up that 2% growth in potential output against the actual growth of 1% last year, a drop of 4% this year, and a 4% rise next year, here are the striking, not to say the startling, results;

- In the current quarter, had we had no slowdown or recession, we would be producing about $150 billion more of GNP a year, at today's prices, that we actually are. Our actual output will be about $2,530 billion this quarter. Had we grown at that modest 2% annual rate, output would been $2,680 billion.

- This shortfall grows to $180 billion by the end of 1980 and then gradually shrinks to about $130 billion by the end of 1981.

The point of this exercise is clear: even with a tax cut of $30 billion, we would not come within a country mile of pressing against the economy's ceilings. The numbers tell us something else: if the economy had been growing at 2% in 1979-81 instead of going through three years of slowdown, recession, and sluggish recovery, it would have produced a total of $300 billion more (in today's prices) than it actually will produce over these three years. The costs of fighting inflation by monetary-fiscal restriction are high indeed.

How much reduction of inflation are we buying for this huge loss in output and job?

On the surface, the answer seems impressive: the consumer price index will drop from its peak of 18% in the first quarter of 1980 to a trough of perhaps 6% late this year before rising food prices and interest rates push it upwards. Most of the drop is simply a case of letting the air out of the CPI as the artificial bubble created by

skyrocketing mortgage interest rates and housing prices is deflated and as we benefit from the let up in OPEC price boosts.

But the hard core or bed-rock inflation rate that lies just beneath the surface will yield very little to the pressures of economic slowdown and recession. Most of this recession will be reflected in loss of jobs and output, not in lower wage and price increases. Catch-up is still the name of the game in a large part of the labor force: nonunion wages are catching up with union wages, and overall wage increases are trying to make up this year for the lag between price and pay increases last year.

As to prices, there is some price cutting and discounting but there is also discouraging evidence of wide-spread price hikes in the teeth of recession. When GM boosts prices of its average car by $135 in an "undaunted effort to pass on to consumers a large chunk of its increased production costs" even in the face of the weakest auto markets in recent memorary, one is moved to ask: "Recession, where is thy anti-inflationary sting"? Indeed, a major manufacturer was quoted recently as saying "we had to raise our prices to make up for the loss of volume". What ever happened to the "rigors of the marketplace"?

Recession and slack in the economy will surely have some moderating effect on price and wage increases. But even at that, it seems unlikely that the rise in average pay will drop much below 9.5% a year by the time recession has run its course. Subtracting a trend productivity increase of less than 1% a year, we find that unit labor costs will be rising 8.5% or more. This will set a virtual floor of between 8% and 9% under our hard core inflation rate as we enter the

next expansion. True, we will come out of the recession with the inflationary gases vented, but the glowing bedrock of inflation will recede little if at all and will threaten to erupt again when recovery is in full swing.

The Budget Background

In considering a tax cut, one has to confront the fact that we now face a $61 billion deficit this year and a $30 billion deficit, for starters, for fiscal 1981. I say "for starters" because chances are that there will some upsweep in that basic deficit number, and one would have to add about $20 billion to it for a $30 billion tax cut effective for the calendar year 1981. (The $20 billion estimate takes into account the fact that the tax cut would be in effect only 10 months of the fiscal year and allows for some revenue feedback).

In looking at these large deficits, one should not ignore the fact that this year's budget labors did produce a budget that, tax cuts aside, would have come close to balance under the working assumptions of a mild recession and unemployment peaking at 7.5%, and would have produced an impressive surplus in the absence of recession. The actual deficit of $30 billion (before tax cuts) is a normal outgrowth of recesssion and slow growth.

In other words, these deficits -- while disappointing and disturbing -- threaten no inflationary thrust or crowding-out of private borrowing. The Treasury's borrowing needs will be largely a mirror image of shrunken private borrowing requirements. That is, the Federal borrowing will not displace private borrowing but instead put

to use funds idled by recession. As a result, deficits will not boost inflation or interest rates and should not act as a barrier to moderate tax cuts.

In this connection, it is worth bearing in mind a fact that is not widely recognized: even with a defense buildup, 1981 budget outlays will be somewhat smaller in real terms than 1980 outlays. Combing out the increase in defense spending leaves a cutback in real nondefense spending of roughly 3%.

Turning to an even broader perspective that takes into account not just spending but revenue increases, we can get a fix on overall fiscal policy in the course of recession and recovery. This reveals that we are in a sharp swing toward fiscal restriction. Because tax revenues are trending upward much faster than federal spending, the budget is making a big swing from stimulus towards restriction between 1978 and 1981; from a high-employment deficit of about $45 billion in 1978, the budget is swinging to a high-unemployment surplus of about $40 billion in 1981 (using a conservative 6% unemployment rate as the benchmark for high employment). Most of this restrictive swing -- as much as $60 billion -- will occur between the fiscal years 1980 and 1981. So an escalating fiscal drag lies dead ahead.

The Case for an Early Tax Cut

Against the foregoing economic and fiscal background, we can now size up the case for an early tax cut:

- First, there is plenty of slack in the economy to absorb the purchasing power released by a $30 billion tax cut without touching off even a ripple of demand inflation.

- Second, the tax overburden has been steadily growing: personal income taxes have moved from 21% of personal income in 1978 to 22% this year and are heading for nearly 23% next year. Most of this rise represents the stealthy boost in taxes "legislated" by inflation as it pushes nominal income into higher brackets.

- Third, $18 billion of new payroll taxes (consisting of $13 billion dollars of rate increases, $2 billion of specific base broadening and $3 billion of automatic base increases indexed to rising wages) and a mounting tide oil profits taxes (gross collection of $14 billion this year plus another $18 billion next year), are coming on stream.

- Fourth, primarily as a result of these huge tax increases, but partly as a function of expenditure restraint for 1981, fiscal policy is swinging hard toward restriction in the face of recession, an almost unprecedented policy circumstance.

- Fifth, properly structured, a tax cut program will not only remove some of the fiscal overburden that will unduly retard recovery in 1981 but can also serve as an important weapon in the battle for higher productivity and lower inflation.

In light of these realities, we could stand a tax cut tommorrow if it were possible to wave a magic wand and produce a balanced pro-growth and anti-inflationary tax program over night. I am inclined to agree with the Administration that under the pressures of an

election year and given the limits of the Congressional calendar, it is not a high probability. The better part of wisdom is to hammer out a carefully designed tax cut that will advance rather than retard our basic economic objectives. But if this Committee, working against the calender and against the odds, is able to produce a balanced tax cut by September, I see no economic reason for postponing Congressional action until after the election.

What it boils down to is this: we should not deny ourselves a prompt tax cut that makes good economic sense because it would be considered "political". That would surely stand election-year economics on its head.

In other words, although I fully agree with the Administration's desire to fend off a big across-the-board tax cut that might win votes but lose the war against inflation -- the proposal for a $36 billion downpayment on a tax cut that would cost over $200 billion by 1985 comes to mind -- I hope it would not reject a carefully designed cut that would strengthen the economy. If Congress, through a Herculean effort, produces such a bill before the election, I hope President Carter will sign it.

The challenge to Congress, then, is to confound the skeptics, take the raw meat of tax cut proposals, cook it to a turn, and serve up a dish that would be nourishing to the economy.

Granted, it is too late in the day for a tax cut that would apply to 1980. But it none too late to move on a carefully crafted tax reduction for early 1981 that will remove some of the fiscal drag, offer business tax incentives in the form of faster capital recovery,

cut back the cost of payroll taxes, and help strengthen the Administration's efforts to restrain wage and price increases.

To further these objectives, a $30 billion tax cut might be structured along the following lines:

- Offset the scheduled 1981 increase of $18 billion in social security payroll tax liabilities, preferably by direct action to cancel such increases (coupling this move with a phased shift of Medicare hospital insurance costs to the general revenues, thereby protecting the integrity of the social security system). If misplaced public fears about the soundness of the social security system prevent a direct cut in payroll taxes, the Gephardt approach of casting the cut in the form of a credit against income taxes for payroll taxes paid would be a second-best approach. Holding the payroll tax at present levels would forestall a boost in business costs that is bound to put upward pressure on prices as these costs are passed through to consumer prices. It would also forestall a cut in take-home pay that will lead to higher wage demands.

- Devote $5 to $10 billion to the first-year costs of a program of accelerated depreciation that will fit the economy's needs for modernizing capital equipment and stimulating productivity. That rules out the 10-5-3 plan, which is not only too expensive, but would provide an undue and unnecessary stimulus to commercial building that will contribute little to the country's "reindustrialization".

- Set aside another $5 billion or so as a contingency fund for real wage insurance to bulwark the voluntary wage-price restraint program.

Such a program would have a four-ply anti-inflationary impact. First, by holding employer's payroll taxes in check, it would curb price increases. Second, by warding off boosts in business costs and cuts in take-home pay, the government would strengthen its appeal to business and labor to stay within the voluntary guidelines. Third, real wage insurance would be an important inducement to labor to comply with the guidelines. Fourth, easing of depreciation allowances would be a significant incentive for the increases in business investment and productivity that can help curb inflation in the longer run.

If it is decided that time is too short in 1980, serious consideration should be given to an interim measure to suspend or postpone the payroll tax increase on January 1. That increase will retard recovery and worsen inflation. If it could be suspended or postponed until Congress has had a chance to enact a permanent tax cut, and if the action could be coupled with a firm and convincing pledge to make up the lost taxes from the general revenue, the economy would reap sizeable benefits. I fully understand that it would be vital to take steps to relieve the deep concern, even anxiety and alarm, about the soundness and safety of the social security system that have been raised by headlines and stories greatly overstating the problems of that system.

The question may be raised: Why so modest a tax cut in the light of the compelling case for such cuts? The answer is to be found in the facts of fiscal life: the built-in civilian spending increases plus the defense buildup require us to keep our tax powder dry. The conservative and prudent course is to hold the tax cut to roughly $30

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billion and retain the rest of the revenue-raising power of our tax system to serve the dual purpose of (a) permitting rapid progress toward a balanced budget as the economy recovers and (b) enabling the monetary authorities to pursue a policy that will be somewhat less restrictive and hence somewhat more favorable to investment.

This is in sharp contrast to the tax-cut program of the fiscal radicals who advocate a $36 billion first installment on a tax cut that would cost over $200 billion by 1985, at the same time that they advocate a $100 billion increase in defense expenditures. That might be "smart politics" -- though I doubt even that in the light of the public mood in America today -- but it would surely be upside-down economics.

Release on Delivery

WHAT TO DO ABOUT TAXES NOW

Highlights of Testimony of Leon H. Keyserling*
Before Senate Committee on Finance
Washington, D.C., Thursday, July 24, 1980

(1) The economy needs a huge fiscal stimulus now, for two reasons: (a) by most measurements, the recession since the start of 1980 has been greater than any of the five previous recessions since 1953, and (b) the current recession is but one consistent episode in a chronic retreat from satisfactory economic performance, which during 1953-1979 meant forfeiture of more than 7.7 trillion 1979 dollars worth of GNP and more than 80 million years of civilian employment.1/ As each recession has tended to be worse and each recovery less adequate than most of the preceding ones, it is imperative that national policies address the chronic disease now instead of guessing how long the latest setback will last or whether it will cure itself.

(2) The huge fiscal stimulus should not be delayed in fear of inflation, for two reasons: (a) the tremendous economic and social costs of the chronic disease far outweigh any benefits resulting from hypothetical reductions of inflation by means of continued recessions, and (b) in any event, the empirical evidence has become overwhelming that the attempted "trade-off" between unemployment and inflation has been a ghastly failure.2/

(3) Fear of increasing the Federal deficit should not delay the needed stimulus, for two reasons: (a) the condition of the economy is vastly more important than the condition of the Federal Budget, and (b) in any event, the chronically rising Federal deficits have been the result of the chronically worsening economic performance,3/ and the only way to reduce and then remove the deficit is to overcome the chronic economic disease.

(4) The first requisite for treating the chronic disease is to diagnose its core cause. This cause has been the repeated tendency during upturn periods for investment in plant and equipment, which adds to production capabilities, far to outrun ultimate demand in the form of consumer outlays plus public outlays. These imbalances have brought on the stagnation-recession periods, and even during these periods the sharp cutbacks in investment have derived from deficiencies in ultimate demand, both as an incentive to investment and as a supplier of investment funds. Relative income trends have been factors in these imbalances.4/ Tax policy, at least since 1964, has aggravated these imbalances instead of reducing them.5/ And this has been made even worse by the economically unsound distribution of the total tax burden.6/

(5) The agitation for "supply-side economics" is pouring old medicine into gaudily-labeled new bottles. The position that the top problem is to use tax reductions and/or concessions to provide direct stimulus to investment is nothing "new"; it repeats errors of long duration. The argument that this approach is needed to "reindustrialize America" and/or to improve productivity fails to recognize (a) that the investment shortfall in a chronically diseased economy derives from the imbalanced underdevelopment of ultimate demand, and (b) that the abysmal decline of productivity growth is not due primarily to investment shortage but rather to underutilization of employed workers and plant in a grossly underutilized economy.7/

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* Chairman, Council of Economic Advisers under President Truman. President, Conference on Economic Progress.

1/ See Charts 1 and 2.
2/ See Chart 3.
3/ See Chart 4.
4/ See Chart 5.
5/ See Charts 6,7,8, and 9.
6/ See Chart 10.
7/ See Chart 11.

(6) It follows that the predominant portions of any tax stimulus now or soon to be enacted should be allocated to the consumption function through reductions in personal taxes (whether income or social security), primarily for middle and low income groups, and that direct tax benefits to investors should be focused upon areas of priority need and accompanied by an effective quid pro quo. As consumer spending in dollar terms is in the range of six times nonresidential fixed investment, I submit as a rough rule of thumb that direct tax reduction aid to the consumer function and to the investor function be in a ratio of approximately 6 to 1.

(7) The current rush to use tax reduction only to stimulate the economy is 100 percent "political" and zero percent responsible. Each dollar of increased Federal outlays, focused upon priority needs, adds more to production and employment than each dollar of tax reduction, even if focused upon priority needs. The outlay course is thus easier on the Federal Budget and less conducive to increasing the deficit in the short run. And it is very much more feasible to train increased outlays than tax reduction upon the great priority needs--job creation, economic growth, housing, health, education, energy and environment, urban aid, mass transportation, equity for farmers, etc. Even taking into account current realities of a political nature, I submit that more than half of any fiscal stimulus applied in the foreseeable future be in the form of increased outlays, and less than half in the form of tax reduction.

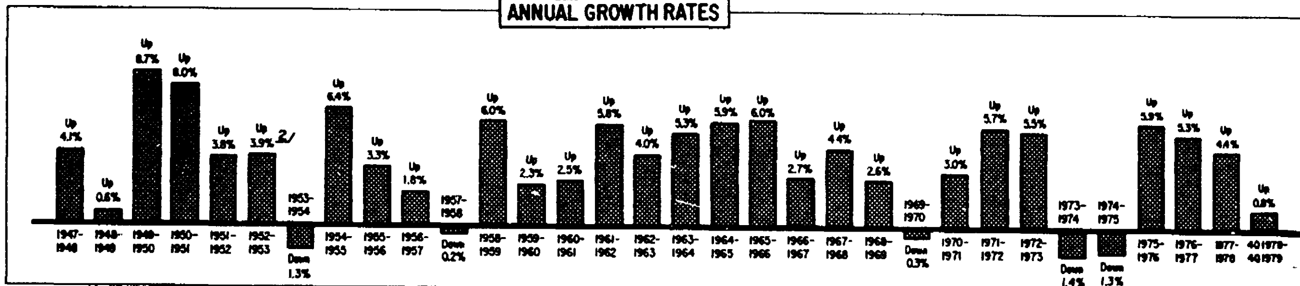
(8) No attempted stimulus can turn the trick unless realistically adjusted to the size of the job. My estimates are that we should still aim in the general direction of reducing unemployment to 4 percent by 1983, the original goal of the Humphrey-Hawkins Act of 1978. We have done even better at times in the past. Surely, it is but a burlesque to adjust policies toward verification of the Administration's estimates that unemployment will be 9 percent at the start of 1982, that inflation will go up 9.8 percent in 1981, and (as of January 1980) that inflation will not go down to 3 percent until 1988. My own estimate is that, for 1979-1983, the goal should be to promote real average annual economic growth at a rate of about 5.7 percent a year. I further estimate that this would require--among many other policy changes--a growth in Federal Budget outlays at a real average annual rate of about 4.4 percent during 1979-1983, with a lower average rate to the extent that properly devised tax reductions are used as a supplementary stimulus.8/ I estimate that, with such policies, and with a genuine anti-inflation program instead of the spurious trade-off, the average annual increase in the CPI can be held to 4.0 percent during 1979-1983.

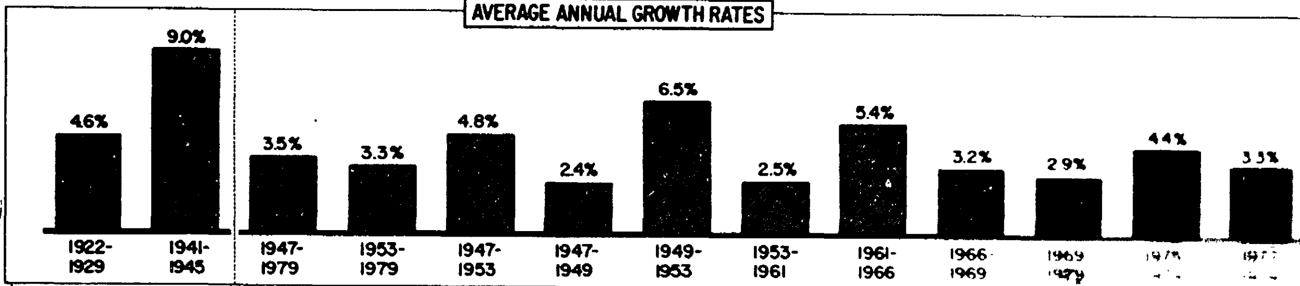
(9) Finally, no fiscal measures however well conceived can attain their fair objectives unless the Congress takes prompt and decisive steps to alter the wayward "independence" and perverse policies of the Federal Reserve Board and System. These policies, in their process of deterioration from 1953 to date, have encouraged recessions, driven up unemployment, fanned inflation, helped to shortchange priority needs, redistributed income in an unconscionable manner, plundered the average family, and imposed intolerable and deficit-creating interest-rate increases upon Federal, State, and local governments.9/

8/ See Chart 12.
9/ See Charts 13, 14, and 15.

THE "ROLLER-COASTER" ECONOMIC PERFORMANCE: ECONOMIC GROWTH RATES, 1922-1929, 1941-1945, AND 1947-1979[1]

(Uniform Dollars)

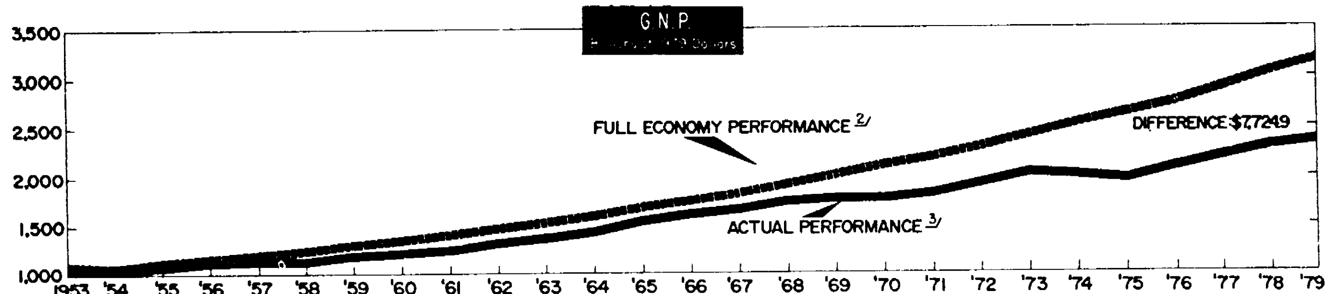


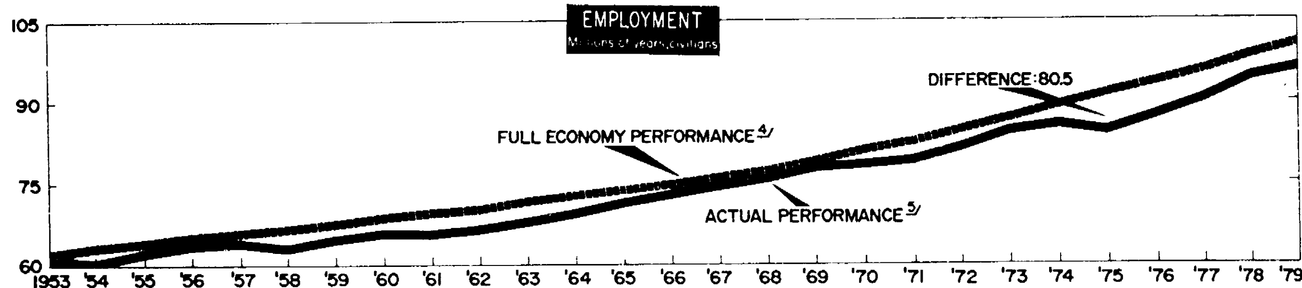


[1] 1979 estimated.

[2] Recession during part of period. There were five recessions, 1953-1978, but some were entirely within one year, and began and ended in different years

COST OF DEPARTURES FROM FULL ECONOMY, 1953-1979 1/





1/ 1979 preliminary.
2/ Real average annual growth rate of 4.4 percent
3/ Real average annual growth rate of 3.3 percent, the 1953-1979 average.
4/ Average true level of unemployment of 4.1 percent, or 2.9 percent full-time unemployment.
5/ Average true level of unemployment of 7.8 percent, or 5.2 percent full-time unemployment.
Basic Data: Dept. of Commerce; Dept. of Labor

Chart 2

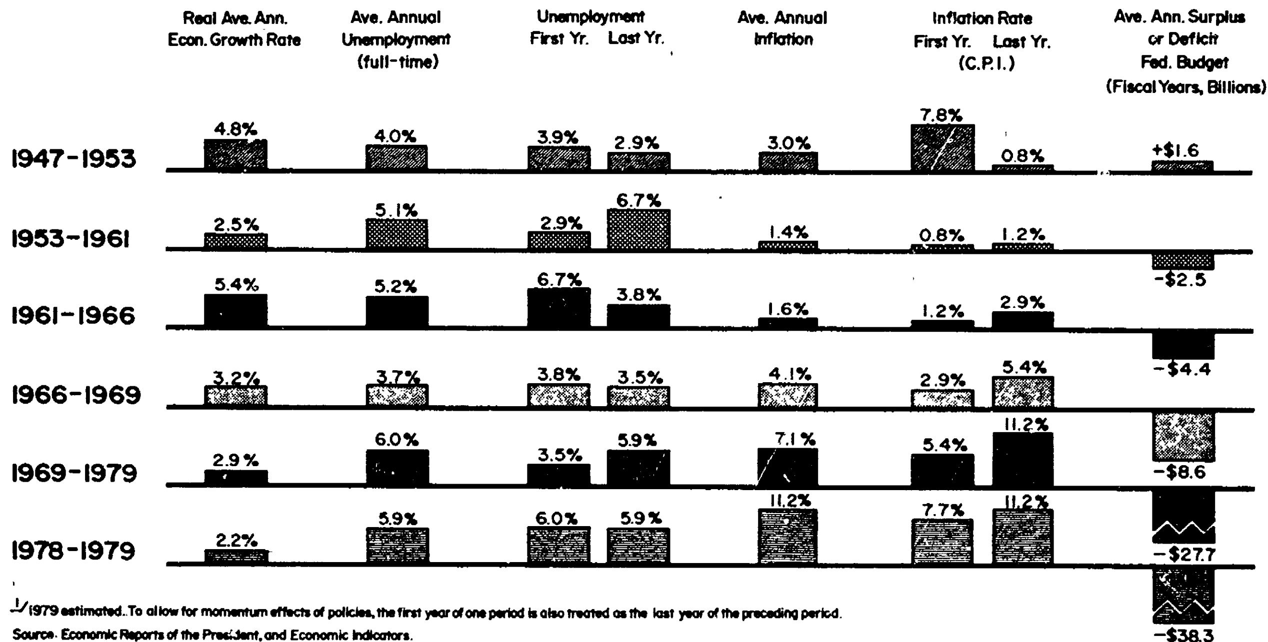
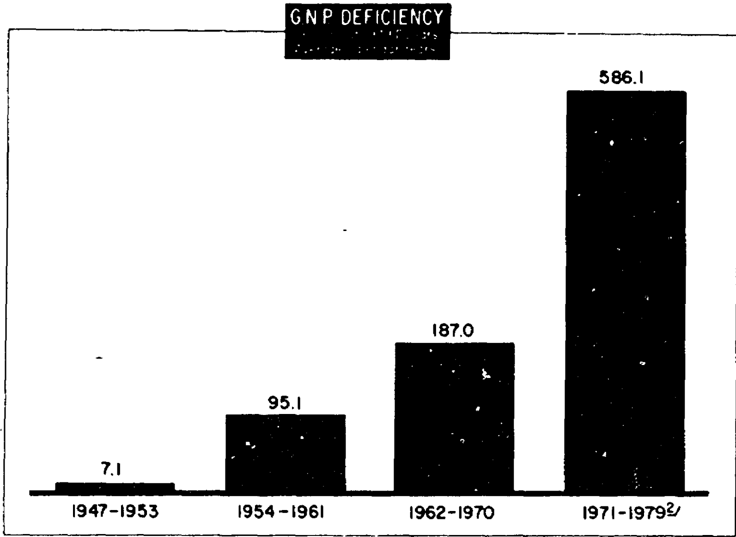
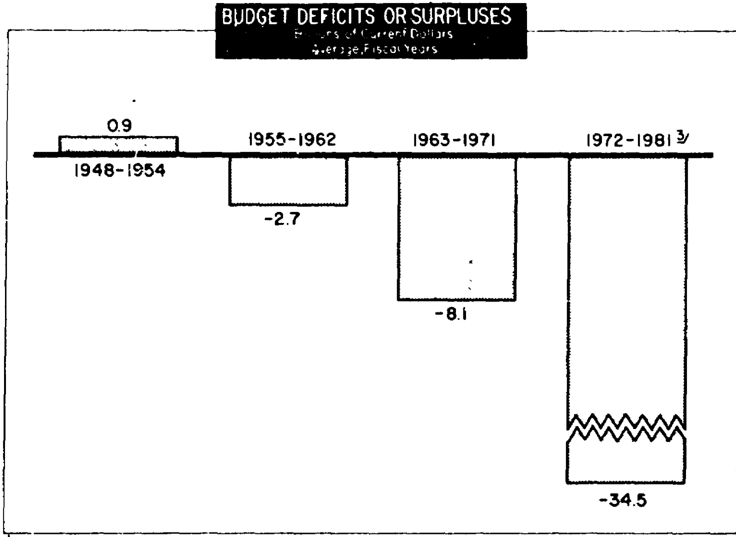


Chart 3

Chart 4

G.N.P. DEFICIENCIES[1] AND BUDGET DEFICITS CALENDAR 1947-1979 AND FISCAL 1948-1980





[1] Production deficiencies represent differences between actual production and production at full economy rate of growth. Projections from 1946. Allowing for nonrecouperable losses, over the years, GNP 190-245 billion below full economy in 1979.

[2] 1979 preliminary.

[3] 1980 and 1981 deficits are the estimates in the President's 1981 Budget.

Source: Dept. of Commerce; Office of Management and Budget, for actual figures

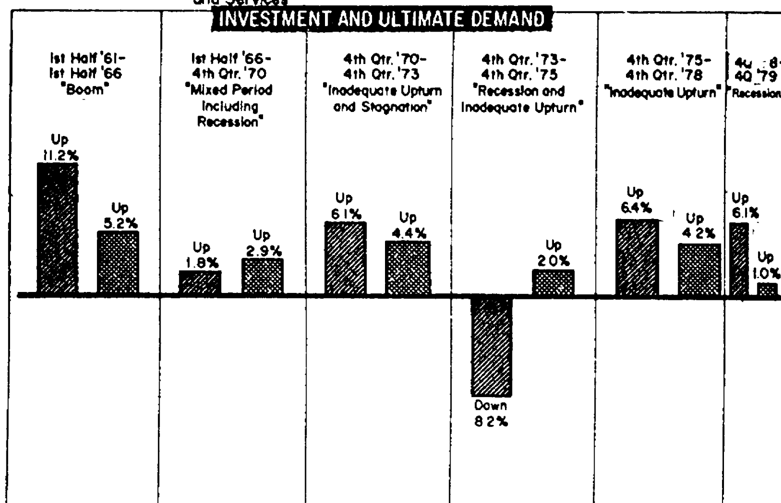
Chart 5

COMPARATIVE GROWTH RATES, 1961-1979 1/

(Average Annual Rates of Change, in Uniform Dollars)

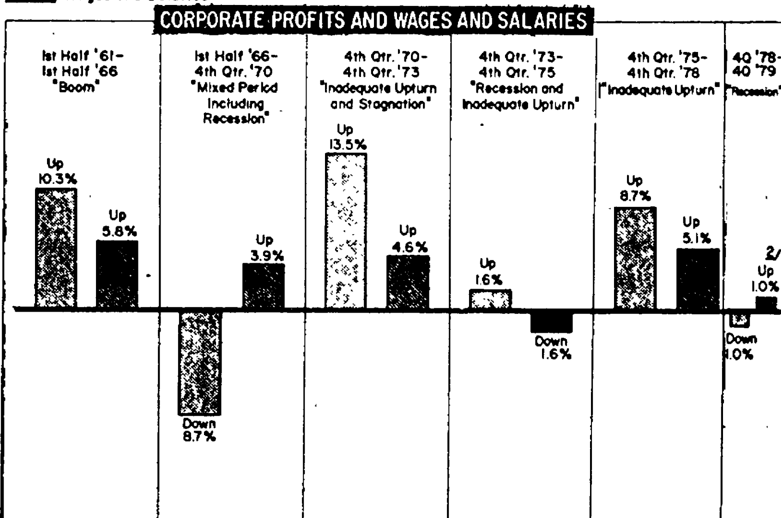
Investment in Plant and Equipment

Ultimate Demand: Total Private Consumption Expenditures Plus Total Public Outlays For Goods and Services



Corporate Profits (and IVA)

Wages and Salaries

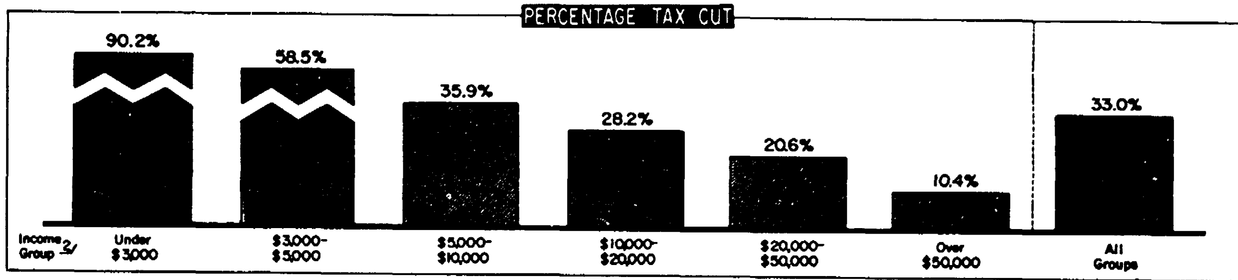


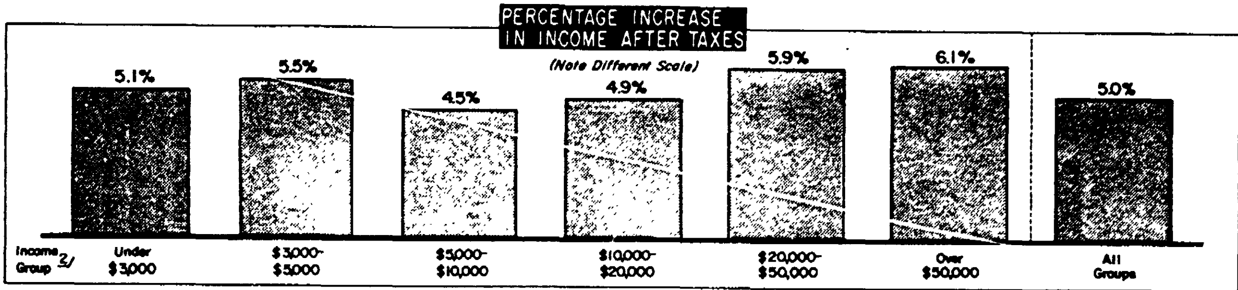
1/ 1979 estimated. 2/ Narrower bars of no significance.

Basic Data: Dept. of Commerce

Chart 6

PERCENTAGE TAX CUT AND PERCENTAGE INCREASE IN INCOME AFTER TAX, VARIOUS INCOME GROUPS, 1963-1973 [1]





1/ Effects due to changes in personal tax under Revenue Act of 1964, Tax Reform Act of 1969, and Revenue Act of 1971 (H.R. 10947, as reported by the House-Senate Conference Committee, excluding the effect on personal taxes of removing the first year convention under the Asset Depreciation Range system)

2/ Adjusted gross income class.

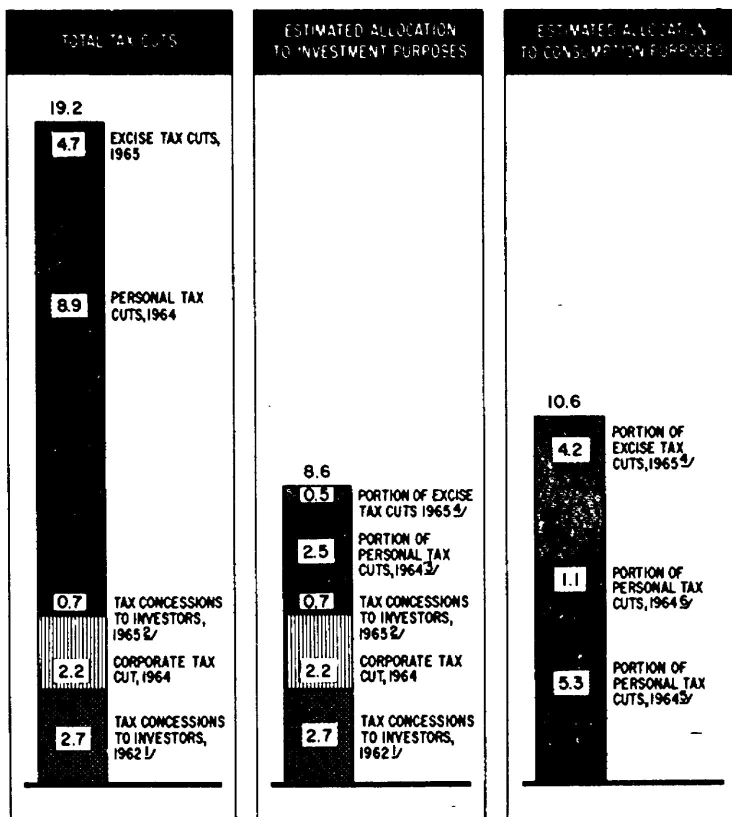
Basic Data: House Ways and Means Committee and Senate Finance Committee Reports, and Congressional Record

Chart 7

Chart 8

ALLOCATION OF TAX CUTS, 1962-1965: INVESTMENT AND CONSUMPTION PURPOSES

(Billions of Dollars)



1/ Through Congressional & Executive Action

2/ Through Executive Action

3/ Estimated portion of personal tax cut, for those with incomes of $10,000 and over, which they would save for investment purposes.

4/ Based on estimates of excise tax cuts passed on to consumers through price cuts.

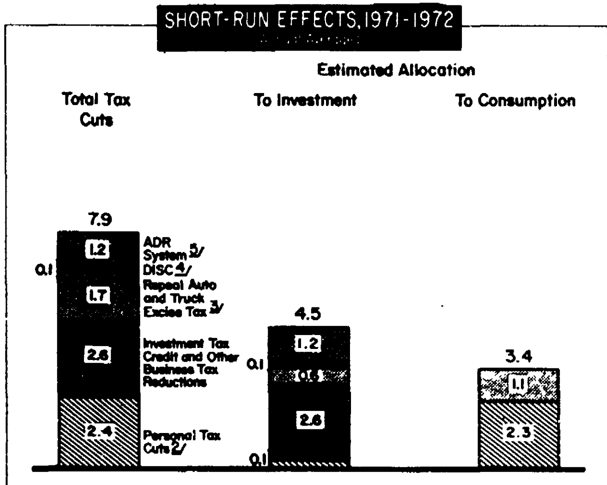
5/ Personal tax cuts for those with incomes under $10,000.

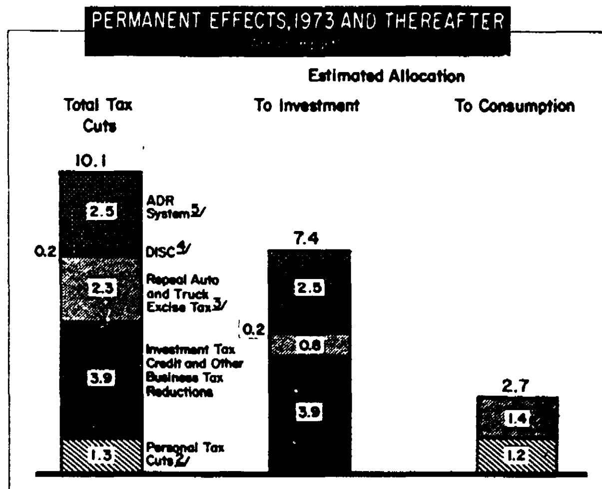
6/ Estimated portion of personal tax cuts for those with incomes of $10,000 and over, which they would spend for consumption.

Note: Estimates of excise tax reduction allocation by C.E.P. (amount might be passed on to consumers by price reductions.) However, a large portion of this did not go to low income consumers.

ALLOCATION OF 1971 TAX CUTS[1]: BETWEEN INVESTMENT AND CONSUMPTION

(Billions of Dollars)





1/ H.R. 10947, as reported by the House-Senate Conference Committee, and Asset Depreciation Range (ADR) System promulgated by the Treasury Department.

2/ Allocation to investment based on portion of cuts for those with income over $15,000, which they would save; remainder allocated to consumption.

3/ Allocation between investment and consumption based on business or nonbusiness use of vehicles.

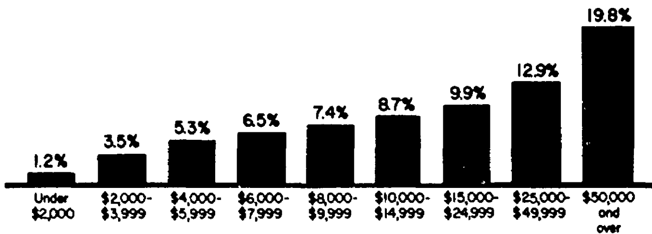
4/ Tax deferral by Domestic International Sales Corporations (DISCs).

5/ Treasury regulations as modified by H.R. 10947 as reported by the conference committee.

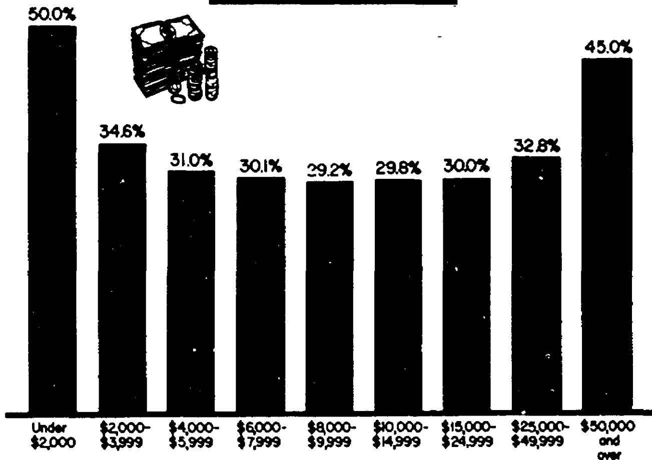
Note: Components may not add exactly to totals, owing to rounding.

TAXES PAID AS PERCENT OF INCOME, U.S. 1968[1]

FEDERAL INCOME TAXES



TOTAL TAXES[2]

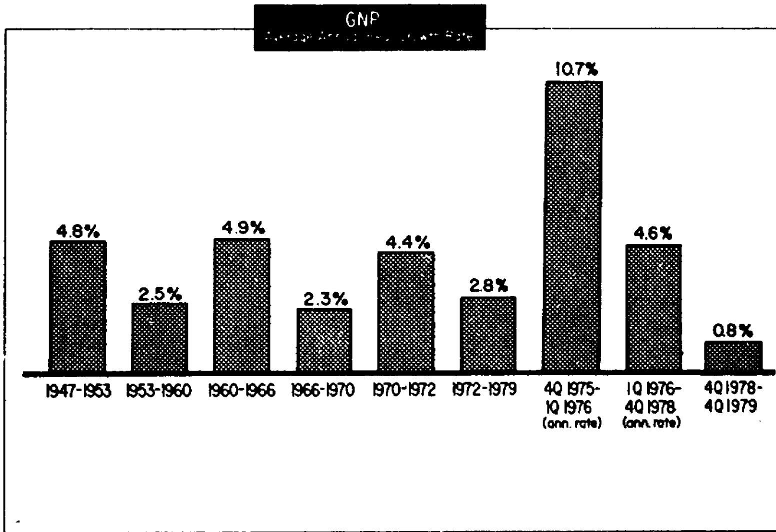


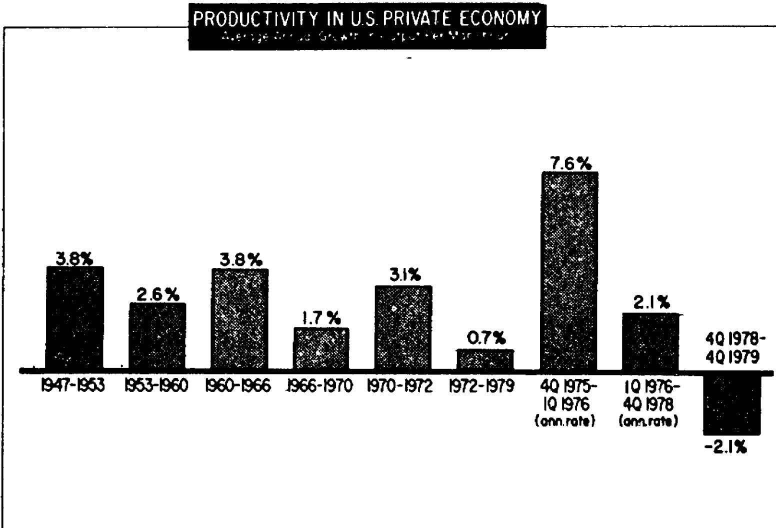
1/ Income relates to total income of all persons in the adjusted money income classes shown. Total income is adjusted money income, plus imputed income, less direct taxes, plus retained corporate earnings, plus taxes minus transfer payments, plus realized capital gains.

2/ Includes the following Federal and State and Local taxes: Individual income, estate and gift, corporate profits, and social security. Also includes Federal excise and customs taxes, and State and Local sales taxes, motor vehicle licenses, property taxes, and miscellaneous other taxes.

Basic Data: Dept. of Commerce, Bureau of the Census

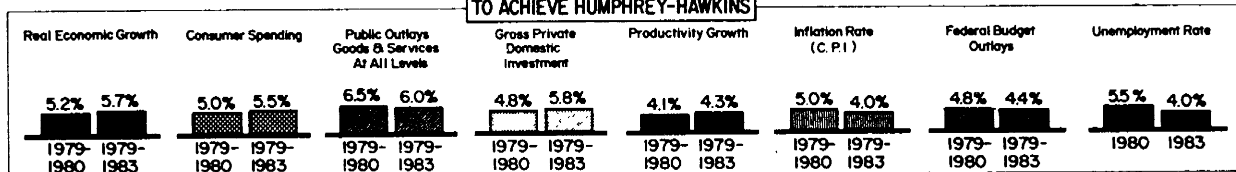
IMPACT OF ECONOMIC GROWTH UPON PRODUCTIVITY GROWTH

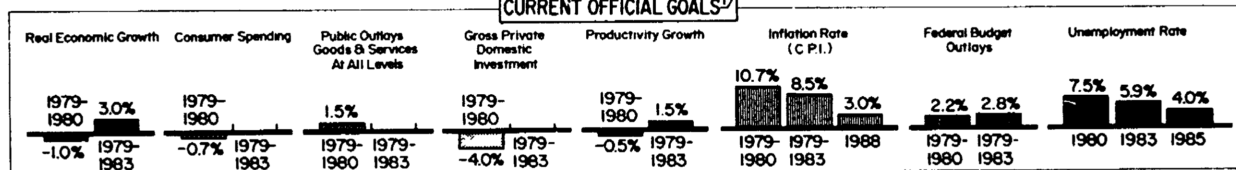


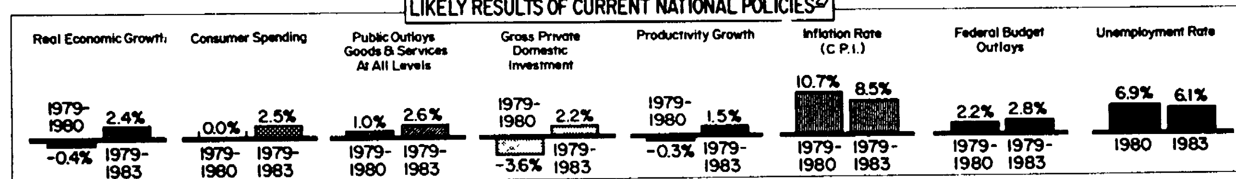


Source: Dept. of Labor, Dept. of Commerce

GOALS TO ACHIEVE GOALS OF HUMPHREY-HAWKINS, COMPARED WITH CURRENT OFFICIAL GOALS AND LIKELY RESULTS OF CURRENT NATIONAL POLICIES





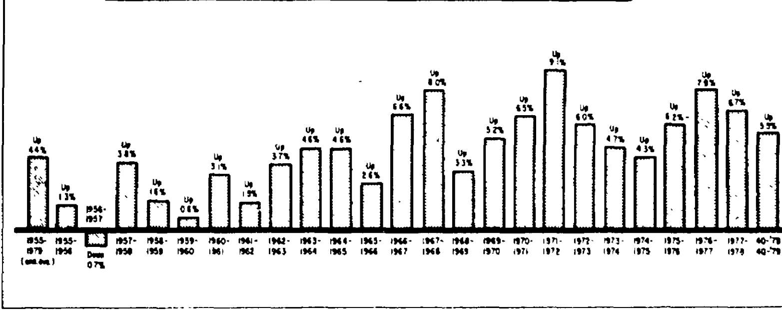


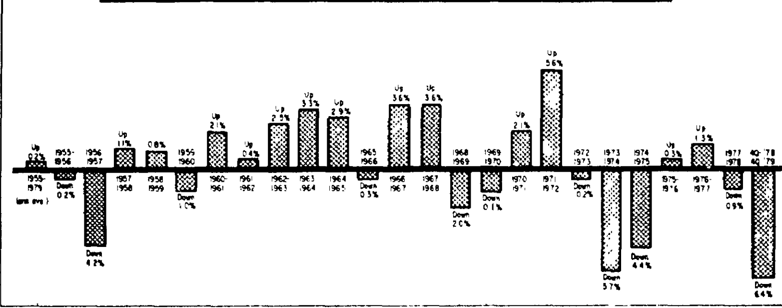
1/ Goals in President's 1980 Economic Report and Fiscal 1981 Budget Message.

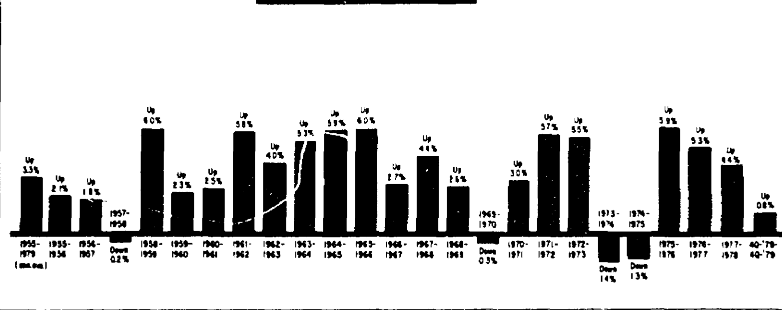
2/ Policies in Economic Report and Budget Message.

Note: All growth rates for various types of outlays are in real terms and at average annual rates.

COMPARATIVE TRENDS IN NON-FEDERALLY HELD MONEY SUPPLY, G.N.P., AND PRICES, 1955-1979[1]







[1] 1979 preliminary.

Data: Dept of Commerce; Dept of Labor; Federal Reserve System

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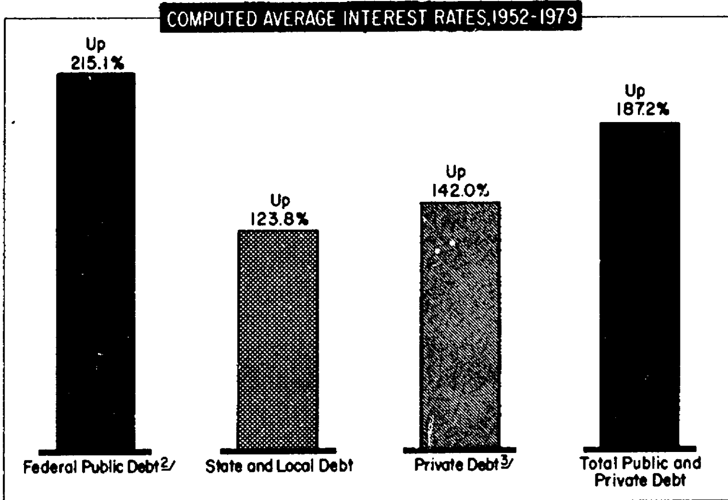
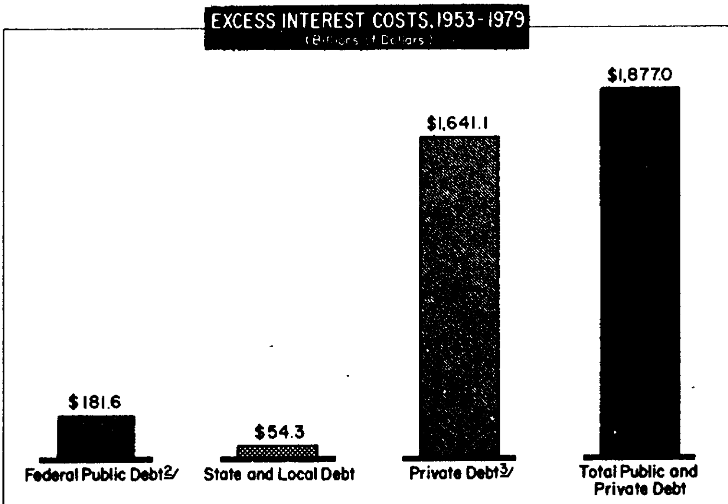
INCREASES IN AVERAGE INTEREST RATES, AND EXCESS INTEREST COSTS DUE TO THESE INCREASES, 1952-1979[1]





[1] 1977-1979 estimated

[2] Includes net foreign interest.

[3] Computed as a residual by subtracting Federal Government and state and local debt from total public and private debt. Includes debt of federally-sponsored credit agencies.

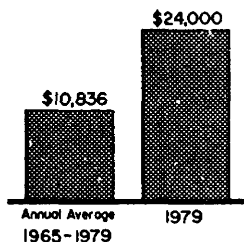
EXCESS INTEREST COSTS IN THE FEDERAL BUDGET 1965-1979 CONTRASTED WITH OTHER COSTS FOR SELECTED BUDGET PROGRAMS

Millions of Current Dollars

EXCESS INTEREST COSTS IN THE FEDERAL BUDGET

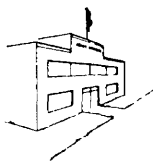
$24,000

$10,836



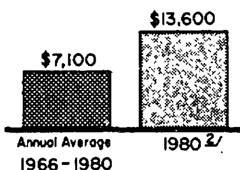
Annual Average 1965-1979 | 1979

BUDGET OUTLAYS FOR EDUCATION



$13,600

$7,100

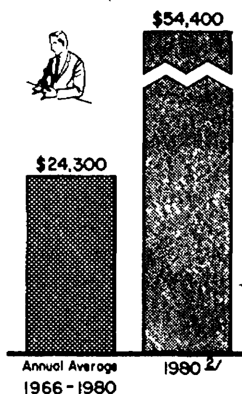


Annual Average 1966-1980 | 1980 2/

BUDGET OUTLAYS FOR HEALTH SERVICES AND RESEARCH

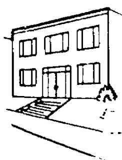
$54,400

$24,300



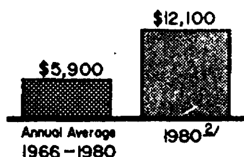
Annual Average 1966-1980 | 1980 2/

BUDGET OUTLAYS FOR HOUSING AND COMMUNITY DEVELOPMENT



$12,100

$5,900

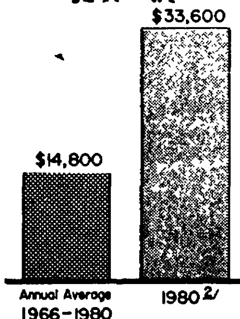


Annual Average 1966-1980 | 1980 2/

BUDGET OUTLAYS FOR PUBLIC ASSISTANCE AND OTHER INCOME SUPPLEMENTS

$33,600

$14,800

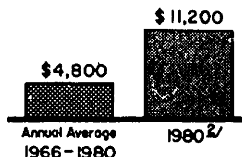


Annual Average 1966-1980 | 1980 2/

BUDGET OUTLAYS FOR MANPOWER PROGRAMS

$11,200

$4,800



Annual Average 1966-1980 | 1980 2/

1/ Interest costs, calendar years; budget outlays, fiscal years. 1978 and 1979 interest costs estimated.

2/ As shown for fiscal 1980 in President's Budget, as revised in Mid-Session Review, July 12, 1979.

The CHAIRMAN. I believe that since the Senate is voting, we would do best to break now and get as many Senators back in here as we can at 1:30, and we will resume the hearing at that point.

[Whereupon, at 12 p.m., the committee recessed, to reconvene at 1:30 p.m., the same day.]

AFTERNOON SESSION

The CHAIRMAN. This hearing will come to order.

Our first witness is Prof. Dale Jorgenson of Harvard University. Dr. Jorgenson, we are pleased to have you.

STATEMENT OF PROF. DALE JORGENSON, HARVARD UNIVERSITY

Mr. JORGENSON. Thank you very much, Mr. Chairman.

This morning, we heard from three distinguished former chairmen of the Council of Economic Advisers that the U.S. economy is in an unprecedented situation. I just want to summarize the basic facts before we begin.

First of all, we are 6 months into a recession and we have a rate of inflation running at 12 percent per year. During the first quarter of this year, the annual rate of inflation by various estimates would have ranged from 16 to 18 percent.

Second, with legislation already on the books, and I think that is something that this committee really ought to focus on, the Congressional Budget Office estimates that there is going to be a tax increase of $80 billion in fiscal 1981. What that means is that we are moving into the trough of a recession with a tax increase, again, already on the books, that is of unprecedented magnitude.

As the three distinguished witnesses this morning told you, it is already 6 months too late to prevent a recession by some form of tax cut, but it is not too late to scale back the tax increase that is already on the books in order to avoid aborting the recovery.

The next 5 years are going to be very difficult years for the American economy, because productivity growth has disappeared since 1973, and the resumption of growth in real income and increased defense spending, if nothing else, is going to necessitate increased economic output, so that the dimensions of the tax increase that is already on the books is something which I think creates a terrifying prospect for people who are concerned as I am and as I know members of this committee are about the future of the economy.

It is easy to outline the dimensions of a tax cut. In rough terms, the size ought to be sufficient to avoid an increase in the deficit, perhaps $30 billion, something of that sort, based on the congressional budget estimates of what the deficit is going to be, in the absence of any further action.

Second, it ought to be balanced between the personal income tax for credits for the payroll tax increase along the lines suggested by Senator Bradley of this committee and by Secretary Miller in his testimony before this committee yesterday. On the other side, on the business side, it seems to me that we ought to have a new system for capital recovery, and since the other witnesses have really covered the ground on what the purposes of a tax cut ought to be and what its dimensions ought to be, I am going to focus my

remarks on what we ought to do in terms of a capital recovery system.

First of all, I have submitted a statement to the committee, and I am going to have to refer to table 3, page 13, in that statement. So I have asked the staff members to Xerox a few copies of table 3, and I want to begin by going over a few simple relationships between inflation and productivity in the Tax Code.

First of all, let's recall that the current tax law bases capital recovery on the actual outlays by the taxpayer. But it spaces out the capital recovery over time, just as the capital recovery itself is spaced out over time. So that the actual real value of capital recovery under current law depends on the rate of inflation. In table 3, page 13 of my statement, I have analyzed the impact of the inflation that has taken place recently on the actual tax rates that are actually paid.

It is important to recognize, then, that the law contains a set of statutory tax rates which as you know currently have a corporate rate at a level of 46 percent, but let me emphasize that the actual rate paid by the taxpayer not only depends on that statutory rate, it also depends on other provisions of the Tax Code, specifically, the tax credit and the capital recovery allowances, and, of course, it depends on the rate of inflation.

So, now let's look at the current system in table 3, where we look at calculations of what the actual tax rates are under various rates of inflation in the current law. What I have done here is to do a few representative calculations, and you can see that at the current rates of inflation of 12 percent, there are substantial differences among the different assets that we have analyzed here.

Construction machinery, for example, instead of having a 46-percent rate, has a 34-percent rate. In other words, the actual rate is actually below the statutory rate. That is due largely to the effect of the investment tax credit.

General industrial equipment, that includes things like machine tools, for example, has an effective tax rate of about 36 percent. Trucks, buses, and trailers, which are very short-lived assets and very important in the investment picture, have an effective tax rate that again is still below the 46-percent-statutory rate.

On the other hand, for industrial and commercial buildings, contrary to what is generally believed in the public and in some legal circles, I understand, industrial and commercial buildings under a 12-percent rate of inflation actually have tax rates that are above the statutory rate. That just reflects the impact of inflation in undercutting the capital recovery provisions in the current law. The rates that you can see in the table there for a 12-percent rate of inflation are 53 percent for industrial buildings and 51 percent for commercial buildings, like shopping centers or office buildings.

Now, turn to the column for 6-percent-inflation rates. You can see that under the current system the effective tax rates for equipment dropped down into the teens. In fact, for construction machinery, because again of the generosity of the investment tax credit, the effective tax rate under a 6 percent rate of inflation is only 6-percent, whereas for general industrial equipment it is 16 percent, for trucks, buses, and trailers, 9 percent, industrial buildings, 49 and 48, again, above the statutory rate of 46 percent.

Well, the conclusion is, then, that inflation has two very substantial impacts under current law. One is that a higher rate of inflation undercuts incentives, because it is effectively an unlegislated tax increase. Rather than have the tax increased by this committee and its counterpart in the House of Representatives, the Ways and Means Committee, inflation does the job for you. It increases the effective tax rates, as you can see here, between a 6- and a 12-percent rate of inflation by 20 percent in the case of general industrial equipment, by 33 percent in the case of trucks, buses, and trailers, by 28 percent in the case of construction machinery, and by modest amounts for industrial buildings and commercial buildings.

The conclusion is that the current system is very, very sensitive to the rate of inflation, and that it has a sizable incentive impact, but the most important conclusion is that under various—whatever the rate of inflation is, you can see that the allocation of capital is very greatly distorted by the fact that the actual tax rates that are confronting a business investor are very different for different kinds of assets, and what that means is that the impact of each dollar of capital formation that does result on productivity is reduced, because of the fact that this investment is misdirected.

It is obviously, for assets with a given rate of return, directed more toward the assets here that have the relatively low effective tax rates and away from assets that have relatively high effective tax rates.

So, to sum up, there is less investment as a result of the increase in the inflation rate, and at any given rate of inflation, the impact of investment on productivity is blunted as a consequence of the misallocations of investment that takes place.

So, those are the two basic conclusions I would like you to take with you about our analysis of the current system. Some people, including people that will be testifying after me, have felt that the solution to these problems is further acceleration of depreciation and further liberalization of the investment tax credit.

I am here to tell you, gentlemen, that this is like applying a gold-plated bandaid to a gunshot wound. It is by far the most expensive form of treatment you could conceive of, and it is totally ineffective in stopping the flow of blood.

In table 3, I have analyzed the 10-5-3 proposal introduced in the House by Conable and Jones in exactly the same way as I just described the first year's system. This proposal is correctly conceived as an effort to reduce tax rates, in other words, to deal with the problem of the incentives to invest.

On the other hand, it is a proposal which has the very serious disadvantage that it blunts further the impact of capital formation on productivity. Let's just look at a few numbers. First of all, remember now that in the second quarter of this year, we have had 12-percent inflation rates. What is that going to—what is the 10-5-3 proposal going to do?

Well, as you can see, it provides a lot of help for people who are buying construction machinery and general industrial equipment. It reduces the effective tax rates by about 20 percent in each of those cases. For trucks, buses, and trailers, it is almost a wash, and

for industrial buildings there is a lesser reduction of the order of magnitude of perhaps 10 percent.

So, the conclusion is that it certainly helps incentives at a 12-percent inflation rate, but now we come to the key problem here, and that is, what would happen under 10-5-3 at a 6-percent rate of inflation? Well, the combination of great acceleration in the capital recovery allowances as well as the continued use of the investment tax credit produces the numbers which you can see in the column under Conable-Jones there for a 6-percent rate.

For trucks, buses, and trailers, for example, the effective rate would be, say, 22 percent at a 6-percent rate. What would the rate be for construction machinery? Unfortunately, the answer is, a negative 23 percent. In other words, the Conable-Jones proposal, the 1053 proposal, is a proposal for replacing the corporate income tax by a corporate income subsidy.

In other words, the tax rates are negative. Let me just be sure that everybody has understood that point. As we go under the Conable-Jones regime from a 12-percent rate of inflation to a 6-percent rate, we shift for construction machinery and general industrial equipment from a corporate income tax to a corporate income subsidy. I don't need to tell you, given the people that you are familiar with in the tax business, that negative tax rates, a corporate income subsidy at a 6-percent rate of inflation is going to create a tax shelter industry that is going to be big enough to deserve its own line in the G. & P. accounts.

As inflation begins to abate——

The CHAIRMAN. Would you mind saying that again? You are talking so rapidly I didn't quite get it.

Mr. JORGENSON. Right. What I said is that at a 12-percent rate of inflation, the 10-5-3 proposal represents an effective cut in the tax rate. In other words, it is more favorable to the taxpayer. But if the rate of inflation should abate to 6 percent, and we have seen 6 percent rates, Senator, as recently as 1976—that is not so long ago—for some categories of equipment, the 10-5-3 proposal is so generous that it will replace the corporate income tax by a corporate income subsidy. We will have negative effective tax rates, 23 percent in the case of construction machinery, 17 percent in the case of general industrial equipment.

You can easily visualize what is going to happen. When inflation rates go down to 6 percent, every 70-percent taxpayer in this country, bracket taxpayer in this country, is going to get a call from his broker telling him that it is going to be possible for him to eliminate his tax liability altogether by just acquiring and leasing assets that have these negative rates.

I don't need to tell you what would happen if we had no inflation, if that ever occurs again.

So, the conclusion is that although 10-5-3 provides additional investment incentives, it is a serious blow to productivity. It will blunt the impact of investment on productivity. So, what is the solution?

My conclusion and, I think, the conclusion of our witnesses this morning was that this is no time for business as usual in tax policy. What we really need is a treatment for the gunshot wound that is afflicting the American economy as a result of inflation,

and what is required is a radical simplification of the capital recovery provisions of the Tax Code, so that that simplification is what I am here to describe as the first year capital recovery system.

Under this system, the incredibly complex provisions of the Tax Code, which occupy something like 250 pages under current law, would be replaced by a simple table, and that table would have 1 number for each 1 of perhaps 20 different asset classes. Let me add, I am not wedded to the idea of 20. It could be 12, it could be 13.

The CHAIRMAN. What page are you on now?

Mr. JORGENSON. We are looking at table 3. I haven't said anything that takes us back into the text yet.

So that what we would have would be a single number representing the first year allowance. Now, let me indicate how this would work.

This allowance would be a once and for all deduction from current income that would provide for all of capital recovery. That might be, say, 50 cents on the dollar of structure, 75 cents on the dollar of equipment, reflecting the fact that structures are somewhat longer-lived assets.

The first year allowances can be set up in such a way that the effective tax rates that we are looking at in table 3, and that is why I wanted to come back to this table, would be precisely the same on all assets, and the formula is simple algebra. Let me explain it.

The first year recovery allowance is simply the ratio of the rate of depreciation to the real rate of return plus the rate of depreciation. Let me give you a numerical example.

Suppose we had a 4-percent rate of depreciation and a 4-percent real rate of return on an asset. That would produce, given the formula that I just described, the result of 50 cents on the dollar, which would be the first year capital recovery allowance on that asset. That would be appropriate, for example, for commercial buildings, which have about a 4-percent depreciation rate.

Let's consider assets like industrial machinery that would have a, say, 12-percent rate of depreciation. Twelve-percent rate of depreciation would produce by that same formula, again, rate of depreciation divided by the sum of the rate of return plus the rate of depreciation, a first year allowance of 75 cents on the dollar.

That would produce the results you see in the last column of table 3, namely, that the tax rates under the first year's system would be identical for all assets. Now let's see how this simple idea solves the problems that are posed by inflation.

First of all, since the deduction, the first year allowance I just mentioned, and the investment on which it is based, are for the same tax year—if we are talking about tax liabilities for this year, it would be tax liability for the year 1980—the value of the deduction to the taxpayer is absolutely independent of the rate of inflation. It is unaffected. We could have an 18 percent rate of inflation. We could have a 12-percent rate of inflation. We could have a 6-percent rate of inflation. It would leave the effective tax rate absolutely unaffected, and would leave the first year allowance unaffected.

So, the conclusion is that this very simple device is the solution to the problem of completely insulating investment incentives from the impact of inflation.

Now consider the second feature of this proposal, the other problem posed by inflation. And that is that as I indicated earlier, both under the current system and under the 10-5-3 or Conable-Jones proposal, the effective tax rates on assets are different among different assets, and, of course, are different at different inflation rates.

So, the solution to that problem is that the first year's system that I have described not only insulates the effective tax rate from the impact of inflation, but it assures you that the effective tax rates are going to be the same for all assets.

So, instead of stimulating the growth of a tax shelter industry, the first year system is going to eliminate many opportunities for tax shelter that currently exist. I would hesitate to suggest that the creators of tax shelters who are very intelligent and forthright people are going to join the ranks of the unemployed. What I would hope is that they are going to go on to constructive work designing investment vehicles that are going to build the American economy and increase productivity.

Well, then, let me leave you with the following conclusions. First, accelerated depreciation is not the answer. We need to have a tax system that will cope with 18 percent inflation, which is what we had in the first quarter of 1980. We need to have a tax system that will cope with 12 percent inflation, which is the inflation rate that we had in the second quarter of 1980, and we need a tax system that will cope with the 6 percent inflation that we had in 1976.

I would hope, in fact, that we would have a tax system that would deal with zero inflation, because that is what we had in the early 1960's, when the Congress legislated tax cuts that led to an investment boom between 1960 and 1966 with the highest levels of capital formation and productivity growth and economic growth of the post-war period.

Let me add that I don't wish to single out 10-5-3 for criticism. That is simply the proposal that we have analyzed here. The same argument applies to two other proposals for accelerated depreciation, namely, the administration plan, which they are very carefully constructing at this very moment, which is essentially a version of the Ullman proposal, which many of you gentlemen have seen in the form put forward in the Ways and Means Committee, that would effectively accelerate the depreciation under the current system, and would provide for a pooling of classes of assets into something like 20 categories.

I have no objection to pooling the categories of assets, but accelerating the depreciation will simply produce a weighted average of the results of the current system and Conable-Jones. In other words, it is something that is vulnerable to the ravages of inflation, in the same way as Conable-Jones is, and has the same defects.

Second, the Ullman proposal itself, which is a less generous version of the same thing, is something which is weighted more toward Conable-Jones and less toward the current system. Again, I would describe that as a bandaid to deal with the gunshot wound.

The conclusion is that accelerated depreciation simply is not the answer to the problem we are confronted with, which is the problem of inflation.

Second, the answer to that problem is the first year system. That is a system which will assure us that, one, the effective tax rates are unchanged by the rate of inflation. No matter what the rate of inflation is, we are going to have the same effective rates.

Second, it assures us that the effective rates will be the same for all assets, and therefore, that every dollar of investment is going to have the maximum impact on productivity.

Naturally, the next question on your minds is, how much is this wonderful conundrum going to cost? Fortunately, there have been a number of estimates of that, both by the Congressional Budget Office and by the Congressional Research Service. And I am going to quote figures from the Congressional Research Service that give the annual cost of a 5-year phase-in analogous to 10-5-3, beginning in January 1st, 1981.

I am just reading the figures now from the analysis of the Congressional Research Service: minus 5.8. In other words, we would have a 5.8 loss in Federal revenue during 1981. That is not a large number: $5.8 billion is something which could easily be fitted in in 1981.

In 1982, the loss rises to $13 billion, and the maximum loss in 1985 is $24.7 billion. By comparison, the corresponding figure for 10-5-3 is—hold your breath—$85 billion. Let me just emphasize that: $24.7 billion is the cost of the first year system by the time it is fully phased in in 1985, whereas 10-5-3 would cost in that same year $85 billion.

Well, the out years, as they say, out beyond 1985, show essentially a tailing off of those costs, and by 1990 the impact would be positive, whereas for 10-5-3 it continues, of course, to grow.

So the conclusion is that this is an eminently affordable proposal. It is a proposal which meets the problem of inflation, that increases the level of productivity associated with any given level of capital formation, and that has associated with it a cost which is sufficiently moderate to be affordable, and therefore I would recommend this as part of any tax cut package to be proposed by this committee.

The CHAIRMAN. Thank you very much.

Are there any questions, gentlemen?

Senator BENTSEN. Let me ask you, Dr. Jorgenson, in figuring out what the rate of return should be and trying to work out your discounting present value, would you tell me again how you would arrive at that, who would make that determination?

Mr. JORGENSON. That is, of course, an empirical matter, Senator, as I am sure you will recognize, and it is just a question of arriving at a rate of return that reflects a reasonable long-term rate of return for the American economy.

Now, in fact, if you look at the whole of the post-war period, the rate of return after all taxes and after the impact of inflation has been very, very stable, it is about 4 percent a year, and that is true for the recent period from 1972 to the present. After the initial downturn in the rate of inflation that accompanied the recession of 1974 and 1975, there was a recovery to the prerecessionary levels,

and in general I think you can regard that as something that is a sound basis for legislation, that as an empirical matter the real rate of return in this economy is about 4 percent a year.

So, I would propose that that number be legislated into the act. If there is going to be a piece of legislation with this system in it, a determination ought to be made by the tax writing committees as to what the appropriate rate would be.

Now, there are very elaborate studies that are available. I refer to them in my submission. It would be possible to use these studies as a basis for making the determination. But roughly speaking, it would result in a real rate of return of the order of magnitude of 4 percent. That is after all taxes and after inflation.

Senator BENTSEN. Well, I frankly think you would get a better equity in the distribution of the use of the depreciation schedules, but Dr. Jorgenson, my concern is having people understand it.

Mr. JORGENSON. Well, again, it is a matter of seeing the terrific simplicity of the thing. If you regard the revisions that I am suggesting here as part of the tax cut, as I say, it is a table. It is a table that occupies about one-half page, and it has a list of assets like the one we are looking at, general industrial machinery, construction machinery, and so on, and for each of those assets, it has a single number like 50 cents on the dollar, 75 cents on the dollar, whatever it may be. That produces the result that the effective tax rates are the same for all assets, and as I say, the formula is very simple. It is just the ratio of the depreciation rate to the sum of the real rate we talked about a moment ago plus the depreciation rate.

So, again, in the case of a 4-percent real rate and a 4-percent depreciation rate, that produces 50 cents on the dollar. The taxpayer applies that to his investment in the year in which the investment is acquired, and then he never sees the Internal Revenue again, never has to go back and justify any subsequent depreciation allowances.

Senator BENTSEN. It is a first year chargeoff, and that is it. You discounted that depreciation that would be allowed over 15 years or 20 years, you discounted that back to the present value and charged it off.

Mr. JORGENSON. Exactly, and we have allowed them to write it off the first year so they get it in the same dollars that they bought the investment in.

Now, what that means is that we would have a vast simplification of the Tax Code.

The CHAIRMAN. Could I ask this question? I came in in the middle of your statement. Do I understand that you are saying you would get your entire writeoff insofar as you are going to get the writeoff the first year you install the equipment?

Mr. JORGENSON. That is exactly what I mean, Senator. Right. Now, it is very important to distinguish this from expensing. Some people say, why not let them write it off 100 percent. We know why that is not justified, because that would create a system of interest-free loans made by the Government to the taxpayer that would be absolutely random in their distribution among different kinds of taxpayers, and would involve billions of dollars.

This system essentially eliminates the differences in different kinds of assets by discounting back to the present, and as a result,

doesn't involve any single element of an interest-free loan from the Government to the taxpayer, so it has to be very carefully distinguished from expensing, but you have fastened on the critical thing here. The writeoff is in the first year. That being the case, it is in the first year, dollars of the same year for which the investment itself was paid for.

The CHAIRMAN. I am sorry we don't have a blackboard here, because oftentimes when we in this room talk about some of these things, when we have a blackboard. Someone could write an example of your idea up on the blackboard, and we could see what it is. It sounds like a very challenging idea.

Senator CHAFEE. Mr. Chairman, could I ask one question here?

I must confess, Professor, I have not followed you completely. Unlike the others who have this clear in their minds, I have been a little bit confused. Could you show me how this works with a $1,000 piece of machine tool equipment? Let's say it is general industrial equipment, $1,000. What happens?

Mr. JORGENSON. OK. You just bought a piece of general industrial equipment. Your depreciation rate is 4 percent.

Senator CHAFEE. How do you arrive at the 4 percent?

Mr. JORGENSON. The 4 percent is again an empirical matter. It is something which can be determined and has been determined by the Treasury in a study which I refer to in my handout. It is something that you get by actually looking at what prices used equipment is actually selling for, so in the case of your general industrial equipment, it amounts to picking up your dealer's blue book and finding out what your equipment, what it sold for, and if it was 5 years old, 6 years old, whatever.

Senator CHAFEE. All right.

Mr. JORGENSON. You end up with 4 percent. All right, now, let's pursue that. We have a real rate of return of 4 percent, so we take that depreciation rate of 4 percent and divide by the sum of the depreciation rate and the real rate of return, 4 percent less another 4 percent.

Senator CHAFEE. Now, the real rate of return, what is that figure? That is the 4 percent?

The CHAIRMAN. You divide by the sum of the depreciation rate and what else?

Mr. JORGENSON. And the real rate of return. Now, you just have two numbers to keep straight, the depreciation rate and the real rate of return.

The CHAIRMAN. What would the real rate of return be?

Mr. JORGENSON. Four percent.

Senator CHAFEE. Is that what we got out of this book? I thought we got depreciation.

Mr. JORGENSON. No. I was just discussing this with Senator Bentsen before you came in. Empirical studies show that the after tax, after inflation rate of return in the American economy has averaged 4 percent over the whole postwar period, so that is our figure.

Senator CHAFEE. So that is a constant?

Mr. JORGENSON. That is a constant. So we look in our book provided for us, a book of depreciation rates, which on general industrial equipment will be 4 percent. I am sorry. Excuse me, Senator. It would be 12 percent. Let me refer back here.

Senator CHAFEE. All right. So now we've got 12 percent as our depreciation rate and 4 percent as our real rate of return.

Mr. JORGENSON. Now let's calculate our first year allowance. It is 75 cents on the dollar, because that is the ratio of that 12 percent to the sum of 12 plus 4, so that is 75 cents on the dollar.

Senator CHAFEE. Now, you lost me again. Don't go too fast. Four percent is your real rate of return.

Mr. JORGENSON. Right.

Senator CHAFEE. Twelve percent is your depreciation rate.

Mr. JORGENSON. Right.

Senator CHAFEE. Now, what do you do with those two?

Mr. JORGENSON. You take the ratio of the depreciation rate to the sum of the two, so we take the ratio of 12 percent to the sum, which is 16. That gives us 75 cents—75 percent.

Senator CHAFEE. Seventy-five percent.

Mr. JORGENSON. That we apply to our $1,000 investment and our first year allowance is $750.

Senator CHAFEE. And that is it?

Mr. JORGENSON. That is it. The taxpayer enters that as a deduction from this year's income, and then it is bye-bye Internal Revenue Service. They never ask again, because you've got the whole capital recovery in the first year.

Senator CHAFEE. Now, is that a high percentage as you look at these other categories?

Mr. JORGENSON. That would be a fairly high percentage, but it would be even higher, say, 80 cents, for trucks, buses, and trailers, but for structures it would be a lot lower than that. It would be down around 50 cents on the dollar. So let's say for industrial equipment it would be 75 cents, for utility equipment it might be 70 cents, for trucks, buses, and trailers, computers, it might be 80 cents.

Senator CHAFEE. OK. Thank you.

Mr. JORGENSON. Anyway, there are 20 of these numbers in this little table, and that is the whole of the Internal Revenue Code on capital recovery.

Senator CHAFEE. Now, suppose you don't make any profits your first year. You have a carry forward?

Mr. JORGENSON. You carry forward, you carry back. You have the same provision you do under current law. I would favor a 100-percent carry forward and a 100-percent carry backward, which takes care of the Chrysler problem.

Senator DOLE. What is the cost?

Mr. JORGENSON. The cost of this scheme as calculated by the Congressional Research Service is $5.8 billion during the first year that it is adopted. This assumes that it is adopted to be effective on assets acquired after January 1, 1981. Then $13 billion during the second year, $17.5 billion during the third year, $20.4 billion during the fourth year, and reaches a maximum of $24.7 billion during the fifth year, and then it goes down.

As I said, for comparison, the corresponding figures for 1053 in the fifth year, when this system costs $24.7 billion in revenue loss, there is $85 billion in lost revenue. This is much less expensive than 1053, much less expensive.

Senator CHAFEE. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Any further questions, gentlemen?

[No response.]

The CHAIRMAN. Thank you very much, Doctor. We appreciate your presentation.

[The prepared statement of Dr. Jorgenson follows:]

THE FIRST YEAR CAPITAL RECOVERY SYSTEM

by

Alan J. Auerbach and Dale W. Jorgenson

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.

The system for capital recovery embodied in current tax law has developed through successive liberalizations of depreciation formulas and lifetimes for tax purposes and through the introduction of the investment tax credit. These changes in capital recovery provisions of the tax code have been partly motivated by the need to bring capital consumption allowances into line with economic depreciation. However, double-digit inflation in the 1970's has undercut the effectiveness of earlier reforms, so that revision of the capital recovery provisions of the tax code is again under serious consideration.

Under current tax law an increase in the rate of inflation results in a heavier tax burden on all assets. This law imposes a greater burden on some assets than others as a consequence of very sizeable differences

between capital consumption allowances and economic depreciation. The size of these 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 purpose of this paper is to present a new approach to capital recovery under U.S. tax law. This approach is based on the recovery of capital consumption during the year an asset is acquired. Accordingly, we describe our proposal as the First Year Capital Recovery System or, more simply, the First Year System. Like the present system for capital recovery, the First Year System is based on actual purchases of depreciable plant and equipment. However, since The First Year System results in a deduction in the same year an asset is acquired, capital consumption allowances are unaffected by inflation or by variations in the rate at which inflation takes place.

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.

The most widely discussed current proposal for reform of capital recovery is the Conable-Jones bill, which has the support of almost 300 of 435 members of the House of Representatives and 51 of 100 members of the Senate. The "10-5-3" system for capital recovery embodied in the Conable-Jones bill would simultaneously simplify and liberalize the capital recovery provisions of the current law. 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 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 capital stock. The Conable-Jones proposal would widen rather than narrow the substantial differentials in tax burdens among classes of assets under present law. In addition, these differentials would be made more rather than less sensitive to variations in the rate of inflation. Taxes would be replaced by subsidies on some types of assets under moderate rates of inflation and these subsidies would grow dramatically under low rates of inflation.

In this paper we describe the First Year Capital Recovery System in detail. We then compare the First Year System with capital recovery under current tax law and under the Conable-Jones or "10-5-3" system for capital recovery. We analyze the macroeconomic impact of the First Year System by simulating the U.S. economy under the assumption that this System is phased in over the five year period 1981-1985. We conclude with a summary of our recommendations for the tax policy.

1. 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. 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 an asset is acquired. Accordingly, we refer to our system for capital recovery as the First Year Capital Recovery System.

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.

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 under the First Year Capital Recovery System. Sellers of used 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 current 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.

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 under the First Year Capital Recovery System. 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.[1]

An important concern about the First Year Capital Recovery System is whether the establishment of large deductions in the first year of investment will encourage the creation of tax shelters. High-bracket taxpayers could purchase assets to take the deductions and lease them to low-

bracket entities which use the assets in production. The First Year System would, if anything, discourage the establishment of such leasing schemes and other tax shelters based on capital recovery. 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.

It is reasonable to assume that high-bracket individuals possess a lower discount rate than others do, precisely because they must pay a higher rate of tax on capital income. The conversion of all future deductions to a single present deduction will be perceived as more generous by low-bracket investors, who have a higher discount rate. They will be encouraged to purchase assets directly rather than to lease them from high-bracket individuals.

We conclude that the First Year System would very greatly reduce the administrative burden imposed on taxpayers and on the tax authorities by the current system for capital recovery. Taxpayers could dispense with cumbersome systems of capital accounts for tax reporting purposes. Tax liabilities and deductions arising from transactions in new and used assets would depend only on the sales price and would not involve records of past transactions. Finally, the creation of tax shelters involving capital recovery would be less rather than more attractive under the First Year System.

2. Alternative Capital Recovery Systems

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.[2]

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.[3]

Although it is a very straightforward matter to describe an ideal system for capital recovery, such a system has proved 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.

To compare the First Year Capital Recovery System with existing law and with the "10-5-3" system for capital recovery embodied in the Conable-Jones bill, 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 tax lifetime embodied in current law and the economic depreciation rate as calculated in a comprehensive study for the Department of the Treasury by Hulten and Wykoff (1979). We also give the proportion of nonresidential investment in 1974 for each asset class. Together these five assets accounted for about a third of investment in that year.

TABLE 1:

ASSETS AND THEIR CHARACTERISTICS

Asset Class	Type	Tax Lifetime[1]	Economic Depreciation Rate[2]	Percentage of 1974 Investment
Construction Machinery (CM)	Equipment	5.5 (7.0*)	.172	2.8
General Industrial Equipment (GIE)	Equipment	8.6	.122	4.4
Trucks, Buses and Trailers (TBT)	Equipment	5.5 (7.0*)	.254	9.0
Industrial Buildings (IB)	Structures	23.8	.036	5.2
Commercial Buildings (CB)	Structures	31.8	.025	11.0

Notes:

1. 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).

2. Economic Depreciation Rates are annual rates of decline in asset value with age, as estimated by Hulten and Wykoff (1979).

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 an investment would have if the corporate tax rate were zero. We then calculate the net rate of return, taking account of corporate taxes and adjusting for capital consumption allowances 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.[4] The first conclusion to 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,

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. Discount rates appropriate for calculating effective tax rates are discussed by Fraumeni and Jorgenson (1980).

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 of 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 balance method after 1966 resulted in increases in the effective tax rates for structures to levels that exceeded those that prevailed before 1954. Reinstitution of the investment tax credit for equipment 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.[5]

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

TABLE 3:

EFFECTIVE TAX RATES UNDER CURRENT AND ALTERNATIVE SYSTEMS OF CAPITAL RECOVERY

Asset Class	Current System		Conable-Jones		
	$\Pi = .06$	$\Pi = .12$	$\Pi = .06$	$\Pi = .12$	First Year
Construction Machinery (CM)	.06	.34	-.23	.16	.46
General Industrial Equipment (GIE)	.16	.36	-.17	.13	.46
Trucks, Busses and Trailers (TBT)	.09	.42	.22	.45	.46
Industrial Buildings (IB)	.49	.53	.36	.43	.46
Commercial Buildings (CB)	.48	.51	.32	.39	.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. "First Year" allows firms a one-time deduction, equal to the present value of economic depreciation.

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.[6]

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 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.

We conclude that the current system for capital recovery results in very sizeable distortions of economic depreciation and that the size of these distortions depends on the rate of inflation. The Conable-Jones proposal would result in greater gaps between capital consumption allowances and economic depreciation than under present law and these gaps would be more sensitive to the rate of inflation.[7] Under the First Year Capital Recovery System capital consumption allowances would be equal to economic depreciation under high, moderate, and low rates of inflation.

3. Economic Impact

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 macro-economic 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 1981. We have assumed that any shortfall will result in the creation of additional government debt and that the Federal Reserve will not adjust monetary policy to accomodate a revenue loss.

We have assumed that the First Year System will be phased in over a period of five years. Twenty percent of the value of assets acquired in tax years beginning in 1981 will be included in the First Year System; forty percent of the assets acquired in 1982 will be included in the System. Sixty and eighty percent of the assets acquired in 1983 and 1984, respectively, and all assets acquired in tax years beginning after 1985 will be included in the First Year System. This pattern of introduction of the First Year System coincides with patterns of adoption following the liberalization of depreciation allowances in 1954 and the shift to the Asset Depreciation Range System in 1971.[8]

The results of our simulation of the U.S. economy from 1981 to 1985 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

TABLE 4:

IMPACT OF THE FIRST YEAR CAPITAL RECOVERY SYSTEM

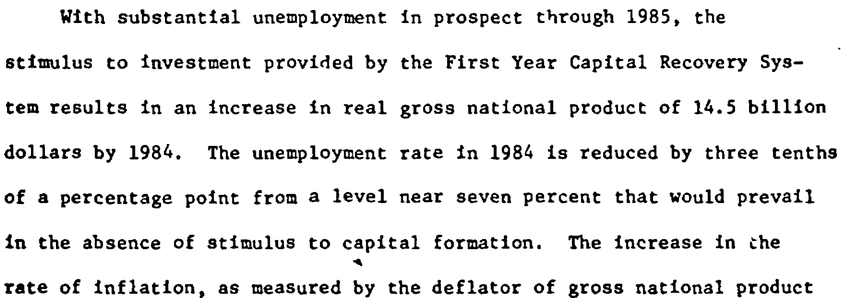
	81	82	83	84	85
Gross National Product (1972 dollars)					
A	1430.5	1485.6	1537.0	1597.4	1648.7
B	1430.6	1487.1	1531.2	1582.8	1635.3
D	-0.1	-1.6	5.8	14.5	13.4
%	-0.0	-0.1	0.4	0.9	0.8
Investment, Producers' Durable Equipment (1972 dollars)					
A	97.6	94.4	94.8	101.2	107.8
B	97.8	98.9	98.2	99.1	101.8
D	-0.2	-4.5	-3.4	2.1	6.0
%	-0.2	-4.6	-3.4	2.1	5.9
Investment, Nonresidential Structures (1972 dollars)					
A	47.1	47.7	50.6	54.9	59.2
B	47.0	46.7	47.1	48.4	50.1
D	0.1	1.0	3.5	6.5	9.1
%	0.2	2.2	7.4	13.5	18.2
Investment, Residential Structures (1972 dollars)					
A	45.7	59.6	66.8	73.9	74.7
B	45.5	57.8	62.3	69.3	72.4
D	0.2	1.8	4.5	4.7	2.3
%	0.5	3.1	7.2	6.7	3.1
Unemployment Rate					
A	8.0	7.7	7.4	6.9	6.5
B	8.0	7.7	7.5	7.2	6.8
D	0.0	0.0	-0.1	-0.3	-0.3
%	0.0	0.3	-0.8	-4.3	-4.4
Federal Government Deficit					
A	1.0	14.5	10.2	22.6	21.1
B	-4.0	20.5	19.4	34.6	49.8
D	5.0	-6.0	-9.2	-12.0	-28.7
%	-123.8	-29.3	-47.3	-34.7	-57.6

Notes:

1. A: Simulation with adoption of the First Year Capital Recovery System, based on CONTROL 6 YR 04 26 80.
2. B: Simulation without adoption of the First Year Capital Recovery System, based on CONTROL 6 YR 04 26 80.
3. D: A-B.
4. %: D/B * 100.

the U.S. Economy.[9] In Table 4 the Base Line simulation, denoted B in Table 4, 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 and that the investment tax credit is discontinued. 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 five years after the adoption of the new System, real investment in equipment has increased by 6.0 billion dollars and real investment in nonresidential structures has increased by 9.1 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, real investment in residential structures has increased by 2.3 billion dollars within five years.



With substantial unemployment in prospect through 1985, the stimulus to investment provided by the First Year Capital Recovery System results in an increase in real gross national product of 14.5 billion dollars by 1984. The unemployment rate in 1984 is reduced by three tenths of a percentage point from a level near 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

(not shown in Table 4), would increase by two tenths of a percentage point per year by 1984.

The Federal deficit for 1981 would decrease by 5 billion dollars as a result of the adoption of the First Year Capital Recovery System. This is partly due to elimination of the investment tax credit. The estimated revenue loss would be 6 billion dollars in 1982 and 9.2 billion dollars in 1983. The revenue loss would mount to 12.0 billion in 1984 and 28.7 billion in 1985 as the increase in capital spending exceeds the total increase in real gross national product. The total revenue loss over the first five years of adoption of the First Year System would total 50.9 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 from equipment 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 maximum impact on productivity and economic growth.

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4. Implementation

We next consider administrative issues that would arise in implementing the First Year Capital Recovery System. As at present, the Treasury would have responsibility for measuring economic depreciation as a basis for the capital recovery allowance for each class of assets. The Treasury study by Hulten and Wykoff (1979) 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 capital recovery. The engineering approach has been used by the Treasury for almost half a century and is 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 entirely eliminated by adoption of the First Year Capital Recovery System. Since the First Year System is based on current transactions in capital assets, no capital accounts would be required to support capital consumption allowances claimed as a deduction for tax purposes.

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 (1979). The real rate of return would be taken to be four percent, as suggested by the study of Fraumeni and Jorgenson (1980). Distortions resulting from small departures from the actual economic depreciation or the actual real rate of return would be very small by comparison with distortions under current tax law or the Conable-Jones bill.

Although the First Year Capital Recovery System does not rely on data required for financial reporting, it could be integrated with a financial reporting system and could lead to major simplifications. At present many taxpayers maintain separate systems of capital accounts for tax purposes and for financial reporting. Since the First Year System does not require capital accounts, one of these systems could be completely eliminated. Capital accounting for financial reporting could be greatly simplified by adopting the declining balance method for capital recovery.[10]

5. Summary and Conclusion

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.[11]

The First Year Capital Recovery System would meet the needs we have identified for a new system for capital recovery. The First Year System would eliminate the differentials between economic depreciation and capital consumption allowances that have arisen under current law. Under the First Year System capital consumption allowances would be unaffected by inflation or by variations in the rate at which inflation takes place. The System would provide a substantial stimulus to capital formation at the cost of a modest revenue loss to the Federal government. The System would also improve the allocation of capital and would maximize the contribution of capital formation to growth in productivity and in economic activity.

The First Year Capital Recovery System could be implemented within the present organizational framework of the Department of the Treasury. The administrative burden on the tax authorities would be substantially lessened by simplifying the system for capital recovery. Moreover, the reporting requirements imposed on taxpayers would be drastically reduced. For tax purposes capital consumption allowances could be ascertained without a cumbersome system of vintage accounts and the same methods would be used for structures and equipment. Finally, the First Year System could easily be integrated with a system for financial reporting.

Footnotes

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1. Current provisions for assessing tax liabilities on sales of assets are discussed by Brannon and Sunley (1976). Our approach is consistent with the principle of tax neutrality of exchanges of assets proposed by Brannon and Sunley.

2. A history of capital recovery provisions under U.S. tax law, an analysis of current tax provisions, and detailed references to the literature are provided by Gravelle (1979).

3. The concept of economic depreciation is discussed in greater detail by Jorgenson (1973).

4. The criterion that effective tax rates should be the same for all assets is discussed in more detail by Auerbach (1980).

5. Our findings for individual assets are consistent with the findings of Feldstein and Summers (1979) for the U.S. capital stock as a whole.

6. The bias toward equipment is not due to the impact of inflation under current capital recovery provisions; biases under current tax law are discussed in more detail by Auerbach (1979).

7. For further discussion of the Conable-Jones bill and alternative systems for capital recovery, see Feldstein (1979).

8. Patterns of adoption of accelerated depreciation are analyzed by Wales (1966).

9. For a detailed description of the DRI model, see Eckstein and Sinai (1980).

10. Rather than requiring a system of vintage accounts, as in the ADR System, the declining balance 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.

11. The impact of provisions for capital recovery on investment expenditures is discussed by Hall and Jorgenson (1971) and Gordon and Jorgenson (1976). The link between capital formation and productivity is analyzed by Fraumeni and Jorgenson (1980).

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The CHAIRMAN. Next, we will have Mike Evans.
Mr. Evans, it is a pleasure to have you here today.

STATEMENT OF MICHAEL K. EVANS, EVANS ECONOMICS, INC.

Mr. EVANS. Thank you very much, Mr. Chairman.

I appreciate the opportunity to appear before the Senate Finance Committee today to discuss tax and fiscal policy for 1981.

Currently the U.S. economy is on the horns of a most unpleasant dilemma. We are in the midst of a fairly serious recession, with the unemployment rate heading toward 8.5 percent or higher, and yet we seem to be stuck more or less permanently with double-digit inflation. So, the question of how to proceed for a tax cut for next year is more complicated than usual.

We cannot proceed with the previous method, business as usual, of simply stimulating demand and spending our way out of a recession. We have tried this several times in the past 15 years, and the net result has always been that the rate of inflation has been higher at the peak of the next business cycle than it has been at the previous one.

It seems to me that in planning any tax cut, we must do away with the short-term aspects of fiscal stimulus and plan what the effect of the tax cut will be over the next business cycle. We can't talk about the next 6 to 9 months. We have to talk about the next 3 to 5 years, because if we don't do that, we are just going to be back in the soup where we were before with inflation rates higher, as I say, at the peak of the next business cycle than they were even in 1979.

Based on this, I would say that the most important issue was not the exact timing of the tax cut, but rather the scope and direction of tax reduction. I think it is much more important to stimulate saving and investment than it is to raise consumption. I believe that any tax cut which is passed should be aimed at solving the long-run problems of productivity growth and inflation and not aimed at solving the short-run problems of spending our way out of the current recession.

In addition, I think any tax cut which is passed should increase the productive capacity of the U.S. economy, and should benefit those people who are in a position to increase the productivity of the economy. While it is true that lower income citizens are hard hit by inflation, this inflation is the direct result of the massive shift of resources from investment to consumption in a misguided attempt to help these very people.

For that reason, I would oppose measures such as an income tax credit to offset the higher social security taxes. Such a method would put more money in the pockets of people, but it would do nothing to help productivity and incentives. As a result, the effect of such a tax cut would be only about half as much as the reduction in personal income tax rate. Such a move would be inflationary, whereas under the proper circumstances, a cut in the personal income tax rate would not be inflationary.

I certainly would have no objection to a business tax cut which was passed this year and made retroactive, say, to the beginning of this week. In fact, I have long argued that the economy needs such

tax cuts. I believe we should have had such tax cuts last year, and I certainly would be in favor of them this year.

However, we should not be deluded about what these tax cuts could accomplish in terms of influencing GNP this year and next year. The effect of passing a tax cut now instead of in 6 months would be less than a half a percent on real GNP next year, and less than a 0.2 percent difference in the unemployment rate.

I am also somewhat concerned about the Christmas tree atmosphere which might prevail if a tax cut were to be passed in the closing days before election, and think that perhaps more thoughtful legislation might emerge if the bill were considered next season.

However, I will bow to the expertise of the chairman of this committee, who has stated that he has had a great deal of experience in shepherding these tax cuts through, and I will take your word for it, Mr. Chairman, that you will be able to manage these things properly.

Before turning to the recommended tax package, I think it is appropriate to point out that we are going to have a very large budget deficit next year, regardless of exactly what is done. My estimate for the budget deficit next year is approximately $60 billion. Even if we do not have any tax cut at all next year, the budget deficit will be at least $45 billion, and this is based on a forecast which shows a fairly vigorous upturn for next year.

If the economy were to stay depressed, if the unemployment rate were to move to 9 percent and stay there, we might have a deficit as large as $100 billion. That is not my standard forecast, but that is the outer limit of what could reasonably be expected to happen.

I think we have to consider, then, what sort of tax cut to have based on the economic scenario, a large deficit next year, continuing high unemployment rate of more than 8 percent throughout 1981, but inflation which unfortunately remains in the double digit range.

Now, some people are bothered by the budget deficit, and certainly I would not say as an out and out statement that I am in favor of them, but I think we should point out that all budget deficits are not created equal, that a budget deficit could be inflationary, and perhaps in other circumstances could not be.

If we had a $40 billion tax cut which stimulated savings and investment, in my opinion that would not be inflationary. On the other hand, a $40 billion tax cut which consisted of a rebate, or a tax credit, or something of that sort would clearly be inflationary.

Now, because the economy is currently in a recession, a variety of tax cuts could be passed now or early next year without having an immediate affect on inflation. In fact, I think the rate of inflation in 1981 and 1982 will be in the 10 to 12 percent range, regardless of the exact fiscal policy which occurs.

However, starting in 1983, as the economy approaches full employment and full capacity, the tax packages which are passed right now will make a tremendous amount of difference. If we have business as usual, more tax cuts for the consumers, the rate of inflation will start to accelerate again in 1983, whereas if we pass a tax package right now for business savings, for personal savings, and for higher investment, the rate of inflation should begin to decline as we go into 1982 and 1983.

In fact, I have estimated that under a correctly structured tax package which stimulates savings and investment, we could reduce the inflation rate to 6 percent by 1985.

Now, unfortunately, this lesson about timing has only recently been learned by the Carter administration, whose economists thought it proper in early 1977 to disregard the possibility of increased inflation and concentrate solely on solving the problems of unemployment.

While they were successful in that endeavor, we are now saddled with double-digit inflation, and while the Carter administration perhaps cannot be blamed for the second energy crisis, I estimate that their policies have added 2 to 3 percent to the present rate of inflation.

Now, certainly we are going to have a tax increase next year if we do nothing. Everybody knows this. Other noted economists have testified to this effect. So, we should have some offset, but it seems to me the greatest need at present is for supply side tax cuts which stimulate productivity in investment rather than those tax cuts which simply add to demand.

Now, a number of bills are possible. Everyone has their own pet project, perhaps, but the suggestions I have for tax reduction are as follows. I divide this into four parts. First of all, I would be in favor of valuing depreciation allowances for new investment in replacement rather than historical cost.

This would originally cost about $5 billion a year, and it would increase as more new investment came on stream. Eventually, it would cost about $30 billion a year for approximately the same amount as the so-called 10-5-3 program would cost.

Second, I would favor a reduction in the corporate income tax rate from 46 to 40 percent, at an annual cost of about $11 billion per year.

Third, I would like to restructure the capital gains tax laws, so that anyone putting venture capital into a company and holding the stock for 5 years or more would not have to pay any taxes at all. This would redirect money into the venture capital market. It would spur productivity in the very important area of research and development and new companies, and would be equitable from the point of view of the taxpayer as well.

Finally, the fourth idea which I suggest is an increase in the exemption on interest and dividend income up to $1,500 per year as a spur to personal saving. I think sometimes we look at business saving, but we neglect personal saving, which in order of magnitude is roughly as large as business savings.

Now, I prefer replacement cost accounting over 10-5-3 for several reasons. I am not opposed to 10-5-3. I think the most essential need is to do something about more realistic depreciation allowances. But I think the replacement cost accounting ties more directly to what is actually going on in the economy.

The tax system should not distort investment decisions in either direction. It should not diminish investment or it should not favor one type of investment at the expense of another type of investment.

Now, 10-5-3, while it is a good bill in many respects, has structures reduced by two-thirds and equipment reduced by half or less in

many cases. Furthermore, the way 10-5-3 is phased in, it has sort of a negative incentive in that it is phased in over 5 years, so there is a negative incentive for investing in 1981 because you may be able to get a better rate in 1982, and this keeps going on until it is fully phased in.

If we had replacement cost accounting, then we would not have this negative incentive effect.

Now, I think the corporate income tax reduction is very important as well. According to our calculations, a dollar's worth of revenue in a corporate income tax cut results in more investment than a dollar spent for an investment tax credit, and the reason for that is that the investment tax credit has some restrictions. It applies to equipment, and it does not apply to plant. It has certain provisions in which not all companies can take the credit.

A pure corporate income tax cut basically gives you more bang for the buck than any other type of corporate tax cut, and I would favor it for that reason.

The capital gains tax reduction, I think, has worked out very well. I testified some time ago, 2 years ago, about the reduction in the capital gains tax rate from 49.1 to 28 percent, and at least in my opinion this has been instrumental in the rise in the stock market which has occurred.

The stock market is up over 20 percent relative to what it was in November 1978. Even though interest rates are much higher and we are in the middle of a fairly serious recession, the stock market has done very well. In fact, it has confounded many of the experts, and I think one of the reasons for that is the capital gains tax reduction.

I think that we should definitely have further reductions in this area, and I have suggested also a restructuring along the lines of helping venture capital.

Now, as far as the personal savings goes, I think I should point out that the U.S. economy is the only industrialized economy in the world that does not give the small saver a break. I have listed some of the examples here, but in Britain and in Germany and Japan and other countries, savers are encouraged.

The amount of interest and dividend income is exempted from income tax up to an amount of $1,500 or $2,000 or even $3,000. Savings itself is exempt from income tax if it is put into various types of funds. As a result, the savings rate and the increase in productivity in other countries of the world is much higher than the United States.

In fact, if we line up the growth in productivity in the 12 major industrialized nations, the United States, unfortunately, comes in dead last, 12 out of 12, and part of the reason, I think, is that we give insufficient incentives for savings.

Senator PACKWOOD. What is the figure again, 12 out of 12 of what?

Mr. EVANS. The major industrialized countries of the world.

Senator PACKWOOD. Twelve out of twelve in what?

Mr. EVANS. I am sorry. In terms of two things. First of all, the proportion of resources devoted to savings and investment, and secondly, the growth in productivity. There is a strong correlation between these two. Japan is first in both, and so forth and so on.

So I think we should help the small savers.

Another possibility, another way to do this would be to start the tax table over from nonwage income. For example, suppose you had income, $50,000 in wages and $10,000 in interest and dividend income. Now, of course, you pay a marginal rate on that minus $10,000, which is quite large, usually 50 percent or more. I would suggest starting the tax table over, and having the marginal rate apply to the $10,000 of non-wage income instead of $60,000.

In fact, if the Treasury were to reduce the maximum tax rate from 70 percent to 50 percent, our estimates show that the Treasury would actually come up $3 billion ahead, could actually make money on lowering the tax rate from 70 to 50 percent, because people would switch out of tax-free securities and out of tax shelters into regular types of income.

Now, I have not yet discussed the implications of a broad-based personal income tax cut. I favor such a cut only if it is accompanied by limits on government spending preferably those which would allow no increase in real terms. These increases would not be horrendous. For example, the 10-percent reduction in personal income tax is for each of 3 years, would raise the rate of inflation by about 2 percent after 5 years.

However, if these tax cuts were accompanied by offsetting reductions in Government spending, the rate of inflation would be about 2 percent lower after 5 years.

Now, this certainly does not mean that we should not have reduction in personal income taxes. It simply means we can't do everything at once. May I refer back to the experience of the mid-sixties? We had the Kennedy-Johnson tax cuts, which basically were well structured, which encouraged growth, which were not inflationary, but that was evidently not enough for President Johnson.

We had the Great Society expenditures, and we had the Vietnam War expenditures, and as a result we turned a stable, balanced growth economy into one in which we had continuing spirals of inflation and a decline in productivity. We never recovered from that.

So, I really would caution this committee against trying to do too much. I think we should have tax reductions, but I don't think we should have too much tax reduction unless we are willing to cut Government spending growth as well.

Now, if we are willing to forego further increases in Government spending, the size of the tax cuts which could be enjoyed could be substantial. In fact, I have estimated that if we could hold Government spending equal to the rate of inflation, we could end up with $54 billion per year in Goverment spending cuts. So, the choice is really between cutting taxes or cutting the level of Government spending growth and combining these two in such a way as to not overheat the economy.

Finally, I would say in conclusion that the balance between Government spending and taxes turns out to be the most important long-run issue surrounding tax reductions. Second in importance is the scope of the tax reduction, whether it stimulates savings and investment or just raises consumption.

Third is the absolute size of the tax cut, although this would be more important if the economy were closer to full employment.

Finally, the precise timing of the tax cut I would put only in fourth place, for that would have little effect on solving the problem of recession. This time, I think we need to aim our sites at solving the long-run problems of productivity and inflation rather than concentrating only on the short-term recession fight.

Thank you.

Senator BRADLEY. Thank you very much, Mr. Evans.

I think under the early bird rules, Senator Dole?

Senator Danforth.

Senator DANFORTH. Mr. Evans, you touched on this, but I would like you to elaborate on it if you would. With respect to the individual portion of the tax cut, what are your views as to the form it should take? This morning, Mr. Greenspan endorsed the indexing concept. He viewed Roth-Kemp as a surrogate form of indexing.

Mr. Heller preferred a social security offset of some kind. His first preference was to fund Medicare out of general revenues. His second choice was a credit for the portion of social security taxes paid.

Others have suggested, and I take it this is what you are suggesting, some sort of saving specific tax reduction, whether it is further capital gains reduction or an exclusion for dividends and interest. I guess that pretty well covers it, unless there are some others that you can think of. But I would just like for you to comment on the variety of approaches and which you think would be better, given *x* number of dollars which would be for individuals. Which form would you prefer?

Mr. EVANS. First of all, let me take them in roughly the order that you have introduced them. I think that the idea of a tax credit to offset the increase in social security is not a good idea. I don't think that we really get very much from that. It puts a little bit more money into people's pockets, but it has none of the incentive and productivity effects that I personally feel are important, so that is really the last choice for me.

The Kemp-Roth plan, whether it is 10 percent a year for 1 year or 10 percent a year for 3 years, makes for some difference because of the size involved. But I have always felt that that was a good idea, but it should be coupled to limits of growth in Government spending.

We have had a steady increase in the percentage of resources devoted to Federal Government spending. The Administration economist—

Senator DANFORTH. Well, if you would, just on the question of, given *x* number of dollars which one way or another is going to be the individual portion—

Mr. EVANS. No strings attached, period, right?

Senator DANFORTH. Assume there is a fund of $15 billion per year in the first year for a tax cut directed at individuals. How would you use that? And how would you not use it?

Mr. EVANS. How would I not use it? OK. I have already indicated how I would not use it. My first choice really would be to have

benefit for the savers, an increase in the exemption of $1,500 per individual to exempt savings and interest income from taxes.

Now, that would cost, according to my estimates, approximately $8 billion a year. That is not far off from the Treasury Department estimates, although it might be a little different, but that would cost about $8 billion a year.

You mentioned a figure, $15 billion. I would use the other $7 billion as the beginning of an across the board personal income tax rate cut.

Senator DANFORTH. I don't understand why the social security credit would be inflationary. I mean, one of the arguments in favor of it is that payroll tax is by definition inflationary. I don't know whether a reduction in payroll takes is a good idea or a bad idea. It does seems to me that we are going to face the idea of social security financing and what to do about it. We are facing a very large increase in social security taxes next year. We are also faced with the fact that what we did in 1977, despite representations at that time, is not adequate due to the fact that we don't have 4 percent inflation, we've got much more than that, and a much greater payout.

So, I think we are going to be looking at social security in any event.

It may be that if we do something in social security, Professor Heller is correct, that it should be the revenue financing of medicare. I don't know, but I must say I don't understand your theory of why that would be less inflationary or more inflationary than a rate cut.

Mr. EVANS. Well, I think we are going to have to do something about social security. Clearly, the benefits are outrunning the amount of money that is coming into the fund through contributions, but there are a number of ways to handle that. I have testified before that one way to handle the situation is to raise the retirement age. That is not very politically popular, but that is personally how I would handle it. That would solve the problem.

But let me get back to your major question. I think we should draw some distinction, it seems to me, between the taxes that are paid by employees and taxes that are paid by employers. If you reduce the amount of taxes paid by employers, you lower unit labor cost, and to the extent that you do that, you lower prices. I wouldn't disagree with that.

If you lower the social security tax paid by employees, then you could make an argument that because wage earners have essentially received a raise, and that they are paying less taxes, that they might be willing to bargain for lower wages in the future. Now, that is not too bad an argument. It is not a bad argument, but you make the same argument for a personal income tax rate reduction.

Now, usually when people refer to the antiinflationary facts of reducing social security tax, it seems to me they are talking about reducing the tax rate to employers, and I feel if you want to reduce the tax rate that is paid by businesses, let's do it through a corporate tax rate cut. It will take a little bit longer, but at least in my opinion the ultimate effects would be a little more favorable.

Senator BRADLEY. Senator Packwood.

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Senator PACKWOOD. On page 11 of your statement, you say that as far as a broad-based personal income tax cut is concerned, it would be plain inflationary if it is not accompanied by offsetting tax reductions, and you would favor it only if there were the offsetting spending reductions.

Mr. EVANS. Yes, that is right.

Senator PACKWOOD. Then you do not support the straight across-the-board Roth-Kemp proposal, just the tax cut.

Mr. EVANS. Not unless it is tied to Government spending limits.

Senator PACKWOOD. Well, it isn't tied to spending limits. Roth-Kemp is just a 10 percent, cut over 3 years. We did tie it a bit to some depreciation that we had 2 or 3 weeks ago, although it was really very highly structured toward the individual, do you think that is the wrong direction to go?

Mr. EVANS. It is not totally the wrong direction, but I don't think we can do everything at once.

Senator PACKWOOD. No, I understand, but I see your priorities. You would prefer the business tax cuts first. If all we are going to have is roughly a $20 billion to $25 billion tax cut, which in 1981 and 1982, $20 billion to $22 billion of it is going to be individual across-the-board tax cuts, you don't regard it as very productive.

Mr. EVANS. No; I would favor the business tax cuts.

Senator PACKWOOD. I understand that, and it is going to widen the deficit $20 billion to $25 billion, and will raise our rate of inflation about 2 percent.

Mr. EVANS. If we have a personal income tax with no offsetting.

Senator PACKWOOD. We have no spending reductions. We haven't gotten to that yet. OK, let me ask you one other question.

On page 6, talking about deficits, you say, it is the size of the public sector rather than the size of the deficit itself which more closely relates to inflation. I have never understood how these Western European countries can tax 41, 42, 43 percent of the gross national product, end up with higher productivity, and lower rates of inflation. Germany is paying higher wages that we are paying. How do they do it?

Mr. EVANS. Basically, they do it through tax incentives for savings and investment. The same plant that we write off here in 30 years, they write that off in Germany in 3 years in many cases.

Senator PACKWOOD. According to the Organization of Economic Cooperation and Development, OECD, Germany's rate of taxation is 41 percent of the gross national product on expenditures, 43.5 percent if you count it on revenues. That means they have got to have a huge tax load on the middle and lower income classes, possibly through the value added tax or some other kind of consumption taxes. Not only is the total rate of taxation higher, if they were exempting savings and faster depreciation or encouraging capital formation, the tax burden has to fall on the lower income classes. Is that correct?

Mr. EVANS. They have a higher tax burden than we do, and the value added tax is the answer. That is right.

Senator PACKWOOD. Should the United States be moving in the direction of increasing its taxes on lower income, decreasing them at the higher end, on business and capital formation or on anything that would relate to capital accumulation?

Mr. EVANS. Well, I haven't really spoken in favor of a tax increase. Most people under $10,000 a year, they only tax they pay is social security tax. I am not suggesting that we go and impose an income tax on these people, but I certainly am suggesting that we lower the burden of taxation on the upper income people. That is right. And then you ask, well, how do we do? There is no free lunch, and all that stuff. I say, well, you reduce the rate of growth in Government spending. I mean, that is the way I am looking at it.

Senator PACKWOOD. I understand. I am all with you on the reduction of Government spending. None of the proposed tax bills are doing that. They are all just cutting the taxes, and nobody is cutting the spending. I want to be very careful, now, how I quote what you are saying. Where the principal tax cuts ought to come in your mind are on those areas that relate to capital formation and investment and depreciation.

Mr. EVANS. And savings.

Senator PACKWOOD. And savings, and that is almost the opposite of what the Roth-Kemp approach is. It is just an across-the-board tax cut of which roughly 80 percent goes to people making $20,000 or less. I have to conclude that that is not the philosophy you are advocating.

Mr. EVANS. I think it is more complicated than that. I would like to see the whole package taken together as one package. I look on taxes and spending as both blades of the scissors, and I don't think you can cut with one blade of the scissors. And I think we need to see a coordinated tax package. I am not trying to avoid the answer, but I am trying to say that I would like to see these both work together.

Senator PACKWOOD. If you were a Member of the Senate and you were presented with a Roth-Kemp bill for a 10-percent tax cut per year, and there was nothing else but that bill, which way would you vote?

Mr. EVANS. That is the only choice I have?

Senator PACKWOOD. That is right, a 10-percent across the board cut.

Mr. EVANS. I may be out of town. It would be a difficult decision. I would vote in favor of it, as a matter of fact, but I would try to work on the other areas as well.

Senator PACKWOOD. You can't pass.

Mr. EVANS. You can't pass.

Senator PACKWOOD. No; you can't claim a conflict of interest. When the vote comes in, you must be on the floor. Then you must decide.

I have no other questions.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Mr. Evans, you come out very strongly for increasing savings as the route to increasing productivity in the country. And you have suggested the vehicle of excluding $1,500 in interest, is that it, and dividends?

Mr. EVANS. Yes. That is correct.

Senator BRADLEY. What other components of savings in the economy, in other words, what percent is depreciation, what percent retained earnings, and what percent is savings accounts in banks?

Mr. EVANS. Well, from 1979, last year, we had figures. Personal savings was approximately $80 billion. Corporate depreciation was approximately $150 billion. Noncorporate depreciation, which is basically on houses, was about $100 billion, and corporate retained earnings was about $75 billion. These are rough orders of magnitude.

Senator BRADLEY. You say 80. Could you go over the figures again?

Mr. EVANS. Yes. These, of course, are rough, but about $80 billion is for personal savings. About $150 billion for corporate depreciation. About $100 billion for noncorporate depreciation, and about $75 billion for retained earnings.

Senator BRADLEY. So that out of this whole figure of roughly $300 billion, less than one-third of it is personal savings.

Mr. EVANS. Not exactly, because a lot of noncorporate depreciation reflects residential construction, and not savings by individuals who own their own homes.

Senator BRADLEY. What I am getting at is, do you think that increasing the exemption for interest to $1,500 for several things which you want to accomplish, which facilitates savings and investment and increased producitivity, versus reducing the corporate income tax rate much deeper than you have suggested.

Mr. EVANS. Well, the bill that I suggested, the package that I put together costs roughly something like $30 billion the first year, and I have allocated roughly about $8 billion, about a quarter of it directly on personal savings. So, I think that is in line with the relationship of personal savings to the aggregate savings. I think we really ought to concentrate on business savings, but not neglect personal savings. That is really what I was trying to say. I think that is also important, source of savings. We shouldn't omit it.

Senator BRADLEY. What would be the effect on the economy of your model, if we eliminated the corporate income tax and assessed individual owners their proportionate share of the earnings of the corporation on their personal income tax?

Mr. EVANS. Basically, the integration of the tax system.

Senator BRADLEY. That is it. What would be the effect on the economy in the way of increased investment and growth and productivity?

Mr. EVANS. It would probably raise productivity about 1 percent a year. Again, this is a rough estimate, and that, at least, as far as my calculations——

Senator BRADLEY. That is in the first year?

Mr. EVANS. No; this takes a while. This takes a while. This is what I would call deferred time. It is about 3 to 5 years out. That would release the rate of inflation by about 2 percent a year. The first year, you get very little effect simply because business decisions to invest are not made overnight. They take a while.

Senator BRADLEY. So, if you abolish the corporate income tax rate, we would get integrated the earnings into the personal. We would get only a 1-percent improvement in productivity and a 2-percent improvement in inflation after 3 to 5 years.

Mr. EVANS. I wouldn't say only before that. Productivity growth has jumped from about 3 percent down to about zero. I think if we

could capture 1 percent, that would be fair, Congressman, but yes, those are the numbers I quote.

Senator BRADLEY. What do you assess as to what you suggested here in reduction of corporate income tax from 46 to 40 on both those things, productivity and inflation? It seems to me the assumption——

Mr. EVANS. That is a much smaller number. That would have an effect—well, let me see, approximately, raising the productivity rate less than half a percent a year, maybe a quarter of a percent, the corporate tax cut from 46 to 40 is a very worthwhile item, but it is only $10 billion or $11 billion a year. I mean, you can't expect miracles for $10 billion or $11 billion a year.

Senator BRADLEY. Well, now, wait a minute. If you took the rate from 46 to 40, you get a half a percent.

Mr. EVANS. No; less than that.

Senator BRADLEY. A quarter of a percent.

Mr. EVANS. Yes.

Senator BRADLEY. You've still got 40 percent more that you can reduce. You are saying in that event you are only going to get an extra percent and a half.

Mr. EVANS. You said, cut the corporate tax rate to zero but integrate.

Senator BRADLEY. Right.

Mr. EVANS. So you would have a smaller corporate where you would have zero corporate taxes but you would have higher personal taxes. Integration is really corporate taxes. The corporate taxes right now, Federal corporate taxes run about $85 billion a year if you cut the rate to zero, but integrate them, you don't get rid of all that $85 billion. You get rid of—I don't know the exact figure, but something like half of them, something like that.

The CHAIRMAN. Might I suggest that we suspend this hearing for a moment to consider an urgent matter?

[Whereupon, at 2:48 p.m., the committee went into executive session. The committee returned to the public hearing at 2:53 p.m.]

The CHAIRMAN. Are there any more questions?

Senator BRADLEY. Could I just ask if Mr. Evans could provide for the record the model that shows the effect on the economy of the reduction of 46 to 40, and then the abolition of the corporate income tax with the integration to personal form?

Mr. EVANS. Yes; I would be glad to.

The CHAIRMAN. All right, sir. Thank you very much.

[The prepared statement of Mr. Evans follows:]

Evans Economics, Inc.

Testimony for Senate Finance Committee

July 24, 1980

by Michael K. Evans

The U.S. economy is currently on the horns of a most unpleasant dilemma. We are in the midst of a fairly serious recession, and the unemployment rate is likely to rise to 8½% or higher by yearend. On the other hand, inflation remains stubbornly in the double-digit range, and is unlikely to dip below 10% this year or next.

Against this backdrop, the question of how to proceed with tax reduction is more complicated than usual. Traditional methods which stimulate demand are likely to lead to even higher rates of inflation two years hence. On the other hand, supply-side tax cuts which work through diminishing costs by raising productivity and incentives have relatively small effects for the first year or two.

It is my position that we must eschew the traditional short-term bias of fiscal policy, and consider the effect of any tax cut over the entire business cycle. Any reduction which accelerates growth next year but results in higher inflation in future years is not worth it.

Indeed, the most important issue is not the exact timing of the tax cut, but the scope and direction of tax reduction. Currently it is more important to stimulate saving and investment than it is to raise consumption. The tax cut should be aimed at solving the long-run problems of productivity and inflation, not at solving the short-run problems of the current recession.

In addition, the tax cut should benefit those who are in a position to increase the productive capacity of the U.S. economy. While it is true that lower-income citizens have been hard hit by inflation, this inflation is a direct result of the massive shift of resources from investment to consumption in a misguided attempt to help these very people.

For that reason I would oppose measures such as an income tax credit to offset the higher social security taxes going into effect next year. Such a tax cut would put more money in the pockets of consumers, but it would do nothing to stimulate incentives, saving, or investment. As a result, the efficacy of such a tax cut on output and employment would be only about half as large as a reduction in the personal income tax rate. Furthermore, since it would not increase productivity, such a tax cut would be more inflationary than would a rate reduction.

I certainly would have no objection to a business tax cut passed this year and retroactive to, say, July 21st. I have long argued that the economy needs such tax cuts, and in fact believe that tax reduction of this sort should have taken place last year. However, we should not be deluded about the differential effect which such a tax cut will have if it is passed now rather than early next year. The effect of a six months' difference in timing would be less than 0.5% on real GNP next year, and less than a 0.2% differential in the unemployment rate.

I am somewhat concerned about the "Christmas tree" atmosphere which might prevail if a tax cut were to be passed in the closing days before election, and believe that more thoughtful legislation might emerge if the bill were considered early in the next session. However, I will bow to the expertise of the Chairman of this Committee when he states that he has had a great deal of experience in shepherding through tax legislation.

Before turning to our recommended tax package, I think it is appropriate to point out that the Federal budget deficit for FY 1981 will be quite large whether or not we have a tax cut next year. I estimate that the FY 1981 deficit will be $60 billion, as shown in Table 1. This assumes a $30 billion tax cut passed early in 1981. However, even if no tax cut were to be passed, the deficit would still be $45 billion. The revenue saved from not having any tax cut would be about $20 billion on a fiscal year basis. However, we must subtract some $5 billion from that figure because the economy would grow more slowly and hence less revenue would be collected from lower incomes.

TABLE 1

Variable Name	1979.4	1980.1	1980.2	1980.3	1980.4	1981.1	1981.2	1981.3	1981.4	CY 1980	CY 1981	FY 1980	FY 1981
Fed. Govt. Expenditures	524.7	538.4	534.4	541.8	562.3	578.3	604.9	630.8	660.8	544.1	618.8	534.8	594.1
Personal Income Taxes	248.5	246.1	249.2	257.6	268.2	255.7	266.7	277.5	289.9	255.3	272.5	250.3	267.0
Corporate Profits Taxes	81.4	86.8	70.5	66.1	68.3	75.4	83.9	90.8	100.4	72.8	87.6	76.2	79.6
Indirect Business Taxes	30.7	33.8	43.0	43.7	49.6	53.5	57.5	61.5	65.5	42.5	59.5	37.8	55.5
Contribu. for Soc. Ins.	164.1	171.7	171.7	174.5	176.1	193.7	196.8	201.0	205.1	173.5	199.2	170.5	191.9
Fed. Govt. Expenditures	540.4	564.1	579.0	607.6	627.7	642.7	659.4	686.9	705.9	592.9	673.7	572.7	654.2
Purchases of Goods & Svcs.	178.4	186.2	192.5	196.9	207.1	213.6	220.2	227.0	238.3	195.5	224.8	188.5	217.0
National Defense	114.6	119.6	123.6	128.4	136.1	142.0	148.0	153.2	161.6	126.9	150.9	121.5	144.8
Nondefense	63.8	66.6	68.9	68.5	71.0	71.6	72.2	73.8	76.7	68.5	73.8	67.0	72.2
Transfer Payments	222.7	225.2	236.1	258.2	266.4	272.3	279.2	297.3	302.2	246.8	287.8	235.6	278.8
Grants-in-Aid	87.3	86.0	86.4	86.8	87.8	89.0	90.2	91.4	92.6	86.7	90.8	86.6	89.6
Net Interest Paid	46.2	50.2	54.5	54.9	55.4	56.6	58.4	59.6	61.0	53.7	58.9	51.5	57.5
Subsidies--Current Surplus	8.8	8.9	9.4	10.8	11.0	11.2	11.4	11.6	11.8	10.3	11.5	9.5	11.3
Surplus or Deficit (-)	-15.7	-22.9	-44.6	-65.8	-65.4	-64.4	-54.5	-56.1	-45.1	-48.8	-55.0	-37.2	-60.1

The principal assumptions underlying this table, in addition to the economic assumptions, are as follows:

1. The windfall profits tax will remain intact, but the gasoline import taxes will never see the light of day.

2. The withholding tax for interest and dividend income will not be passed.

3. The $16 billion package of spending cuts proposed by President Carter will not be enacted, nor will any other similar package.

4. Supplemental unemployment benefits will not be increased, unlike the situation in 1975.

5. Congress will pass a tax cut of $30 billion effective January 1st, which will consist of approximately a $20 billion reduction in personal income taxes and a $10 billion reduction in corporate income taxes through shorter depreciation lives. This tax cut probably will not be passed until early 1981, but will be made retroactive to the beginning of the year.

Under the assumptions, the Federal budget deficit on an NIPA basis will rise from $37 billion in FY 1980 to $60 billion in FY 1981. This sharp increase in the deficit will be due primarily to the recession and the 14% increase in Federal government expenditures, much of which is brought about by the higher transfer payments associated with the slowdown. While defense spending is expected to rise some 19%, this still accounts for only $23 billion of the total increase of $82 billion which we project for Federal spending next year.

Because of the high rate of unemployment, a $60 billion deficit will not be particularly stimulative. If we use the rule of thumb that each 1% increase in the unemployment rate raises the budget deficit by $25 billion, then we would find that the budget is in balance at a 6% unemployment rate, which is close to full employment for current demographic conditions.

However, all budget deficits are not created equal. We find little correlation between the size of the budget deficit and the rate of inflation. Indeed, it is the size of the public sector, rather than the size of the deficit itself, which is more closely related to inflation. Given the choice between an $800 billion budget which was in balance and a $400 billion budget with a $50 billion deficit, we would have little hesitation in proclaiming that the $800 billion budget was the more inflationary of the two.

To put the matter another way, a $40 billion tax cut which consisted of a rebate, an earned income credit, or an offset against higher social security taxes would clearly be inflationary. Yet a $40 billion tax cut which stimulated personal and corporate saving while reducing consumption would actually reduce the rate of inflation.

Because the economy is currently in a recession, a variety of tax cuts could be passed without having a material effect on inflation in the next two years. The differences begin to occur in 1983 and later years, when the economy once again approaches the region of full employment and full capacity. The course of the economy chosen now will influence what kind of inflation we can expect in 1983 and 1984.

This lesson has only recently -- and sadly -- been learned by the Carter Administration, whose economists thought it proper in early 1977 to disregard the possibility of increased inflation and concentrate solely on solving the problem of unemployment. While they were successful in their endeavor, we

are still suffering the burden of increased inflation today. While the Carter Administration cannot be blamed for the second energy crisis, we estimate that their profligate fiscal policies have added from 2% to 3% to the present rate of inflation.

The tax increase in FY 1981 due to the imposition of the windfall profits tax, the boost in social security contributions, and the "bracket creep" effects of higher inflation amount to approximately $50 billion; it surely is not unreasonable to expect some offset to these increases. However, the greatest need at present is for supply-side tax cuts which stimulate productivity and investment, rather than those tax cuts which add only to demand. A number of bills are possible to reduce the burden on savers and stimulate investment and productivity growth. The tax package which I suggest is composed of the following elements:

1. Valuation of depreciation allowances for new investment in replacement rather than historical costs. Original cost $5 billion per year, increasing to about $30 billion per year when all investment would be covered.

2. Reduction in the corporate income tax rate from 46% to 40%, at an annual cost of about $11 billion per year.

3. Restructure the capital gains tax laws so that anyone putting venture capital into a company and holding the stock for five years or more would not pay taxes. This restructuring would also include indexation of capital gains so that holders would not be taxed on increases due to inflation. The cost of this program is difficult to measure, but is under $3 billion per year.

4. Increase in the exemption on interest and dividend income to $1,500 per person, at a cost of about $8 billion per year.

I prefer replacement cost accounting over 10-5-3 for the following reasons. First, the current version of 10-5-3 contains a negative incentive

to investment for the first four years because of the phase-in clause. Since the rate of return on investment will be better in 1982 than in 1981, some businesses may choose to postpone investment for an additional year in order to obtain more favorable treatment. The same argument applies for 1983 and 1984. Replacement cost accounting for new investment would also generate a revenue loss which would grow slowly over time, but it does not have this objectionable feature of negative incentives.

Second, 10-5-3 introduces some distortion into the tax laws by giving a larger tax break to structures than to equipment. In my opinion, the tax effects of depreciation ought to be as neutral as possible; we ought not to introduce diversions from optimal capital accumulation through quirks in the tax law. Replacement cost accounting would reduce these distortions to a minimum.

The cost of replacement cost accounting would be approximately the same as 10-5-3 when fully phased in, or about $30 billion in 1980 dollars after taking account reflows -- i.e., higher tax revenues because of increased economic activity. I do not object to the cost of these programs and feel they are necessary to accomplish the aims of higher productivity growth and lower inflation. However, I do think that replacement cost accounting has some advantages over other methods of raising depreciation allowances.

According to our calculations, a reduction in the corporate income tax rate will generate a larger increase in investment per dollar of revenues loss than will an investment tax credit. The corporate rate cut is a "pure" reduction which does not have the restrictions of the investment tax credit, such as the fact that it can apply only to equipment. One of our most pressing needs currently is for a substantial increase in industrial construction; the investment tax credit does very little to solve this problem. Hence I would favor a reduction in the present corporate tax rate from 46% to 40%.

One of the most important areas for tax reduction is further diminution of the capital gains tax. The reduction of the maximum rate on capital gains tax from 49.1% to 38% in November 1978 has had a salutory effect on the stock market, with stock prices up more than 20% since that time in spite of sharply higher interest rates and a fairly severe recession. Indeed, if it were not for the recession, the increase in stock prices would have been responsible for a substantial increase in capital spending this year. A Conference Board survey taken early in 1980 showed that investment appropriations for large corporations were expected to rise 30%, a record increase. Furthermore, the BEA survey of investment anticipations indicated a 15% rise in capital spending this year, and the first quarter actual figures were even higher than the anticipated numbers.

In addition, the venture capital markets have been revitalized because of the reduction in capital gains taxes. While they still have quite a way to go before reaching the $3 billion figure of 1968, the amount of venture capital in 1979 was almost double the figure in 1978.

For these reasons, I favor further reduction in capital gains taxes. However, instead of a further increase in the exemption from 60% to 70% and hence a drop in the effective top rate from 28% to 21%, I would propose an alternative. All investors who provide venture capital to a corporation and hold the stock for five years or more would not have to pay any taxes on the capital gains. This restructuring would attract further funds to venture capital operations and would help to spur productivity on a long-term basis.

Most of the tax cuts which have been suggested in recent weeks have focused on the investment side of the equation. However, I think it is important that we also take steps to stimulate the supply of personal saving. This could be done in several ways. The method I have proposed would increase the exemption on interest and dividend income to $1500 per person.

This would not be a radical step, but would simply be in line with the methods used by virtually every other industrialized country in the world.

In Britain, for example, individuals may buy National Savings Certificates in amounts up to £1,000 with interest income completely free from income tax. Other plans, including British Savings Bonds, the various Save As You Earn schemes, and National Savings Bank accounts all pay interest which is partially or totally free from income tax.

Germany does not offer quite as wide a scheme of tax-free saving incentives, but the overall effect is much the same. Deposits at savings and loan associations and insurance companies are deductible up to a maximum which varies based on the size of the family, veteran status, and several other factors.

Japan treats interest income even more favorably. In fact, any person receiving either interest or dividend income can choose to have all of this income taxed at the flat rate of 35%, compared to a maximum income tax bracket of 75%. Compare this to the U.S. tax tables, where interest and dividend income are taxed at a maximum rate of 70% instead of the 50% cap on earned income.

Small savers in Japan receive even further incentives to save. Interest income from a savings deposit of up to ¥3 million (about $15,000) is totally exempt. Furthermore, life assurances premiums are totally deductible from income tax up to an amount of ¥25,000 per year, and partially deductible up to ¥100,000 per year. Virtually no capital gains are taxed unless (a) the taxpayer has regularly engaged in security dealings during the year, (b) the gains are from the sale of shares accumulated with the object of manipulating their market price, or (c) the sales are a substantial part of a corporation.

Another possibility would be to "start the tax table" over for nonwage income. For example, if a taxpayer had wage and salary income of $50,000

and interest and dividend income of $10,000, he would pay the marginal rate appropriate to $10,000 rather than $60,000 on his nonwage income. Furthermore, the maximum tax rate on wage and nonwage income alike would be set at 50%.

The present maximum rate of 70% actually costs the Treasury money. We estimate that a reduction in the top marginal tax rate from 70% to 50% would actually result in a $3 billion increase in Treasury revenues per year. The reason for the gain is that many investors would switch their assets from tax-free or tax-sheltered sources into bonds or equities.

According to our estimates, such a program could reduce the rate of inflation to 6% per year by 1985, providing it was not offset by inflationary increases in government spending.

I have not yet discussed the implications of a broad-based personal income tax cut. I favor such a cut only if it is accompanied by limits on government spending, preferably one which allows no increase in real terms. Such a tax cut would be moderately inflationary if it were not accompanied by offsetting reductions in government spending from the 14% increase currently expected for FY 1981. The increases would not be horrendous; for example, a 10% reduction in personal income taxes for each of three years would raise the rate of inflation by about 2% after five years. If these tax cuts were accompanied by offsetting reductions in government spending of the same amount, the rate of inflation would be about 2% lower after five years.

This certainly does not mean that we should not have a reduction in personal income taxes, only that we cannot do everything at once. We should have learned this lesson from the experience of the mid-1960's. The Kennedy-Johnson tax cuts were well structured and raised productivity and real growth without being inflationary. However, that was evidently not enough for President Johnson; we also had a huge increase in expenditures for the Great

Society and the Vietnam War. As a result, a period of stable prices turned into one with sharply higher inflation and the beginning of the long-run decline in productivity.

Finally, in focusing on the optimal type of tax policy, we should not neglect the fact that the difference between tax cuts augmenting or diminishing inflation hinges critically on what happens to government spending, which has been pushed to the background during these recent hearings.

If we are willing to forego further increases in government spending in real terms, the size of tax cuts which can be enjoyed without worsening the net balancing position of the Federal budget are sizeable. Assume an equilibrium growth in the economy of 3%, with 9% annual inflation. Since the elasticity of the Federal income tax system is about 1.5, a 12% increase in nominal GNP would raise tax receipts by about 18%. Thus if taxes were to grow 18% per year in the absence of any reductions, and government spending were to increase only 9% per year, this would allow tax reductions of 9% of total receipts, or about $54 billion per year at 1980 levels of the economy. Even if government spending were to grow at 12% per year, thereby keeping the ratio of government spending to GNP constant, that would permit tax cuts of $36 billion per year.

These figures sound almost too seductively delicious to be true, and yet the nirvana of tax cuts and balanced budgets always seems to recede into the distance. Part of the problem is that a nasty recession always seems to keep popping into place just as we are about to balance the budget "next" year. But another part of the problem is the unwillingness or inability of the President and Congress to keep that ratio of Federal spending to GNP in line. Look what has happened under Carter, the self-professed fiscal conservative:

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TABLE 2

Year	Govt. Spending	GNP	Percentage
1972	245	1171	20.9
1973	265	1306	20.3
1974	299	1413	21.2
1975	357	1529	23.3
1976	385	1702	22.6
1977	422	1900	22.2
1978	460	2128	21.6
1979	509	2369	21.5
1980	593	2551	23.2
1981 E	671	2846	23.6

Thus in the final analysis, the propriety of a tax cut hinges on whether government spending can be brought under control; at a minimum growing no faster than GNP, but preferably holding the line at no growth at all in constant prices.

The balance between government spending and taxes turns out to be the most important long-run issue surrounding tax reduction. Second in importance is the scope of the tax reduction -- whether it stimulates saving and investment or just raises consumption. Third is the absolute size of the tax cut, although this would be more important were the economy closer to full employment. The precise timing of the cut is found only in fourth place for that will have little effect on solving the problems of recession. This time we need to aim our sights on the long-run problems of double-digit inflation and declining productivity.

The CHAIRMAN. Next we will hear from Dr. Charls Walker, chairman of Charls E. Walker & Associates, and former Deputy Secretary of the Treasury, among many other achievements.

Dr. Walker, we are very happy to have you here today, and we will be pleased to hear your profound views on this subject.

Senator DOLE. I thought we could ask Dr. Walker if in the course of his discussion he could explain to us what Dr. Jorgensen was talking about.

Mr. WALKER. No. [General laughter.]

I can explain to you what I felt was wrong with it.

Senator DOLE. I don't think I understood any of it.

Mr. WALKER. Well, I think I have a few comments on the idea.

STATEMENT OF CHARLS WALKER, FORMER DEPUTY SECRETARY OF THE TREASURY

Mr. WALKER. Mr. Chairman, I am Charls Walker, chairman of Walker Associates, and I am also voluntary chairman of the American Council for Capital Formation, but I am testifying today at the invitation of the committee as an individual economist and as a former Treasury official.

I will just summarize my statement and submit it for the record, by saying, first of all, that I think the witnesses this morning quite clearly covered excellently the first point. The question of whether an early tax cut is or is not desirable is really the wrong question.

With the economy in the grip of what may be the worst recession in a half century, with the administration estimating unemployment at 8.5 percent through next year, with the Congressional Budget Office yesterday estimating 9 percent unemployment through next year, the relevant question is whether taxes in fiscal year 1981 should be allowed to rise by the whopping $86 billion projected by the administration.

To even consider that, it seems to me sort of an amazing chapter in the annals of modern fiscal policy. My friend, former Treasury Secretary George P. Shultz, doesn't use words carelessly, as you know, but when discussing this on "Meet the Press" a few Sundays ago, he said that any such increase in taxes in the middle of a recession is simply "an insane policy".

Second, I think Congress should enact major tax cut legislation now, and except for Mr. Evans, the other witnesses made that point very, very strongly. Otherwise, you are going to have considerable uncertainty in the business and financial community. You are going to have investment decisions postponed. We also need a major restructuring of the Nation's tax system—which the thrust of my testimony indicates we can do over the next 5 years—and the time to start is now.

Certainly, a good time to start is in the middle of a recession, as opposed to an overheated period a little later.

Moving specifically to the tax cut and the resolution or request under which this committee is operating, you were asked to come forth by September 3 with a responsible targeted anti-inflationary tax cut proposal. I want to speak to those particular points.

As to the targets of the legislation, I think we should realize that our tax system is 50 years out of date. It is outmoded. It simply does not suit the needs of this country in the 1980's and beyond.

It was born in the Great Depression, and as a result has some very glaring weaknesses growing out of the social and economic views of that period. Or the social side, the popular idea was to redistribute income, from rich to poor, or, in the vernacular, to soak the rich.

As to economic theories of the 1930's, the concern was not with which, when further shaped in World War II and beyond, brought the marginal rates to a very high level.

Also to economic theories of the 1930's, the concern was not with savings and investment. Economists said we saved too much. As to investment—that flowed from demand, as Mr. Keyserling maintained this morning. It is said that what we needed to do was consume, to spend more and save less so we created an income tax system which is biased against savings and investment.

Now, the American people know that this system is not working right. On the one hand, interacting with double-digit inflation, the progressive income tax system has created a crushing and highly unfair tax burden on the middle class. Those rich people that they wanted to soak in the 1930's making $25,000 or $30,000 a year are now not rich people at all. As it is now defined, the middle class in this country has a family income of $20,000 to $50,000 or $60,000 a year.

With high marginal rates and double-digit inflation, we have the phenomenon of bracket creep, which pushes these people into ever higher tax brackets. Taking the 1978 figures, and I have no reason to believe it is much different today, if you array the taxpayers in this country by adjusted gross income from top to bottom, the top half are paying over 90 percent of all Federal individual income taxes.

It is no real mystery why we have tax revolts, no real mystery why we have a growing underground economy, and no real mystery why more middle income people are entering into the underground economy.

We see evidences of the underground economy all around us. If we don't do something about it, it continues to get worse. It could have far-reaching social and political and economic effects, because of the impact on the middle class, our most productive and politically stable group.

So, the first target, it seems to me, must be to start reducing this rapidly growing tax burden on the middle class. In fact, there is not much you can do in the short run to reduce it, but at least you can have, as Dr. Heller said today, some degree of tax abatement.

The second target is on the savings-investment-capital formation side. If you look at the individual side of the picture, we tax savings in this country as if it were a sin, not part of the Puritan Ethic. If you and I make the same income, and you save a great portion of yours, but I blow mine on wine, women, and song, you don't get much of any special benefits in the income tax law.

On the corporate side, the high corporate taxes reduce the after-tax rate of return for new investment and reduce the cash flow needed to finance this additional investment. And with the under depreciation that we have seen because of the rapid rates of inflation, the actual corporate tax is much higher than the 46-percent rate.

SEC Chairman Harold Williams noted recently that with the combination of inflation, high corporate tax rates, and the dividends that corporations have to pay out in order to stay viable, to satisfy their stockholders, we are rapidly decapitalizing American industry.

So, there is your second target, I think. The first target has to do with the middle class, and the second target has to do with promoting capital formation through savings and investment incentives, particularly at this stage of the game, by lowering business taxes.

There is a tax proposal that seems to me goes to these very targets. I don't think it will surpise you when I say that it is the proposal introduced by Senator Dole and 37 other Senate Republicans, which will reduce the individual income tax rates by 10 percent across the board, so that you will get a reduction, a significant reduction for the middle-income families that I was referring to, and with an intention to follow up in the next few years with a couple of more cuts in the 10-percent area.

You would cut your marginal rates from 70 to 50 percent at the top, and from 14 to 10 percent at the bottom. It still would be a very progressive system, but I think one that people would view as eminently fair.

The second provision of the bill introduced by Senator Dole enjoys support of more than 300 Members in the House, and some 70 Members in the Senate have either sponsored the bill or legislation which includes the legislation. It is the Capital Cost Recovery Act, the "10-5-3" depreciation bill. That one would give you a big bang for the buck in the investment area.

Can these tax cuts be responsible and anti-inflationary? They can, Mr. Chairman, if they are combined in a 5-Year Fiscal Plan of the type I have outlined in my paper. If I could just wrap up by looking at this table, which is the last page of the statement that I presented, it will give you a quick picture of what I am suggesting.

This approach is based, first of all, on the assumption that the Federal Government is much too large, with Federal spending at 23 percent of gross national product, the highest level in history, or at least since World War II. It is absorbing too much of our resources, transferring too many resources from productive people to nonproductive people, and is the basic cause of our inflation problem.

At the same time, the tax burden is too high. So, in the restructuring to take place in the tax system, you reduce the high marginal rates and increase capital formation by reducing business taxes. You look ahead 5 years, and not 1 year. One of our big problems has been that we try to legislate from year to year instead of taking the longer view.

If we take this longer view, what will we find? In the figures out Monday from the administration office of Management and Budget, we have projections of the gross national product for the next 5 years. The gross national product would rise from $2.5 trillion—this is column 2 in the table—to $4.3 trillion in fiscal year 1985. This forecast is reasonable; it assumes that in 1985 both unemployment and inflation will be at 6 percent.

I hasten to add that these are estimates, and may not come true. I am just illustrating the dimensions of the problem as well as the opportunity.

Now the truly startling figure is column 3, which shows that Federal revenue without any more tax legislation than is on the books right now, with a couple of minor exceptions, will increase by a whopping half trillion dollars over that 5-year period, from $518 billion to $1.05 trillion.

Now, if we have no spending restraint, but continue the rate of spending relative to gross national product (column 4) 23.1 percent, and then follow that on through, the budget would be up (column 5) to $995 billion by fiscal 1985, and there would be some surplus, $57 billion.

But look what we can do with spending restraint in table 2. This is not cutting back on the level of spending; it would instead slow the rate of increase in spending to get the economy back down in relative size to where it was in the early 1960's, during the Kennedy administration. At that time, the level of gross national product for Federal spending relative to GNP was about 19 percent. Now, why 19 percent?

During that period, we provided adequately for domestic needs. We provided adequately for national defense needs. And at the same time, we had declining unemployment and stable prices. If this is achieved by the Congress and the Chief Executive cooperating over the next 4 to 5 years, reducing the ratio from 23 percent to 19 percent, your budget is still going to go up, in fact, it will rise almost by half, by 50 percent (column 5, $579 billion to $819 billion). But the revenues that would be released because the spenders don't get hold of them would accumulate to $233 billion a year. That would be the annual rate of surplus in fiscal year 1985.

So, my fundamental point is this, that if we can have just a modicum of restraint on domestic spending, we can release a very large amount of Federal revenues for tax cuts over the next 5 years.

You don't stick to this plan absolutely, precisely. You adjust as you go along. You not only have that leeway. There is no assumption in here at all of any feedback, any reflow, because your tax cuts stimulate the economy, as they always have in the past, and you have a broadening of the tax base, and get more revenues back.

To get around Senator Packwood's problem, my suggestion is that this committee make very clear to the Senate and the public that for a tax cut to be responsible and anti-inflationary, you must have the spending restraint. I would like to see that done by cooperation of the Congress and the Chief Executive, and I think Congress could show its good faith in that respect by insisting through legislation that the budget next year, fiscal 1982, be at 22 percent of GNP, and gradually reduced to 19 percent by 1985.

This 5-Year Fiscal Plan, I suggest, is a way that you can meet the mandate which you have been given, for a responsible anti-inflationary tax measure.

Thank you very much.

The CHAIRMAN. Senator Dole.

Senator DOLE. That sounds pretty much what Governor Reagan indicated in the statement he made the day the Republicans introduced the bill. He did, I think, indicate restraining the growth of Federal spending, did he not?

Mr. WALKER. In his statement, the day the bill was introduced here, he stated his first budget he would submit to the Congress if elected would start a trend downward to the level during the Kennedy administration, and that he would defend those budget requests with his veto power. So, yes, it is very much the same thing. These figures here are not something you are going to be absolutely stuck with. These are just to give the ball park that you have got to work in.

Senator DOLE. I think that would satisfy some of the concerns that maybe Mr. Evans and others have. And I think also we are talking about middle-income Americans, and I think that has been one criticism of this approach, is that they would get too much of a tax cut; or again, maybe tax abatement is a better word, but they really don't, and I am not certain of the figures. Middle-income Americans pay most of the taxes. They pay about 51 percent of taxes, they get 48 percent of the tax abatement or vice versa. I can't remember the precise figures. I think that is it.

Mr. WALKER. The top one-half of the taxpayers are paying over 90 percent of those taxes, and what you would be doing with your bill is cutting taxes proportionately to the way people pay taxes. Some people say that is not fair. I can't see what is unfair about it, particularly when you look at a typical family with one wage earner and three dependents, earning about $35,000 a year (adjusted gross income). They are paying $5,000 in Federal income taxes.

Let's take a family in the general range of about $11,000 to $12,000 a year. That is about one-third of the income. That family is paying about $500 in Federal income taxes. The $35,000 family on 3 times the income is paying 10 times the taxes.

Is that fair? The tax reformers, or the redistribute-the-wealth people, may say that is fair, but not that middle income family that is trying to make ends meet and send kids to college. It seems to me that is what you've got to look at.

On Dr. Jorgenson's plan, what didn't come through in his testimony—not that he was trying to hide it, because he is very explicit about it, is that his proposal doesn't do anything to liberalize depreciation, and those of us that have been working for almost 2 years to develop something like 10-5-3 were trying to develop a more liberal system in order to foster saving investment and productivity.

There is a consensus that we need better and accelerated and simplified depreciation and liberalized depreciation for just this purpose. But Dr. Jorgenson's proposal does not liberalize. If you take the figures from the Congressional Budget Office that were released yesterday, Dr. Jorgenson's depreciation proposal—and this is another defect—would have an immediate first-year effect of $13 billion, 10-5-3 has a first year effect of about $4 billion.

Senator DOLE. He said 5.8.

Mr. WALKER. Yes, but he was assuming repeal of the Investment Tax Credit, which I doubt will happen. My figures are from the Congressional Budget Office and apply only to his depreciation

proposal. The revenue losses start at $13 billion for fiscal 1981, and they rise to $31 billion in 1982 and the fall down to zero in 1985. No more bang for the buck from Dr. Jorgenson's proposal when you reach 1985.

Why? Because he would not liberalize the depreciation schedule at all. He assumes that all of our depreciation problems come from inflation, and that is not true. We've got basically a capital cost recovery system that is too slow, even if you don't have inflation.

Also—do you still have the table 3?

Senator DOLE. Yes, his table 3.

Mr. WALKER. Most critical from the standpoint of increasing productivity, from the standpoint of moving toward automated plants to increase productivity—I would say that the most critical category of equipment listed there is "general industrial equipment." According to Jorgenson, under the current system and assuming 6-percent inflation, businesses are paying an effective tax rate of 16 percent. Under his system, they would pay 46 percent. Is that what we want, a 30-point increase in the tax rate on new and more efficient business equipment? That works exactly in the wrong direction.

That is a major criticism of his approach. In addition, Jorgenson says his system is much simpler. But how do you get this so-called simplicity? Under 10-5-3, you get it by setting up three categories, and you say, take it, there it is. To get simplicity under his system, you have to set a discount rate, and that discount rate is all-important. If you are talking about a building with a 33-year life, the difference in a discount rate of 3 and 4 percent makes a very big difference as to present value.

Jorgenson says, finally we all agree that expensing is not justified. I don't think we should argue this in terms of theoretical economics, or how many angels can dance on the head of the pin, or what is the exact life of an asset. I say, let's look around the world and see what is happening. They are expensing in Great Britain now finally, after all these years. They have moved very close to it in Canada. Other countries have very fast depreciation. It is a conscious instrument to try to promote investment in productive equipment, and I couldn't care less if the useful life of something is 40 years, because what we are after in the bottom line is to create jobs, and create jobs by getting business to invest.

So, I don't think Dr. Jorgenson's proposal really cuts the mustard.

Senator DOLE. Thank you.

The CHAIRMAN. Let me just check out one or two things with you, Dr. Walker. Do you anticipate under the suggestions you make here that there will be an increase in defense spending?

Mr. WALKER. I am not anticipating that in this table. I am saying nothing about that, but I would expect there would be, yes.

The CHAIRMAN. Well, I think most people, and I for one share that view, believe that we are going to have to increase defense spending, and I think even Governor Reagan tends to share the view that there will have to be an increase in defense spending, and I was just wondering, in terms of what you have here about reducing spending as a percentage of GNP, what you would antici-

pate that the increase in defense spending would be as a percentage of GNP.

Mr. WALKER. I would like to see defense spending increase relative to GNP. I think you miss the real question, it seems to me, Senator. Looking at column 5 in my table 2, the budget under this fiscal plan would increase from $579 billion this year to $819 billion in fiscal year 1985.

Senator PACKWOOD. Which fiscal plan is that?

Mr. WALKER. Sir, that is table 2.

Senator PACKWOOD. Which spending restraints?

Mr. WALKER. Table 2 is spending restraints.

Senator PACKWOOD. What spending restraints?

Mr. WALKER. It is reducing the Federal budget relative to GNP from 23.0 today to 19 percent in 1985.

Senator PACKWOOD. No, I understand that. Where is the plan to do that?

Mr. WALKER. I suggested that Congress enact the ceiling.

Senator PACKWOOD. A spending ceiling?

Mr. WALKER. Yes, as part of this legislation, as part of the tax legislation.

Senator PACKWOOD. I see.

You agree with Mr. Evans in that sense.

Mr. WALKER. I agree with Mr. Evans but I go further and say that Congress can and should—it should be cooperative between the Congress and the executive, and Congress can show its good faith by putting in the ceiling beginning at 22 percent for fiscal 1982 and declining one point thereafter until you reach 19 percent.

Senator PACKWOOD. Should we enact a tax cut that has no spending restraint at all?

Mr. WALKER. I would be very leery of that.

Senator PACKWOOD. Leery of it?

Mr. WALKER. I would be very leery about it. If you say to me you are going to do it, I will believe you and I will take your word for it. I will believe you even more if you would enact that ceiling and make it part of the budget process.

Senator PACKWOOD. Excuse me, Mr. Chairman. You were asking the questions.

Mr. WALKER. What you have, Mr. Chairman, is an increase in the Federal budget of $240 billion in this illustrative plan over the period. So, the question is whether you can get sufficient restraint on growth in your domestic programs—not cuts—to accommodate rising defense outlays.

The CHAIRMAN. I believe I agree with you, but I just want to make sure I understand you.

To do what you were talking about doing, you are certain we must reduce social welfare spending as a percentage of GNP, I would think. I don't see how you can avoid that. Would that be correct?

Mr. WALKER. Yes, you would expect that. But let me put it the other way around. I am not singling these out necessarily, but just to look at them for illustrative purposes. Between fiscal 1975 and fiscal 1980, category 500 in the budget, education, training, employment, and social services—you remember "social services"——

The CHAIRMAN. Yes; I am familiar with that. It was originally going to cost $40 million.

Mr. WALKER. Yes.

The CHAIRMAN. When we first agreed to it in this committee, that is what it was supposed to cost, $40 million. We finally managed to put a lid on it. At the time we finally managed to get the lid on it, it was projected to go to $4 billion.

Mr. WALKER. That was in 1972. $2½ billion. It was predicted to go to $8 billion, $9 billion, $10 billion.

The CHAIRMAN. It was headed the next notch up. It was headed to $4 billion. It was originally supposed to cost $40 million, and it was on its way up, I think the next place where it would have crossed the line on the chart would have been at $4 billion when we finally managed to put the lid on it; the spending rate was actually about $2.9 billion when we finally managed to get the lid on it. That was about 70 times the original estimate.

Mr. WALKER. That was a very fine joint effort we engaged in in the 1972 revenue sharing bill. Now, if that had not been done, we would have been worse off here.

My point is that in these categories, this first category, education, training, and so on, increased from $16 billion to $30 billion between 1975 and 1980, an increase of 88 percent. The health increase has been 104 percent. Income security increased from $109 billion to $190 billion, 77 percent.

I am simply saying, do they have to go that fast over the next 5 years? If they have to go that fast over the next 5 years, then you can't do the plan, but if you can do some topping off, if you can do some decoupling of the relation to the consumer price index, a better price index that does not include mortgage rates—it just has all sorts of opportunities. We are talking about slowing the rate of increase, and that would mean that percentagewise, relative to GNP, social spending would go down, but I have not put any revenue feedback in here, and I have every reason to believe that over the next decade, these tax reductions, this 5-year fiscal plan of spending restrain and responsible tax reductions—would give you a much healthier growth of GNP, particularly in real terms, and that is the way you really finance these increases in spending.

The CHAIRMAN. I hope the committee will pardon me if I ask about one more matter. I have to go to a meeting immediately after I have my turn, and I will leave it with Senator Packwood to finish chairing the hearings today.

We have had little or no discussion about the possibility, or the desirability as the case may be, of having a refundable investment tax credit, and you have given some thought to that matter. I believe you are one of the advocates of a refundable credit, and personally, I think that if you recognize the investment tax credit as a subsidy to encourage employers to buy new equipment and to modernize their plant and machinery, it seems very unfair to me that the companies that need it the worst don't get it. In other words, if a company is having a very difficult time making a profit for whatever reason, be it the steel industry, a railroad that needs to be modernized, or an airline, or an airacraft manufacturer who is on the ropes, or someone like Chrysler who is trying to come back, or even a new company, it seems unfair if you are going to

subsidize an employer in purchasing new equipment, that the subsidy be denied to the one who needs it the most.

That is my view, and you are familiar with my view on the matter. I would appreciate it if you would tell us what your thought would be on that subject.

Mr. WALKER. Take the airlines, the steel companies, it has been reported informally that steel companies have $600 million of accumulated tax credits that they have not been able to use.

The CHAIRMAN. I don't think that you have to go any further than the case of a farmer who had a bad year. He has a bad year, so he buys a piece of equipment. Some of these new pieces of farm equipment are very expensive. It makes him more productive, but it is very expensive.

Let's say that the drought takes his crop, so he has a bad year. What kind of fairness is it that because he has a bad year, he can't get the subsidy to buy equipment? He can't get it, nor can the steel companies get it.

Perhaps you ought to tell us about the steel industry, though, because I am not familiar with their problems, that is, in terms of the figures. I know they have a problem.

Mr. WALKER. The steel industry is in a situation now where it has got to modernize its plant and equipment in order to compete with the Japanese and the Germans. They are going to have to invest more. If you go around and look at some of those new modern plants we have in the States, you will see what difference it makes. But 10-5-3 does not do the job for them now. Later on, yes, but not now.

We represent a steel company, and an auto company. They want 10-5-3. They plan to be profitable. They don't plan to go out of business, 10-5-3 will be very important to them. But 10-5-3 will not do the job for those companies right now. In fact, if they took a greater depreciation, they would have even less profits to take their investment tax credits against.

So I think you are going to hear increasingly in the weeks ahead about this problem. The one point I would want to make is that refundability is not competitive with 10-5-3. It is complementary to 10-5-3, or whatever accelerated depreciation this committee and the Congress decide to go with.

If you took refundability alone, it would help these industries, but not in the long run as they become profitable. If you take 10-5-3 alone, it will help a lot of industries, but not these companies right now. If you take the two together, some way integrating, perhaps both phased in over a 5-year period, then they work together and provide a complete capital cost recovery system.

We talk about industrialization and revitalization, and what are we talking about there? We are talking about transportation. We have got to rebuild the railroads of this country, and that is one group that is very important here. We are talking about the steel industry in competition around the world. It is very important here. We are talking about auto industry retooling, and modernizing to compete with the Japanese, refundability is very important here.

So I commend this to you for a very hard look.

The CHAIRMAN. The big problem and the big impediment is that members of the Appropriations Committee are very fearful of their turf. They are afraid that it might trespass on their jurisdiction, that we might start using the refundable tax credit to pay the Army, the Navy, the Air Force, to run the whole Government with.

That, of course, should not be done. These things all ought to be handled by annual appropriations. But if that is what it takes in order to get them to cooperate and go along with a refundable credit, it would be all right with me. If we can get something done, let us refer the bill to them, and let them make their suggestions.

They can look at it and pass judgment, and if they want to recommend something different, then they can recommend it, and then let the Senate decide whether or not it is the right thing to do. We ought not be denied an opportunity to do something that appears to be a good answer to a problem, or the best answer we can find to a problem, just because of jurisdictional restraints or arguments about the relative influence of one Senator or another.

It seems to me that it would be better to decide matters based not on who is right, but based on what is right. If a refundable tax credit is the best way to do the job, or the best tool to use to do the job, then it seems to me that we ought to use it. To me the investment tax credit has proven to be a wise decision.

If you agree that it is wise, as I do, it seems very unfair to me that it is denied to those companies that need it the most, even though they have paid large amounts of taxes in years gone by, and even though they have prospects of paying us a lot of taxes in the future. It seems to me that it makes sense that there should be a refundable tax credit.

Thank you, Dr. Walker.

Next is Senator Chafee. And I will now turn this over to Senator Packwood.

Senator CHAFEE. Mr. Walker, I was not here during your presentation, so I may be ploughing over old ground. Did you listen to Professor Jorgensen's proposal?

Mr. WALKER. Yes.

Senator CHAFEE. It seems to me that what his proposal was, after all was said and done, and this may be a simplification of it, but it seems to me that it was permitting the depreciation in the first year of the value of the equipment, less what might be called its recoverable value. Am I shortcutting it too much?

Mr. WALKER. Just one word, the discounted value of the equipment.

Senator CHAFEE. Why that did not have a greater impact on the Treasury, I could not figure out, since we took that one piece of machine tool equipment, and applied the formula to it, and depreciated 75 percent of it in the first year, and then nothing else. What did you think of that approach, and have you commented on that before?

Mr. WALKER. I gave a short critique of it. To summarize it, the basic problem is that it does not liberalize. Do you have his Table 3 there?

Senator CHAFEE. Yes.

Mr. WALKER. The people that worked on 10-5-3, and the people who worked on a similar and very constructive proposal that Rep-

resentative Ullman had introduced, which some call 12-9-6-3, and moves in the same direction, have as their basic goal to liberalize the depreciation system. Not to offset what inflation has done, but to move more closely to what our foreign competition has done.

His does not do that. His offsets inflation by definition——

Senator CHAFEE. Because you recover in the first year?

Mr. WALKER. That is right.

Now coming from where you come from, the machine tool industry area, look at his table, and look at the most significant item there, general industrial equipment. That would include your machine tools. It would include your automation equipment, and so on. That is where we are going to get the goal in increasing productivity.

Senator CHAFEE. Yes.

Mr. WALKER. If you take the current system, with 6 percent inflation, the effective tax rate is calculated at 16 percent. Look at his plan, the last column, the rate would be 46 percent. That is moving exactly in the wrong direction. He increases the tax rate by three times, so there is no liberalization in there—just the reverse.

There are some other drawbacks as well, I think.

Senator CHAFEE. I see.

As I understand your last discussion, as I just got in on the end of it, with the chairman, you think that there should be a refundable depreciation setup?

Mr. WALKER. No; a refundable investment tax credit.

Senator CHAFEE. Take the investment tax credit, even though you are not making a profit.

Mr. WALKER. That is correct. If you are marginally profitable. I gave the illustration, and the figures are rumored to be that the steel companies so badly need to modernize and invest. They have $600 million of unused credits.

Senator CHAFEE. Let me ask you another question. Do you think that if we got into a more rapid depreciation system, and let's say that we got to the 10-5-3, what is the argument for keeping the investment tax credit? I know that the investment tax credit is holy ground, but can we really justify keeping an investment tax credit?

That, in effect, permits somebody to deduct 110 percent of the value of the machine, isn't that, or even more than that?

Mr. WALKER. For your 5-year equipment, you could argue that, yes. My argument would be jobs. As I stated when you were not here, that if you look at this theoretically as an economist, at the theory of income and the flow of income from a machine that will last 30 years, you get the value over that period of time, should write off so much income each year.

I say that that is a very interesting exercise for freshman students in economics. You can test them with it, and see how good they are. But in the here and now of this rough old world of international competition, they either don't teach it, or they don't believe it among our competitors abroad.

They have gone to expensing in the United Kingdom.

Senator CHAFEE. Is that a fact that they can write off their equipment in the first year?

Mr. WALKER. That is my understanding. Canada has moved close to it. They have a 2-year deal now for certain things. That is the first point, international competition.

The second point is—this gets to these revenue estimates that we are having to deal with. Secretary Miller comes up and says that over 5 years 10-5-3 will cost $50, $70, $80 billion. The Congressional Budget Office's most recent figure is $43 billion. What is that telling us?

That is telling us that the bigger those figures are, there is a Dickens of a lot of investing taking place out there. That is what a big revenue impact means. Unless you are buying the equipment, and putting it into place, you are not getting the tax benefit. So I don't get up all that tight about high revenue figures. I say that it is an indication of hard-headed businessmen making a judgment that they can make a profit from this, and putting their money where their mouth is.

Senator CHAFEE. In the ideal world, I would like to see us get into an expensing situation myself

Mr. WALKER. I would, too.

Senator CHAFEE. Let them do it. They will hang themselves in the end if they get too greedy, and the Government will get it in the second year if somebody writes it all off in the first year. But I must say, if we expense things, I would have real trouble with the investment tax credit, except on the basis you said, it is a highly competitive world.

Thank you, Mr. Chairman.

Senator PACKWOOD. Senator Danforth.

Senator DANFORTH. Mr. Walker, you over the years have been very patient with me in giving me the benefit of your advice. Over the past number of years, I have supported the following tax cut ideas:

For individuals, I have supported rate reductions, indexing, incentives for saving and investment, including capital gains reduction, and exclusions for interest and dividends, and a social security credit. I have entertained the possibility of funding medicare out of general revenues.

On the corporate side, I have supported rate reduction, increasing the investment credit, expanding the ADR, 10-5-3, a refundable investment credit, and tax incentives for research and development.

Sometimes people ask me what are the revenue effects of these ideas. Bob Packwood tells me that maybe it is irresponsible to be for everything at the same time. I assume that all of these have some good things that could be said about them.

On the corporate side, for example, a couple of years ago I noticed that you were the head of a group that specifically favored expanding the investment credit. You talked to Senator Long today about making it refundable. I have supported corporate rate reductions, and so have you.

It seems that in any given tax bill, you can only do so much. Whatever we decide, we are probably going to have a target revenue loss figure. We will probably decide that that will be without consideration of reflows, just for the sake of figuring out how much it is going to be.

My question to you is, on both sides—corporate and individual—what should we be trying to do in this bill, and what should we, for present purposes at least, rule out in this bill?

I take it your view on the corporate side is that 10-5-3 should be the area of concentration this year.

Mr. WALKER. 10-5-3, or something very close to it, with a niche carved out for starting a refundable ITC on a phased-in basis.

Senator DANFORTH. Therefore, you would rule out this year a rate reduction.

Mr. WALKER. Yes—except that 10-5-3 liberalizes the ITC for short-lived assets.

Senator DANFORTH. You would rule out this year increasing the investment credit, with the possible exception of something for refundability?

Mr. WALKER. Yes.

Senator DANFORTH. There have been proposals—something to encourage business spending on research and development. The most recent version of that would be very cheap, and that is a 25-percent credit for increased spending on R. & D. Should we try to put something for R. & D. in this bill, in your opinion?

Mr. WALKER. You said that it would be very economical.

Senator DANFORTH. I don't have the figures in front of me, but it is. Supposing that it could be done for half a billion dollars.

Mr. WALKER. Yes.

Senator DANFORTH. How about on the individual side? I put the same question to everybody today, I think. Some people support indexing. Some people support individual rate reductions. Some people support, as Mr. Evans did, a specific tax reduction to encourage savings. Some people support a tax credit for social security. Some people support funding medicare out of general revenues.

What are your views on that—how would you rate those ideas, and why?

Mr. WALKER. I would put top priority today on the bill introduced 3 weeks ago for the 10-percent reduction across-the-board. This is not just economic. It is quite a bit social and political.

If you go the social security route, it seems to me that you are making a mistake in two directions. One just from the pure overall effect, it is sort of a hype because it is putting purchasing power which is going to be largely spent and since it is really a tax on labor, there is really no incentive capital formation in that at all.

The second reason is, I think that we ought to take the social security system by itself, and study it, and decide what we do, and not mix it up with what we are doing with the income tax system. We should keep those things separate.

Then look at, let us say, Representative Gephardt's proposal. It is a 10-percent credit on your income tax for the social security taxes you pay. It is a tax cut of up to $195 right across the board for everybody because it is a credit, not a deduction.

The 10-percent across the board cut is proportionate to the way people pay taxes; it will help deal with this problem of what is happening to the middle class, and help deal with the underground economy problem. It also does quite a bit for saving and investment because you are reducing that top rate from 70 to 63 percent

initially, and if you take the second two 10-percent cuts you reduce the top rate from 70 to 50 percent. So you are going to increase incentives to save and invest, and incentives to work.

That is my top priority, but I said in my statement that there are other ways to approach this. If you want to come in with some particular zings for individual saving, there are a number of good proposals before the Congress. The dividend reinvestment proposal, for example, would defer taxes on dividends reinvested in new issue stock.

The bill that has been introduced by Mr. Heinz over here, and Messrs. Holland and Martin over on the House side, would allow you to roll over your capital gains into new investments, like you do on a home and you would defer the taxes.

And then there is Senator Cranston's bill to cut capital gains taxes to a maximum of 21 percent.

One alternative would be to combine this 10-percent cut in the bill which you gentlemen introduced a couple of weeks ago, and make that a 7.5-percent cut. That will reduce the first year impact from $31 billion to about $24 billion, or about one-fourth, and you could use the other $7 billion for special saving incentives.

I still prefer the 10 percent, and the 10-5-3.

Senator DANFORTH. Do the targeted approaches for savings work?

Mr. WALKER. Yes, sir. I think the roll over of capital gains would have a great deal going for it. You could roll over your dividends, or capital gains in a special investment account, sort of like Keogh account. That would give you great mobility. You could go out of stock X in which you have a high capital gain, into stock Y. If you do it now, you have to pay a capital gains rate of up to 28 percent. Why should you? You are simply shifting your investment.

Senator PACKWOOD. Let me ask you a question.

A little while ago you said that you would be very leery of voting for any tax cut that did not have an expenditure reduction with it. Yet, you have no qualms at all about this tax cut.

Mr. WALKER. That is the tax cut I am for. I am leery of voting for it unless the Congress would enact a spending ceiling.

Senator PACKWOOD. But there is not going to be a ceiling in this tax cut.

Mr. WALKER. Then I would be leery of voting for it.

Senator PACKWOOD. Pardon me?

Mr. WALKER. Let me put it this way. If that top table 1 prevails at that 23.1 present spending level for the next 5 years, the ballgame is over.

Senator PACKWOOD. If we get something similar to Roth-Kemp, with maybe some 10-5-3 in it, that is all we are going to get. There is not going to be a spending reduction. Would you vote no?

Mr. WALKER. I don't think I would vote no, but the answer I would give there would get into speculation about the outcome of the Presidential campaign.

I think that a fiscally conservative, determined President can send a budget up here—Jerry Ford did it back in 1975 and 1976—and defend it with a veto. Send a tight budget up here next year and say: "Here is the total. This total comes to no more than 22 percent of gross national product projected for 1982."

Senator PACKWOOD. You would veto everything above it?

Mr. WALKER. I would veto it, and Congress would have to get two-thirds plus one——

Senator PACKWOOD. But that is not what we are going to have this fall, not from this President, and not from this Congress.

Mr. WALKER. I would bet that we would have a fiscally conservative President.

Senator PACKWOOD. And vote for the tax cut anyway.

Senator DANFORTH. Wait until after the election. That is what President Carter suggests. There will be no tax cut before the election.

Mr. WALKER. I find that a rather strange position. If we need it, we need it.

When you read the mid-year budget review sent up on Monday, which paints this very black picture, unless we do something, but which says that we are not going to do anything. It is strange reading.

Senator PACKWOOD. Let me ask you one other question. You kept talking about meeting the competition; expensing in England, and coming close to expensing in Canada. Isn't it true that what our major competitive Western nations are doing is moving more and more toward regressive taxes, consumption taxes, and lessening their tax on capital investment. Is that what you are suggesting we should move toward?

Mr. WALKER. We should move toward taxes on consumption. It does not have to be all that regressive. Until recently, I favored a value added tax adjusted for its regressivity, which we can do in various ways.

Senator PACKWOOD. Let me come back to that.

Isn't that basically what our Western European nations have done? They have freed up their capital by skewing their taxes much more heavily on those persons making under $15,000 or marks, whatever the translation is, than we do.

Mr. WALKER. Yes, because they rely so heavily on value added tax.

Senator PACKWOOD. Yes.

Mr. WALKER. But they have various ways that they get around that. The French stagger their rates from 8 percent to above 30 percent. The British exempt certain things.

Senator PACKWOOD. All I am saying is that they skew it much more toward lower and middle income than we do.

Mr. WALKER. Yes. But when you talk about the taxes in Germany being 40 percent of the gross national product——

Senator PACKWOOD. It is 42 percent.

Mr. WALKER. You have got two things there. First of all, you can't compare over here with over there, unless you make adjustment for the relative size of the Federal, State and local sectors. We are close to 40 percent when we take Federal, State and local.

Senator PACKWOOD. No, we are not. Ours are 32 percent counting State and local. This is what this comparative table is, and these are comparative totals.

Mr. WALKER. That makes some difference, but the real difference is the extent to which they rely on consumption taxes.

Senator PACKWOOD. But this table on total taxation, both in the Federal Republic of Germany and the United States, includes all taxes, what percent the total take of the Governments are, Federal and otherwise, of the gross national product. Ours is around 32 percent, and Germany's is around 42 percent.

All of the other industrial nations are above us, with the exception of Japan. Japan has about two-thirds of its industrial costs in fringe benefits, and they do things through businesses that other governments do through government costs. I am not at all sure that Japan is in any way analogous to any other country in that sense.

Mr. WALKER. I would say that the difference in the situation in Germany largely reflects the heavy reliance on the hidden value added tax. You can have a higher tax burden, and you can stand a higher tax burden——

Senator PACKWOOD. If they don't see it.

Mr. WALKER. ——if they don't see it. You get used to it. But even if they do see it, the polls have indicated that people would rather pay sales taxes than property taxes and income tax. They prefer to pay a little bit a day instead of that big hunk.

Senator PACKWOOD. We are all burned and burnished by experience. Oregon has no sales tax. We have had it on the ballot five or six times over the last 30 years, and the closest it has ever come to passing has been defeated 6 to 1.

Mr. WALKER. They feel pretty strongly about it.

Senator CHAFEE. Mr. Chairman, are you through?

Senator PACKWOOD. Yes.

Senator CHAFEE. Did I understand you to say—Senator Danforth said something about under your tutelage he had fostered an indexing proposal.

Senator DANFORTH. No, I have not fostered it. All I am saying is that these are just a number of the ideas that in 1978 were floating around, and that have been floating around since. I don't think that anybody support them all at the same time, but at one time or another these are various notions that have been supported.

Senator CHAFEE. But are you supporting indexing?

Mr. WALKER. Only on capital gains. I support indexing of capital gains because we tax so much real capital there. I am very leery of moving into indexation of general income taxes. I think that if we can strike at the will of fighting inflation.

Senator CHAFEE. I could not agree with you more. I think indexing is a pernicious vehicle that insulates people from the evils of inflation, and thus reduces the overall objections, and makes it much more acceptable.

Thank you very much.

Senator DANFORTH. Let me ask you one more question, Mr. Walker.

Secretary Miller yesterday testified, that we are the victims of all kinds of external forces. OPEC has raised the price of oil. There are world problems, so on and so forth. In sum, the government is doing about all it can, and the economic conditions today really cannot be laid on Government policy. Do you agree with that?

Mr. WALKER. I don't agree with it. I would like to quote you some figures that I ran off the other night.

The Federal budget and the size of the Government is the big factor, it seems to me. Between 1975 and 1980, the Federal Government's budget grew 77 percent. Between 1960 and 1965, it grew 28 percent. I don't think there is any accident that during that period we had stable prices, we had strong economic growth, and we had declining unemployment.

So it is not only very much within our control to do something. It is actually the fault of the way our Government has been run that we have this situation.

Senator DANFORTH. Thank you.

[The prepared statement of Mr. Walker follows:]

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SUMMARY

Statement of Dr. Charls E. Walker
Former Deputy Secretary of the Treasury
before the Committee on Finance, United States Senate
July 24, 1980

1. The question of whether an early tax cut is or is not desirable is now being debated; that question is the wrong question. With the economy in what may be the worst recession in a half century, the relevant question is whether taxes in FY1981 should be allowed to rise by the whopping $86 billion projected by the Administration.

2. Congress should enact major tax cut legislation now. Otherwise, uncertainty will plague the business and financial community, and there will be undue delay in beginning the major restructuring that this nation so badly needs.

3. This Committee is charged with the task of reporting a responsible, targeted, anti-inflationary tax cut proposal.

   (1) The major targets of the legislation should be a reduction in the crushing middle-class tax burden by reducing the ultra-high marginal tax rates; and a reduction in the bias in the tax system in favor of consumption and against saving and productive investment. The proposal introduced by Senator Dole and 37 Senate Republicans -- which would reduce individual income tax rates by 10 percent and initiate the 10-5-3 system of capital cost recovery -- would meet those tests very well.

   (2) The tax actions can be both responsible and anti-inflationary if combined in a Five-Year Fiscal Plan which would reduce the rate of increase in Federal spending, bringing down the ratio to gross national product from 23 percent today to no more than 19 percent by FY 1985.

4. Such a Five-Year Fiscal Plan is eminently "doable," and would be facilitated by a Congressional limit on spending, beginning at 22 percent for FY 1982 and declining to 19 percent by FY 1985. On the basis of projections from the Administration, this degree of spending restraint would make available upwards of $200 billion in surplus revenues by 1985 (See Tables I and II at end of statement). To the extent productivity-oriented tax reductions are enacted, the "feedback" that usually results from such actions will provide even more revenues.

5. The American people are ready to support -- in fact, are implicitly calling for -- the very policies that can restore balance between the Federal and private sectors; lighten and more equitably distribute the tax burden on work, saving and investment; and at the same time bring inflation under control.

Statement of Dr. Charls E. Walker
Former Deputy Secretary of the Treasury
before the
Committee on Finance
United States Senate

Thursday, July 24, 1980

Mr. Chairman and Members of this Distinguished Committee:

My name is Charls E. Walker. I am chairman of Charls E. Walker Associates, Inc., and voluntary chairman of the American Council for Capital Formation. I am testifying today, at the Committee's invitation, as an individual economist and former Treasury official.

This week, this distinguished Committee and its counterpart in the House of Representatives are conducting hearings on the question of a major "tax cut" to be effective in 1981. Whereas the Ways and Means Committee is first addressing the fundamental question of the desirability of such tax legislation, this Committee, responding to a call from Senate Democrats, is working to report to the Senate "a responsible, targeted anti-inflationary tax cut to take effect in 1981." Senate Republicans overwhelmingly favor immediate tax action in the form of a 10 percent, across-the-board reduction in individual income tax rates, and enactment of the Capital Cost Recovery Act (S. 1435).

In effect, therefore, the Senate has answered the question of whether early action to reduce tax rates is desirable. Indeed, the question of whether an early "tax cut" is in fact desirable is the <u>wrong</u> question. With the economy in the grip

of what may be the worst recession in a half century, and with the Administration forecasting unemployment at 8½ percent throughout 1981, the relevant question is not whether Federal taxes should be cut next year under this year, but whether they should be allowed to rise by the whopping $86 billion projected by the Administration in its mid-session budget review. For FY 1981, budget receipts are now estimated at $604 billion, up from $518 billion in FY 1980.

Regardless of the school of economics to which one subscribes--Keynesian, supply-side, or what-have-you--tacit acceptance of an $86 billion tax increase in the middle of a severe recession can only be viewed as an amazing chapter in the annals of modern fiscal policy. Equally surprising, however, is the Administration's argument in supporting this largely unlegislated tax increase for FY 1981. Noting that economic recovery is not expected to begin before the end of this year and admitting that its projected unemployment rate is "unacceptably high," the Administration states that it will be "working with the Congress to develop a program that will assist the economic recovery at the same time that it helps to achieve long-term economic goals."

The Administration concludes:

> It is quite likely that a tax cut will be desirable in 1981. But it is not appropriate to propose one now. The Administration believes strongly that the last months of a congressional session, in an election year, are not the best time to make the judicious decisions needed for a skillfully designed tax program to improve economic performance.

One can only conclude that once again this Administration is abdicating its responsibility for fiscal leadership to the Congress. Fortunately for the country, the Senate is responding positively to that challenge. In that response, the Senate can, I am sure, design a responsible, targeted anti-inflationary cut this year and, in so doing, the damage that can result from Administration inaction will at least be minimized, if not entirely avoided. For the fact is that the Administration's approach will keep consumers, workers, producers, and participants in financial markets in the dark for many more months--until well into 1981. The danger of undue delay in initiating investment projects because of widespread uncertainty over tax policy is great indeed. If the Congress finally approves an appropriate tax reduction, some time in 1981, the lost ground cannot be made up.

The time for enacting tax legislation is now, not next year.

An Income Tax System in Need of Reform

The case for early tax action is bolstered by the fact that the Federal income tax system is fifty years out of date. It does not serve the nation's needs for the 1980's. Shaped in the Great Depression of the 1930's, the system is plagued with fundamental weaknesses resulting from the social and economic views of that unfortunate period.

Reflecting depression-oriented social views favoring income redistribution from rich to poor, the individual income tax system is characterized by highly progressive marginal rates. These high rates blunt incentives to work, save, and invest. Inflation-induced increases in taxable income generate "bracket creep," which rapidly escalates the burden on middle-income taxpayers. As taxable incomes rise, the Federal government claims a rising percentage of that income, thus increasing the burden of individual income taxes relative to gross national product.

Reflecting depression-oriented economic theories, the Federal income tax system is biased in favor of consumption and against the saving and productive investment so necessary to help reverse our declining productivity. The income tax hits both consumption and saving, providing no reward for the latter. High marginal rates sharply reduce the after-tax return on the savings of thrifty Americans--in fact, we tax saving as if it were a sin, not part and parcel of the Puritan Ethic. High business taxes reduce the after-tax return on new productive investment and curtail the cash flow necessary to finance that investment.

Thoughtful Americans recognize these deficiencies and are ready for true tax reform in the 1980's. They want lower taxes, a fairer tax burden, and taxes that do not unduly penalize productive work, saving, and investment. This type of tax system cannot be created overnight. It can only be

achieved over several years in an economy moving toward price stability and healthy economic growth.

To this end, I propose a Five-Year Fiscal Plan for responsible tax reduction and restructuring. Led initially by the Congress in the absence of fiscal leadership from the Executive Branch, this nation can restore balance between the Federal and private sectors of the economy. Such balance is the key to economic revitalization, growth, and price stability in this country. It also represents the best path to achievement of the balanced budget which Congress is seeking and the American people are demanding.

Impediment to Capital Formation

The Federal income tax system impedes capital formation by reducing the after-tax return to savers and investors.

Consider the taxpayer who saves part of his income and puts it in a regular savings account. The extra income that he earns as interest (beyond a $200 exemption available in 1981 and 1982) is taxed at 14 percent in the lowest bracket and 70 percent in the highest bracket. If a taxpayer purchases a corporate stock, the corporation's earnings are taxed up to 46 percent. In addition, the extra income he receives as a dividend (except for a $200 exemption) is taxed at rates up to 70 percent. This results in a top combined marginal rate approaching 84 percent. And if the taxpayer sells the stock, he pays a capital gains tax of up to 28 percent of any profit, even though much or all of that profit may represent inflation.

High business taxes reduce the after-tax return on new productive investment and curtail the cash flow necessary to finance that investment. Existing tax credits and accelerated depreciation are insufficient to offset the negative investment impact of these high rates. This is further compounded by under-depreciation of assets. Inflation, combined with high statutory tax rates, raises corporate tax burdens, primarily because the historic cost method of depreciation causes a significant overstatement of taxable profits. As a result, the total effective tax rate on corporate sector capital income is far higher than it otherwise would be. In fact, as SEC Chairman Harold M. Williams noted recently, the combination of high tax rates, inflation, and necessary dividend payouts is in effect decapitalizing a large segment of American business.

The Growing Tax Burden

The impact of double-digit inflation on a progressive income tax system has rapidly increased the tax burden and concentrated its impact on the most productive sector of society.

Federal receipts as a percentage of gross national product are the highest since World War II and still rising. In addition, the top half of taxpaying individuals and households (measured by adjusted gross income) pay more than 90 percent of all Federal income taxes. The tax burden,

therefore, falls heavily on the nation's middle class--its most productive and socially stable group.

Failure to reverse the uptrend in taxes relative to GNP, and also to promote fairer distribution of the burden, will further feed the underground economy. The danger of a national taxpayer revolt will increase. If it occurs, the political consequences could be both severe and long-lasting.

Targeting the Tax Legislation

Given this background, the answer to the first question that confronts this Committee--that of appropriately "targeting" the tax proposal to be reported by early September--seems clear. Top priority should be given to the goals of (1) individual tax reductions which significantly cut the high marginal rates which blunt incentives and which also have converted a "soak-the-rich" depression concept into a "clobber-the-middle-class" device, and (2) business tax cuts to liberalize and simplify capital cost recovery. There are, of course, any number of approaches to serving these goals, but the most direct and widely supported approach is embodied in S. 2878, introduced by Senator Dole and 37 other Senate Republicans. On the individual side, this legislation would represent a vital first step in slowing the growth of the already tremendous tax burden now borne by the nation's middle class. On the business side, the Capital Cost Recovery Act has been supported by over 300 members of the House of Representatives, over 70 members of the Senate, and almost every major business association.

If, over the next few years, enactment of S. 2878 were followed by two additional 10 percent cuts in individual income tax rates, the necessary restructuring of the Federal income tax system could be largely accomplished. Individual income tax rates would range from a minimum of 10 percent to a top rate of 50 percent, a range that most Americans would view as eminently fair. Under-depreciation of business assets would be eliminated, small business problems with the complexity of existing accelerated depreciation systems would be a thing of the past, and the stage would be set for gradual reductions in the corporate tax rate in the ensuing years.

The Tax Proposal: Responsible and Anti-Inflationary?

A five-year restructuring program of tax reform can be both fiscally responsible and anti-inflationary--provided that it is integrated with a multi-year plan to reduce the rate of increase in Federal spending. S. 2878 would in the long run help fight inflation by increasing productivity, which means greater output for each unit of input of labor and materials. In the short run, however, inflationary pressures can only be contained by attacking its root cause--an overblown Federal establishment and a Federal budget that has increased by 78 percent in the past five years.

A Five-Year Fiscal Plan that includes the tax restructuring could well contemplate a gradual reduction in the ratio of Federal spending to gross national product from the ultra-high 23 percent that now exists to a level no higher than 19 percent.

This is the percentage that prevailed during the administration of John F. Kennedy, a period when we provided adequately both for national defense and domestic needs, unemployment declined steadily, and prices were stable.

The American public is convinced that Federal spending has to be brought under control, toward the worthy end of balancing the Federal budget. With the economy in such bad shape, however, that balance cannot be achieved in FY 1981. It can be achieved within a few years, especially if Congress continues to work diligently to slow the rate of increase in Federal spending.

The public is skeptical of Congress' willingness and ability to continue on the path of fiscal restraint. To add credibility to that effort--and to underline the responsible approach of your forthcoming tax proposal--I would strongly recommend that this Committee propose that enactment of tax legislation this year be accompanied by adoption of a spending ceiling designed gradually to return, by FY 1985, to the 19 percent goal. If this approach is taken, the ceiling for FY 1982 should be no higher that 22 percent.

This Five-Year Fiscal Plan is responsible. The tax reductions are targeted and indeed would constitute true reform to restructure our out-moded Federal income tax system. The combination of productivity-oriented tax cuts with gradual reduction in Federal spending relative to GNP--coupled with

an appropriate monetary policy--would mount an effective battle against inflation.

How Practicable is the Five-Year Fiscal Plan?

Administration forecasts of GNP and the budget for the next five years indicate that the plan is workable. To be sure, at this stage those estimates are just that--estimates, but they do indicate the dimensions of the problem and of the opportunities.

Consider the attached tables, which are based on the Administration's assumptions in its mid-session budget review. As indicated in Column 2, GNP is expected to increase to about $4.3 trillion in FY 1985 (this assumes 6 percent inflation and 6 percent unemployment by that time). If this level of GNP is attained, Federal revenues (Column 3) are expected to reach an annual total of $1.05 trillion in that year, an increase of more than a half trillion dollars.

If no spending restraint is achieved, if the level of spending relative to GNP remains at the 23.1 percent level projected for next year, Federal spending will rise to almost one trillion dollars in FY 1985 and the resulting surplus will total over $50 billion (Columns 5 and 6 in Table I). But if the Five-Year Fiscal Plan is effected, gradually reducing Federal spending from 23.1 percent of GNP to 19 percent by FY 1985, a surplus of $233 billion will be realized (Columns 5 and 6 in Table II).

It should be emphasized that these projections are (with only minor exceptions) based on current tax law--they do not assume any of the tax cuts of the type proposed here. If, in fact, these tax cuts are enacted, the resulting stimulus to the economy can significantly widen the tax base and through "feedback" generate additional revenue. If such "feedback" occurs--and this has been the case with earlier tax reductions--the surplus figure for FY 1985 could be much larger.

This is, of course, a hypothetical exercise. But it demonstrates that the Five-Year Fiscal Plan is eminently "doable"--provided only that Congress and the President work together to apply effect the needed fiscal restraint and move immediately to schedule the tax cuts that begin the restructuring of the system. Needless to say, the plan should be flexible; year-to-year variations are to be expected. Given the state of the economy, the case for relatively heavy tax cuts now is strong. What is important is to stick with the basic game plan over the five-year period.

Conclusion

Mr. Chairman, this Committee begins these deliberations at a time of great challenge but even greater opportunity. The American people are ready to support--in fact, are implicitly calling for--the very policies that can restore balance between the Federal and private sectors; lighten and more equitably distribute the tax burden on work, saving, and

investment; and at the same time bring inflation under control. This cannot be done overnight. It will require several years. But it can be done, based upon a simple but flexible fiscal plan.

I have submitted the basics of that Five-Year Fiscal Plan to you today, and I commend it to you in your deliberations.

Thank you very much.

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GROSS NATIONAL PRODUCT AND THE FEDERAL BUDGET
FISCAL YEARS 1980-85
(Dollar amounts in billions)

TABLE I
without spending restraint

(1) Fiscal Year	(2) Gross National Product*	(3) Budget Receipts*	(4) Budget Outlays and Surplus Percent of GNP	(5) Budget Outlays and Surplus Amount	(6) (Deficit) Surplus
1980	$2,516	$ 518	23.0	$579	($61)
1981	2,739	604	23.1	634	(30)
1982	3,090	711	23.1	714	(3)
1983	3,480	818	23.1	804	14
1984	3,887	930	23.1	898	32
1985	4,308	1,052	23.1	995	57

TABLE II
with spending restraint

(1) Fiscal Year	(2) Gross National Product*	(3) Budget Receipts*	(4) Budget Outlays and Surplus Percent of GNP	(5) Budget Outlays and Surplus Amount	(6) (Deficit) Surplus
1980	$2,516	$ 518	23.0	$579	($61)
1981	2,739	604	23.1	634	(30)
1982	3,090	711	22.0	680	31
1983	3,480	818	21.0	731	87
1984	3,887	930	20.0	777	153
1985	4,308	1,052	19.0	819	233

*Dollar amounts as projected by the Office of Management and Budget, July 21, 1980

[Whereupon, at 4 p.m., the committee recessed, to reconvene at 10 a.m., Friday, July 25, 1980.]

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TAX CUT PROPOSALS

FRIDAY, JULY 25, 1980

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

The committee met, pursuant to recess, at 10:05 a.m., in room 2221, Dirksen Senate Office Building, Hon. Russell B. Long (chairman of the committee) presiding.

Present: Senators Long, Ribicoff, Byrd, Nelson, Bentsen, Moynihan, Bradley, Dole, Packwood, Danforth, and Wallop.

The CHAIRMAN. The committee will come to order.

We are extremely pleased to have this very prestigious group of witnesses here today. Speaking for myself, and I am sure for the committee, I am very happy to welcome before us two men who have been of great service to their country: Arthur F. Burns, former Chairman of the Federal Reserve Board, and who served in many other capacities with this Government; and also Mr. Henry Fowler, who served as Secretary of the Treasury.

I believe that these two gentlemen are going to testify as a panel, and I would like to ask the two of them to take a seat. I suppose, Chairman Burns, that you would lead off. I am just putting you in alphabetical order, and not anything else.

STATEMENT OF HON. ARTHUR F. BURNS, SCHOLAR IN RESIDENCE AT THE AMERICAN ENTERPRISE INSTITUTE, FORMER CHAIRMAN OF THE FEDERAL RESERVE BOARD

Mr. BURNS. Thank you very much, Mr. Chairman, for giving me and my very good colleague, Secretary Fowler, an opportunity to testify before your distinguished committee.

The CHAIRMAN. I am going to urge that we hear from both of these two very eminent witnesses before we interrogate them. That being the case, in case one of them has to go and fulfill some other commitment, at least we will have had the chance to hear both of their statements in chief.

Go ahead, sir.

Mr. BURNS. Our country finds itself once again in the midst of a recession, and the Members of Congress are naturally concerned about the steps that could wisely be taken to limit the decline of economic activity and to speed economic recovery. That, I take it, is the major reason for holding the hearings on tax policy at this time.

Let me remind you at the outset that the recession did not start suddenly. Its coming had been expected for many months in governmental as well as business circles. Throughout 1979, signs kept multiplying that forces of recession were gathering in our country.

Housing starts and automobile sales declined last year, and so, too, did their auxiliary trades—such as the lumber industry and the rubber tire industry.

Sensitive indicators of the labor market in manufacturing industries—notably, a shortening of the workweek, a reduction in overtime work, and a decline in the rate at which individuals were quitting jobs—signaled that economic expansion would soon end.

Industrial production, taken as a whole, moved sidewise throughout 1979. Moreover, during much of last year the real volume of orders received by manufacturers was tending to slip, while delays in filling orders were becoming less frequent.

At the same time, interest rates were moving up with extraordinary rapidity; output per hour in the Nation's workshops was turning down; workers' real incomes were eroding; and even the nominal profits of corporations, properly reckoned, were declining.

There was nothing mysterious about these harbingers of recession. The erosion of workers' real incomes, the sharp rise in interest rates, the slump in the homebuilding industry, some part of the decline in automobile sales, the decline of productivity, the slippage of corporate profits, all these disturbing developments reflected the economic imbalances bred by last year's raging inflation.

For a time, to be sure, the widespread and growing expectation that inflation would continue in the future prevented overall production and employment from declining. Consumers, in particular, kept spending rather freely, often beyond their income, because they felt that goods could still be acquired at bargain prices relative to what would have to be paid later.

There are limits, however, to consumer buying power. These limits could not be stretched indefinitely. They were already being strained toward the end of last year, and the new credit restrictions imposed by the Federal Reserve this March prevented their being stretched further.

As the record stands, the recession that got underway in January is still with us. And as so frequently happened in the past, most recently in 1974 and 1975, the widespread unemployment that is again afflicting our country was brought on principally by inflation.

Recessions inevitably cause hardships to many businesses and their workers, and that is why they are so troublesome. But we must not lose sight of the fact that a recession is normally a temporary and passing development, and that the lasting consequences of inflation can be much more serious to a nation.

The galloping inflation that this country experienced last year and in the early months of this year was not an isolated phenomenon. On the contrary, it was the latest installment of an ominous chapter in our Nation's history.

From the earliest days of the Republic until the end of the 1930's our country avoided persistent, cumulative declines in the purchasing power of its currency. In fact, during the century and a half prior to 1939 measures of both wholesale and consumer price levels moved down in about as many years as they moved up. However, in the 40-year stretch since then, the general price level has gone up almost without interruption—consumer prices in 38 years and wholesale prices in 35 years.

In terms of annual figures, the consumer price index has risen steadily since 1955, the wholesale price index since 1963. These unbroken strings of increases—16 years for wholesale prices and 24 years for consumer prices—are wholly without precedent in American history. Their cumulative effect is registered in a devastating decline of the purchasing power of the dollar.

At present, our consumer price level is almost six times as high as it was in 1939. Still more ominous is the fact that while the price level has risen at widely varying rates from year to year, the general trend—particularly since the mid-1960's—has been toward an accelerating pace of inflation.

The damage that this great revolution in prices has already caused in our country is all around us. Inflation has eroded the real value of everyone's money earnings and monetary assets. It has created large and wholly arbitrary redistributions of income and wealth. It has deprived people of effective means of planning for their future and of providing against the contingencies that arise in life.

It has been destroying the self-respect of many of our citizens by forcing them onto the welfare rolls. It has been reducing the efficiency of financial markets and of the workshops of our economy. It has been weakening business innovation, and capital investment by multiplying risks, driving up interest charges, and causing taxes to be paid on phantom portion of profits.

It has been making our economy more vulnerable to recessions. It has been weakening the economic security that Congress sought to build through massive social legislation. It has been reducing the value of the dollar abroad as well as at home, thus diminishing our country's power and prestige in the international arena. In short, persistent inflation has been undermining our Nation's economic, moral, and political strength.

I have been emphasizing the longer-run effects of inflation because I sense that some citizens, both within and outside the Federal Government are beginning to forget that inflation has been—still is—our Nation's No. 1 economic problem.

In the course of a recession the rapidity of price advances usually abates and that is also happening now. But we must be alert to the danger that this slowing will lead to complacency about inflation, and that the concurrent rise in unemployment will again lead to highly stimulative fiscal and monetary policies. By travelling that road in recent decades we have brought on the stagnation and malaise that of late has afflicted our economy.

In view of the danger that inflation poses for our Nation's future, a number of citizens who have had extensive governmental experience in handling economic and financial issues recently established a committee to fight inflation. The committee is thoroughly bipartisan in its makeup.

Its members, now all in private life, represent diverse backgrounds. Five are former Secretaries of the Treasury, two are former Chairman of the Federal Reserve Board, and one is a former Chairman of the Council of Economic Advisers, one is a former Under Secretary of the Treasury, and the remaining four are former Members of Congress who had major responsibilities in the economic and financial area.

What this group has in common is the conviction, born of a shared experience stretching over the last three decades, that inflation poses a major threat to the stability of our economic, social, and political system.

About a month ago the Committee to Fight Inflation issued its initial policy statement. The program for fighting inflation recommended by the committee covers a wide range of policies, but I shall concentrate this morning on the fiscal area that is the subject of these hearings.

The committee is deeply concerned about the manner in which Federal finances have been managed in recent decades. Since 1950 the budget has been in balance in only 5 years. Since 1970 a deficit has occurred in every year. Budget deficits have thus become a chronic feature of Federal finance. They have been incurred when business conditions were poor and also when business was booming.

Not only that, but the deficits have been mounting in size, a trend that becomes more worrisome when "off budget" outlays, which have increased rapidly since their emergence in 1973, are included, as they indeed should be, in the budgetary calculation. This persistent pattern of deficit financing has contributed powerfully to the impetus of inflation and to the rapid spread of inflationary psychology.

In view of this development the Committee to Fight Inflation recommends a revision of the budget process that would make it much more difficult to run deficits. The committee's proposal would require:

> A balanced budget unless a deficit is authorized by something more than a simple majority—say, two-thirds—of each House of Congress. Such a measure would demonstrate to the public that the Congress is finally ready to take stern and responsible action to end the persistent deficits that have nourished our inflation.

The committee recognizes that deficits can be eliminated either by raising or by holding down expenditures, but it expresses the firm belief that "the national interest would now be best served by restraints on expenditures."

In developing its program for fighting inflation, the committee has been especially mindful of the great importance of changing the environment for business investment. Let me quote again from the committee's policy statement:

> Inflationary pressures have been fostered in recent years by a flattening out of the trend in the output of goods and services per manhour, and most recently by an absolute decline in productivity. Our country needs urgently to encourage productivity-enhancing capital investments and, more generally, a greater willingness by business firms to innovate and assume risks. The Congress should promote these objectives, while scheduling reductions in business taxes in each of the next 5 to 7 years—the reduction to be quite small in the first 2 years but to become substantial in later years. This sort of tax legislation, supplemented in due course by reduction in the capital gains tax, would not run up the budget deficit in this critical year or next. It would thus scrupulously avoid fanning the fires of inflation. Its passage would, however, release powerful forces to expand capital investment, thereby improving the Nation's productivity and exerting downward pressure on prices later on.

Such tax legislation, I might add, would also help in the more immediate future by improving prospect for useful jobs.

Limitations of time have made it impossible for me to canvass further the thinking on taxes by members of the Committee to Fight Inflation. From this point on, I am on my own. Fortunately,

Secretary Fowler, the distinguished Vice Chairman of the committee, is with me, and he will amplify or perhaps amend my comments in whatever ways he sees fit.

In addition to what I have already said as Chairman of the Committee to Fight Inflation, I urge the Congress in the course of its deliberations on tax policy to keep the following considerations in mind.

First, the sacrifices imposed by the ongoing recession on many of our families and businesses are the price that our Nation is paying for letting inflation run riot.

Second, both inflation and recession are only the outward expression of numerous difficulties besetting our economy in recent times—among them, the increasing reliance on Government for the solution of economic and social problems, the flattening out of the trend of industrial productivity, the increasing cost and uncertain dependability of energy supplies, the growing burden of taxes despite persistent budget deficits, the tension of labor-management relations, the depression in true corporate profits, the loss of competitiveness by some of our key industries, and the proliferation of Government regulations. Tax policy can alleviate some—but by no means all—of these problems.

Third, however regrettable the human aspects of recession may be, it is now helping to moderate inflationary pressures by forcing businessmen to eliminate waste and concentrate production in more efficient installations, by making it necessary both for them and their employees to work harder, by slowing here and there the upward climb of wages and prices, and by causing an actual decline of prices in numerous commodity markets.

Fourth, in the course of a recession the private economy tends on its own to generate forces of recovery. These include the improvements in efficiency already mentioned, the working off of excessive inventories, and the emergence of a better financial environment—that is, lower interest rates, greater availability of credits, and often higher stock prices.

Fifth, these natural corrective forces are reinforced by stabilizers built into our economy. As income from production declines during a recession, much of the decline is offset by increases in unemployment compensation, and other transfer payments, by relative stability in dividend payments, and by lower income tax payments of both individuals and business. Meanwhile, employment is the greater part of our economy—Government and the various service trades—is hardly affected by recession.

Sixth, we can reasonably count on the automatic stabilizers and the corrective processes internal to the private sector to lead to economic recovery. In any event, we should give those processes a fair opportunity to work, keeping in mind that if significant fiscal stimuli are now legislated, they will undercut the dampening of inflationary pressures that is underway. When the Government can be counted on to respond vigorously to any signs of recession, both labor and management are relieved from the necessity of making hard choices that would probably result in slowing the rise of prices.

Seventh, governmental attempts at fine tuning the economy have rarely worked as expected. Economic forecasting is at best a

primitive art. Time and again, stimulative fiscal actions taken by Congress have had their main effect only after a recession had run its course.

Eighth, antirecession measures, whether of a fiscal or monetary character, have worked more poorly in recent times than they did two or three decades ago. The responsiveness of the economy to such measures has changed because of the growing expectation of the public that inflation is here to stay. With fears of inflation dug deep into our national psychology, attempts at short-run stimulation of the economy are widely interpreted to mean that new forces of inflation are being released. This tends rather quickly to drive up interest rates, encourage speculative activities, and produce attacks on the dollar in foreign exchange markets.

Ninth, in view of the hearing of the level and structure of Federal taxes on the future of our economy and our Nation's role in the world, the Congress should focus on the kind of tax system that will best serve the Nation's long-run needs, instead of attempting to use the tax system for short-run countercyclical objectives. If Congress yields once again to short-range concerns, we can be quite certain that prices will gain by rising more rapidly at the start of the next economic recovery than in the one that preceded it, that inflation will have gained new momentum, and that our economic and social troubles will not diminish.

Tenth, an election year is generally a poor time for tax legislation. Not only that, but this session of Congress is well along and will soon come to an end. There is hardly enough time for the careful deliberation that constructive tax legislation requires.

Eleventh, it is nevertheless essential that tax planning get under way promptly, so that constructive legislation can be acted on after the election. This will be an enormously difficult task. The burden of Federal taxes by our citizenry has been rising and is now about as heavy as at the peak of World War II. Even so, our Government has been running huge budget deficits—in fact, a record-breaking deficit in current dollars is projected for this fiscal year. Even more troublesome than the level of taxation is the bias against personal saving and business capital investment built into our tax structure. Unless that bias is corrected, our economy will continue to stagnate, the standard of living in our country may deteriorate, and social tensions will multiply.

Twelfth, and this is my final comment, the reconciliation of various desirable tax objectives with larger spending on defense and budgetary balance cannot be accomplished in any one year, nor can it be done without some sacrifices by the American people. Our country is in great need of a stable, consistent, long-run fiscal policy. The state of confidence among members of the business and financial community has been badly shaken by the frequent and extraordinary shifts concerning Federal expenditures, taxes, and borrowing requirements that have been projected officially during the past year. To carry out intelligent planning, businessmen in particular, but not only they, deserve a stable as well as sound fiscal policy from their Government. The recommendation by the Committee to Fight Inflation of legislation that would schedule reductions in business taxes over the next 5 to 7 years, but do so in a way that protects the budget, would go a considerable distance,

in my judgment, in rebuilding confidence in the economic future of our country and its role in the world.

This, Mr. Chairman, concludes my formal statement. Now, with your permission, I would like to submit three documents for the record.

First, a full listing of the members of the Committee to Fight Inflation.

Second, the initial policy statement of the Committee to Fight Inflation issued on June 23.

Third, a letter that I addressed to you, Mr. Chairman, on July 22, in response to some questions, particularly the question of indexing the income tax, which was put by you to members of our committee.

Thank you very much.

[The material referred to follows:]

June 23, 1980

COMMITTEE TO FIGHT INFLATION

Chronic inflation at unprecedented levels is a serious threat to the stability of our system--economic, social, and political. Since efforts to control inflationary pressures have not been successful, a serious crisis of confidence has developed. The growing public concern about the destructive effects of inflation has created an opportunity to marshal and maintain broad support for effective anti-inflation policies. A committee of private citizens with extensive experience in government has been formed to promote such policies.

Founding members of the committee include:

Arthur F. Burns, Chairman, former Chairman of the Board of Governors, Federal Reserve System.

Henry H. Fowler, Vice Chairman, former Secretary of the Treasury.

W. Michael Blumenthal, former Secretary of the Treasury.

John W. Byrnes, former Ranking Minority Member, Ways and Means Committee, U.S. House of Representatives.

Frederick L. Deming, former Under Secretary of the Treasury.

C. Douglas Dillon, former Secretary of the Treasury.

Paul W. McCracken, former Chairman of the Council of Economic Advisers.

George H. Mahon, former Chairman of the Appropriations Committee, U.S. House of Representatives

William McC. Martin, Jr., former Chairman of the Board of Governors, Federal Reserve System.

Wilbur D. Mills, former Chairman of the Ways and Means Committee, U.S. House of Representatives.

George P. Shultz, former Secretary of the Treasury.

William E. Simon, former Secretary of the Treasury.

John J. Williams, former Ranking Minority Member, Finance Committee, U. S. Senate

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Mailing address: Sidney L. Jones, Secretary of the Committee to Fight Inflation, American Enterprise Institute for Public Policy Research, 1150 17th St., N.W., Washington, D.C. 20036

June 23, 1980

COMMITTEE TO FIGHT INFLATION

A POLICY STATEMENT

The problem of inflation has reached crisis proportions in our country. From an annual average rate of rise in prices of 1.9 percent over the eleven years ending in 1967, inflation accelerated to a rate of 6.3 per cent over the next eleven years, ending in 1978; and then to a rate of 13 percent in 1979 and to a still higher rate in early 1980.

The rapidity of price advances will abate during the recession that is now under way; indeed, the most recent price indexes suggest that such a process has already begun. We must be alert to the danger that this slowing will lead to complacency about inflation, and that the concurrent rise in unemployment will again elicit highly stimulative fiscal and monetary policies. In that event we can be certain that prices will be rising more rapidly at the start of the next economic recovery than in any preceding recovery, that inflation will have gained strong new momentum, and that the hope of ending it in the reckonable future will sharply diminish.

The urgency of dealing with the inflation problem can hardly be exaggerated. By causing economic imbalances, inflation has been the primary channel through which recession--and with it widespread unemployment--has come twice to our country since 1973. The signs of havoc brought on by inflation are all around us. Inflation has created large and wholly arbitrary redistributions of income and wealth. Inflation has eroded the real value of everyone's money income and monetary assets. For example, the real value of a 1967 dollar had declined to 41 cents by early 1980.

Inflation has thus been depriving people of effective means of planning for their future and of providing against the contingencies that arise in life. It has been destroying the self-respect of many of our citizens by forcing them onto the welfare rolls. It has damaged our nation by increasing anxiety, and by breeding discontent and social tension. It has reduced the efficiency of financial markets and of the workshops of our economy, and it has made our economy more vulnerable to recession. Ultimately, inflation threatens the survival of free competitive enterprise and of our democratic institutions.

Our rapid domestic inflation has already substantially reduced the value of the dollar abroad, and with it the power and prestige of the United States in the international arena. As inflation continues, it poses a continuing threat of flight from the dollar, and thus of further contraction of its value in foreign exchange markets. Such a development would intensify

domestic inflation by raising the costs of all imported goods, and it would further weaken our country's international prestige.

We cannot afford delay in taking the measures needed to restore general price stability in our country. If we are to rout inflationary psychology we must act with determination to see the matter through despite the short-run costs that will be incurred by some, perhaps many, of our citizens. Under present circumstances, we must forswear superficially attractive but ultimately counter-productive measures such as mandatory wage and price controls.

We urge the prompt adoption of a program dealing with the following areas:

(1) FISCAL POLICY

During recent decades there have been sharply rising pressures on Congress to adopt new spending programs and to expand existing programs. Pressures for spending cuts or tax increases have been much weaker. The result has been a virtually unbroken string of budget deficits over the last twenty years. Moreover, these deficits have been generally increasing both in dollar amounts and--since the 1950's--as a percentage of the gross national product. This persistent pattern of deficit financing has contributed powerfully to the impetus of inflation and to the rapid spread of inflationary psychology.

In the Budget Act of 1974 Congress adopted new procedures designed to deal on a unified basis with separate revenue and expenditure decisions. While these procedures

represent an important step forward, it is essential that the ability of Congress to resist pressures for deficit financing be considerably strengthened. We recommend a further revision of the budget process that would make it much more difficult to run deficits. Our proposal would require a balanced budget unless a deficit is authorized by something more than a simple majority--say, two thirds--of each house of Congress. Such a measure would demonstrate to the public that the Congress is finally ready to take stern and responsible action to end the persistent budget deficits that have nourished our inflation.

Deficits can, of course, be eliminated either by raising taxes or by holding down expenditures. We believe that the national interest would now be best served by restraints on expenditures. We recognize that significant over-all savings are becoming difficult to achieve partly because of the requirements of national defense but also because of rapid growth of social security, federal pensions, and the other entitlement programs that are automatically linked to rising prices. We therefore urge the Congress to consider proposals to weaken the tie between the price indexes and outlays under the entitlement programs, insofar as that can be done without injuring those most in need. In addition to its beneficial effect on federal spending, such a course would strengthen the constituency opposed to inflation, and it would also set a constructive example for the private economy.

(2) MONETARY POLICY

The ability of the Federal Reserve System to combat inflation has in the past been limited by lack of understanding and support in the Congress. Although the System has at times stepped hard on the monetary brakes, its policies have at other times accommodated a good part of the inflationary pressures in the market place. At present, the general thrust of monetary policy is appropriately restrictive. The Federal Reserve has been and will remain the faithful agent of Congress; but if it is to continue to combat inflation forthrightly and with vigor, it must have the strong and steadfast support of Congress. We recommend that Congress adopt a concurrent resolution stressing the importance of restrictive monetary policies in furthering the goal of ending inflation.

(3) GOVERNMENT PRICE-RAISING ACTIONS

Over the years, our government has persistently acted to raise prices by measures that served to boost incomes and protect employment of particular groups at the expense of the public at large. These

measures include tariffs, import quotas, marketing agreements and other restraints on international trade. They include farm price supports and acreage restrictions that raise the cost and reduce the supply of food. They include the minimum wage and Davis-Bacon legislation that tend to raise labor costs throughout the economy. They include also restrictions on competition in the transportation and numerous other industries. In view of overwhelming evidence of the power of market competition to serve the public interest by holding down prices, it is vitally important that Congress, first, stop raising prices by enacting new restraints on trade; and second, that it proceed methodically to dismantle, or at least weaken, much of existing legislation that impedes the competitive process.

(4) GOVERNMENT REGULATION

During the past decade Congress has poured out a flood of legislation in response to public concerns about degradation of the environment and hazards to the health and safety of both workers and consumers. Much of this legislation and the regulations promulgated under it have been running up costs and prices unnecessarily.

It is essential that there be a thorough reform of outstanding laws and regulations, and more careful design in any future measures, so that basic national objectives may be achieved at minimum feasible cost. The reform should take full account of costs as well as benefits; it should seek the most efficient means of reaching agreed-upon goals; it should give careful attention to the pace at which changes in processes, practices, or products are mandated; and it should provide expeditious procedures that yield timely and definitive conclusions.

(5) THE ENVIRONMENT FOR BUSINESS INVESTMENT

Inflationary pressures have been fostered in recent years by a flattening-out of the trend in the output of goods and services per manhour, and most recently by an absolute decline in productivity. Our country needs urgently to encourage productivity-enhancing capital investments and, more generally, a greater willingness by business firms to innovate and assume risks. The Congress should promote these objectives by scheduling reductions in business taxes in each of the next five to seven years--the reduction to be quite small in the first two years but to become substantial in later years. This sort of tax legislation, supplemented in due course by reduction in the capital gains tax, would not run up the budget

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deficit in this critical year or next; it would thus scrupulously avoid fanning the fires of inflation. Its passage would, however, release powerful forces to expand capital investment, thereby improving the nation's productivity and exerting downward pressure on prices later on. Such tax legislation would also help in the more immediate future to ease the difficult adjustments forced on many businesses and their employees by the adoption of other parts of our suggested program.

(6) OTHER MEASURES TO INCREASE PRODUCTIVITY

We urge that other feasible means be adopted to increase the productivity of our economy. These should include larger private and public outlays for research and development; more carefully designed manpower training programs; productivity councils in individual plants, shops, and offices in communities across the country, in which employees and employers can pool their ideas for improving the efficiency with which their tasks are discharged; and other means of encouraging cooperative efforts of labor and management in furthering their common interest in greater efficiency.

(7) ENERGY

The problem of energy is intertwined with that of inflation. On the one hand, skyrocketing costs of imported oil have contributed to our domestic inflation; on the other hand, governmental actions to limit the rise in domestic prices of oil products have weakened incentives for conservation and for expansion of the domestic supply of oil and of alternative sources of energy. We believe that, despite the short-run effects on the price level, the rapid decontrol of oil prices--and perhaps the addition of consumption taxes--would serve the national interest by speeding the-day when our nation regains substantial independence in the energy area. Only then will we be free of the threat to the stability of our price level--and to our national security--that is posed by present dependence on foreign energy supplies.

CONCLUDING COMMENTS

Our critical problem of inflation did not emerge suddenly. It has been gathering force for many years. Its roots lie deep in the political and philosophical attitudes that emerged from the Great Depression of the 1930's.

While our inflation is largely a consequence of government actions, those actions in turn reflect excessive public demands for the good things of life--rising living standards, better provisions for income security, more assistance to the disadvantaged among us, a cleaner environment, fuller protection of the public's health and safety, and special benefits for a growing number of interest groups. Each of these demands is thoroughly understandable. Together, however, they release persistent inflationary forces--first, by requiring of government greater outlays than tax revenues can finance, second, by demanding of the private economy greater output than its languishing productivity can support.

At best, the task of ending inflation will be difficult. But there is no hope of eventual success unless the American people come to understand the nature of the problem and are prepared to support the stern measures required to solve it. We see some signs that the needed understanding and support are growing. And we look forward to the time when our nation will again experience the economic progress that is possible in an enviroment of generally stable prices.

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1150 Seventeenth Street, N.W., Washington, D.C. 20036

Arthur F. Burns

July 22, 1980

The Honorable Russell B. Long
United States Senate
Washington, D. C. 20510

Dear Senator Long

The letter that you addressed to individual members of the Committee to Fight Inflation on July 15, 1980 is of great interest to me and my colleagues. In the limited time available for discussion I have found that eleven of the thirteen Committee members are flatly opposed to indexing the personal income tax. The reasons for opposition to indexing are given in the following statement:

> A strong majority of the members of the Committee to Fight Inflation opposes current proposals to "index" the Federal personal income tax by annually adjusting tax brackets and the personal exemption to reflect increases in the general level of prices.
>
> Such proposals, like other governmental and private indexing arrangements, have a powerful appeal in that they promise to mitigate unintended and undesirable effects of inflation. Nevertheless, we oppose such arrangements because they serve to intensify inflationary pressures and diminish hopes of restoring general price stability.

Indeed, in our initial policy statement of June 23, 1980 we recommended a reduction in the present scope of indexing. Specifically, we urged the Congress to consider proposals to weaken the tie between the price indexes and outlays under Federal entitlement programs, insofar as that can be done without injuring those most in need. To index the personal income tax at this time would be to move in precisely the wrong direction.

Every extension of indexing by the Federal government lends support and encouragement to its use in private contracts, including both cost-of-living adjustment clauses in wage agreements and price adjustment clauses in other types of contracts. Such arrangements speed up the transmission of inflationary impulses throughout the economy.

Further indexing, whether of the personal income tax or private contracts, is a counsel of despair. It means that a nation has decided that living with inflation cannot be avoided in the future; and that instead of fighting inflation we must be content with reducing some of its harsh and unjust impact on people.

Indexing can provide little or no relief from inflation to people who are poor and unsophisticated in financial matters. These are the people who have been suffering most from inflation, and who are likely to suffer still more once wider indexing intensifies the momentum of inflation.

The willingness of the public to support the stern measures required to overcome inflation depends, ultimately, on two factors; how well people understand the real costs of inflation, and how they assess the chances that it can be overcome. To index the personal income tax would weaken the constituency opposed to inflation both by seeming to protect the public against one major cost, and by suggesting that the government itself has given up the battle. Once people are persuaded that they can live with inflation, they are condemned to a life of inflation.

With respect to your question concerning an across-the-board reduction in personal income taxes, I respectfully call your attention to the following passage on taxes in our unanimous statement of June 23, 1980:

> Our country needs urgently to encourage productivity-enhancing capital investments and, more generally, a greater willingness by business firms to innovate and assume risks. The Congress should promote these objectives by scheduling reductions in business taxes in each of the next five to seven years--the reduction to be quite small in the first two years but to become substantial in later years. This sort of tax legislation, supplemented in due course by reduction in the capital gains tax, would thus scrupulously avoid fanning the fires of inflation. Its passage would, however, release powerful forces to expand capital investment, thereby improving the nation's productivity and exerting downward pressure on prices later on.

I hope that this letter will be helpful to you and your colleagues.

Sincerely yours,

The CHAIRMAN. Thank you very much, Chairman Burns.
Now, let's hear from Secretary Fowler.

STATEMENT OF HON. HENRY H. FOWLER, FORMER U.S. SECRETARY OF THE TREASURY

Mr. FOWLER. Thank you very much, Mr. Chairman.
I appear here today as the vice chairman of the newly organized Committee to Fight Inflation.
The CHAIRMAN. Might I just ask both of you gentlemen to be so kind as to provide us with your credentials, not only the principally important positions you have held, but also the various other positions you have held in Government, and before you came into Government.
I think that it is impressive for the record to see the credentials that you two witnesses have, and I think that those reading the record ought to know about them.
Mr. FOWLER. Mr. Chairman, in my statement, I have included the basic experiences here that are relevant to this hearing. I did not read them in order to save time. But if the statement is put in the record as a whole, I think that this will serve.
I do appear here today because of a conviction that the decisions in this and the next Congress on fiscal policy and tax issues will probably determine whether the United States is to rid itself of its now chronic addiction to a raging inflation that has been described by Dr. Burns.
For more than a decade this inflation has been and continues to be destructive of our national values, our currency, our economic and political system, and our position of world economic leadership.
At the outset, may I associate myself fully with the statement of Dr. Arthur Burns, particularly as it develops and reflects sections of the initial policy statement of the Committee to Fight Inflation, issued on June 22, which relate to the tax issue before this committee.
In addition, I should like to offer my own personal comments. As Dr. Burns noted, since the invitation to appear before this committee was received, we have not had an opportunity to consult sufficiently with the other members of the Committee to Fight Inflation and formulate a point statement for submission to your committee other than the initial policy statement that Dr. Burns has offered for the record. Therefore, the observations that follow are my own.
The Committee to Fight Inflation is fairly bipartisan in its makeup and, yet, its 13 founding members unanimously approved the policy statement. It embodied shared convictions, born out of experiences shared over the last few decades, in which each of the 13 members held important economic and financial responsibilities in the Congress or the executive branch, or the Federal Reserve System.
The policy statement of the Committee to Fight Inflation sets forth a program composed of seven distinct, but interrelated policies. We believe that each and every one of these elements of policy must be followed persistently and consistently if the United States is to restore the noninflationary growth economy which the attainment of our national objectives requires.

Decisive action by the tax writing committees of the Congress along the lines outlined in the sections of the Committee's policy statement on "Fiscal Policy," and "The Environment for Business Investment" is particularly essential to this restoration of a noninflationary growth economy. These actions are especially relevant to the questions uppermost in these hearings—the advisability of the enactment this year of a tax cut effective January 1, 1981—the form, composition and size in both fiscal 1981 and subsequent years of any tax cut—how its enactment can be developed so as to become an initial phase in a broader restructuring of the income tax system.

There is an inescapable conclusion to be drawn from the committee's policy statement as it relates to fiscal policy and tax cutting in the contemporary environment.

It is that the overriding objective of budgetary policy and tax legislation at this time should be to reduce inflation and provide a strong fiscal plant in an anti-inflationary program.

Any tax cut should be primarily an anti-inflationary tax cut, and a part of a long term structuring of a tax system to encourage job-creating business investment and increase productivity.

Your committee will properly wish to be advised as to the effect of any tax cut on existing unemployment, the current recession, high interest rates, low levels of capital investment, wide swings in housing construction, the dollar and other facts of the economy.

An anti-inflationary tax cut and fiscal program will yield lasting jobs in the private sector, minimize the risks of new and worse recession sometime in the future, result in lower levels of interest rates, increase job-creating and productivity capital investment, strengthen the dollar, and avoid the damaging swings in housing construction that have characterized the past decade.

Therefore, and I say this as the primary thrust of my comments, I hope that your decision on tax action will make its impact on the reduction of inflation the primary and overriding test.

If the weight of the evidence is that a proposed tax cut will increase inflation, will risk an increased inflation, or fail to reduce inflation, then oppose it.

If the weight of the evidence is that the primary purpose and effect of a proposed tax cut is to reduce inflation, then support it.

In according this priority to anti-inflationary tax and fiscal policy, your comittee and Congress would be following the objective counsel of economic and financial authorities of the other industrialized democracies, as expressed in the recent communiques of the OECD, the recently released World Economic Outlook of the staff of the International Monetary Fund, and the Declaration of the Venice Summit released on June 24. In the latter document it was said:

> The reduction of inflation is our immediate top priority and will benefit all nations. Inflation retards growth and harms all sectors of our societies. Determined fiscal and monetary restraint is required to break inflationary expectations.

The application of this priority to an anti-inflationary fiscal and tax policy in the present situation, characterized by both a national election campaign and the emergency of a clearly discernable recession, will require nerve, courage and a willingness to allow natural forces and our built-in stabilizers to effect a more natural

economic recovery before resorting to that degree of emergency stimulation that risks an increased inflation when it becomes fully effective.

With some misgivings, in light of what I have read in the press about these hearings, and the attitude on both sides of the aisle, I come to the next sentence with a little caution, but with a real conviction.

I would urge that you forego hasty resort in the middle of a presidental and congressional election campaign to a quickie tax cut, heavily weighted to increase demand and consumption by a reduction in personal income tax rates.

Instead, I would urge that you opt at this time for a tax cut decision—final decision—certainly deferred until after the election. Then, in a more objective atmosphere, the Congress can set about to develop and enact a more carefully crafted anti-inflationary tax reduction that will be a component of a comprehensive anti-inflationary fiscal policy, envisaged by section 2 of the policy statement of the Committee to Fight Inflation, and give adequate promise to the creation of an environment for business investment along the lines set forth in section 5 of that policy statement.

The Congress can do so with the guidance and objective participation of a President and his advisers who, over the next 4 years, will share with the Congress a long term responsibility for restoring and maintaining a healthy, noninflationary growth economy.

By following a timetable that calls for tax reduction decisions after the election or early in 1981, to be effective for the calendar year 1981, Congress can provide the steadiness and consistency in fiscal policy that breeds confidence. It can repel either pessimism about the longer term future or expectations of a renewed inflationary surge.

What the Nation needs is, as Dr. Burns has indicated, a comprehensive fiscal policy with a long-term direction that embarks on a long-term policy of tax reduction in proper context with concerns about budget deficits and inflation.

The scale and size of a tax reduction enacted after election or early in 1981, can be more properly and realistically integrated with budget expenditure decisions which will be reflected in 1981 and 1982.

The economy can be put on a more assured path to a balanced budget, than would be the case of a tax reduction enacted in the current environment of political campaigning and wide swings in estimates for both Federal expenditures and revenues in fiscal 1981.

To act precipitately on a tax reduction under current conditions would be to ignore the impact of fiscal policy on inflation. To move the economy toward a durable pattern of noninflationary growth, the Nation must have a comprehensive fiscal policy that—and there are at least four ingredients:

(*a*) It does not enact tax reduction out of context with inflationary concern;

(*b*) It moves steadily in the direction of an era of balanced Federal budgets by holding down expenditure increases rather than increasing taxes.

(*c*) It achieves and maintains that balance while allocating a sizable share of the increased revenues that flow from increased growth to reducing the burden of taxes on the taxpayer;

(*d*) It assures that a far greater share of the tax reduction goes to creating a better environment for business investment and personal savings for capital investment than has characterized the past.

This brings me to a few concluding remarks about the composition of any tax cut and the implementation of section 5 of the policy statement of the Committee to Fight Inflation.

You will note its proposal that Congress "schedule reductions in business taxes in each of the next 5 to 7 years—the reduction to be quite small in the first two years but to become substantial in later years."

You will also note its observation that:

> This sort of tax legislation supplemented in due course by a reduction in the capital gains tax, would not run up the budget deficit in this critical year or next; it would thus scrupulously avoid fanning the fires of inflation.

Please also note that the Committee to Fight Inflation has not voiced any voices as to the mix or composition of the reductions in business taxes it proposes. Yet that does not imply that the choices are easy, and not deserving of critical and considered examination by the Congress. Liberalizing depreciation allowances, increasing the investment tax credit, cutting corporate income taxes, all constitute separate options with strong supporting cases.

Or maybe some combination of them might be more effective in achieving the noninflationary growth goals envisaged by section 5 of the policy statement.

I would challenge anyone to read carefully the special issue of Business Week of June 30, 1980, on "The Re-Industrialization of America" and particularly pages 127 through 131, and conclude that they are not difficult decisions not to be taken lightly or in haste in the composition of tax cutting for creating a better environment for business investment.

Finally, I would urge that any tax reduction enacted in the near term future include a further reduction in the capital gains tax.

The reasons advanced in support of the reduction in the percentage of capital gains taxable as ordinary income in the Revenue Act of 1978 from 50 percent to 40 percent justify at least further reduction to 30 percent. This was the level recommended as long ago as 1963 by President Kennedy in his tax message of January 4 of that year. Its enactment is long overdue for the reasons stated in my testimony before this committee on August 2, 1978, and that of many other witnesses in those hearings.

Moreover, although not quite 2 years have elapsed since the Revenue Act of 1978, the positive results of a reduction in the capital gains tax in that act more than justify a further decrease at least to the 30 percent inclusion level.

The detailed factual case supportive of this conclusion will be submitted, I would think, during the course of these hearings by representatives of the Security Industries Association, and other witnesses. They will demonstrate that the removal of tax disincentives in the capital gains tax cut does work, and it appears that higher capital tax reduction may offset most of the initial receipts lost by lowering the effective tax rates on long-term capital gains.

I would suggest that this committee request the Treasury Department submit the actual figures on 1979 income tax returns showing the exact determination of the impact of the 1978 changes in the long-term capital gains tax rules on equalizations from revenue from that source.

In addition, I would urge the exploration of other supplementary tax reduction measures such as those exempting capital gains from taxation if rolled over into new investments.

In summary, then, Mr. Chairman, and members of the committee, I would urge that the first priority in tax reduction be given to promoting increased business investment to increase productivity, and to make our economy more competitive.

Second, I would urge that this reduction in taxes on business investment and any tax action taken by this committee be carefully integrated and to become a part of the longer term comprehensive fiscal policy summarized in the four basic points appearing on page 17 of my statement.

Third, I would suggest that the final action on a tax reduction policy, or action in the near-term future could have more meaningful, long-term implications if it were taken after the election in the context of the views and responsibility of the President and the administration who will share with the Congress in the next 4 years this all important responsibility of bringing out economy to an anti-inflationary, or noninflationary growth basis.

Finally, I would urge that the priority in business investment to increase productivity include a further reduction in the long-term capital gains tax in light of the experience and the rational that motivated this committee in 1978 to call for a reduction of the inclusion of long-term capital gains from 50 percent to 30 percent, and did result, at least, in the compromise that brought that down to a 40-percent inclusion rule.

Thank you.

The CHAIRMAN. Thank you very much, gentlemen.

Let me suggest to both of you witnesses that when the committee members ask their questions, since they hope to get in more than one question, you try to make your answers brief to accommodate committee members, and reserve, if you need, the right to supplement your answers, so that they might have the chance to ask more than one question.

I know that some of them want to get two or three questions in, and if they have the benefit of one long answer, they lose their chance to ask another question.

The CHAIRMAN. Senator Dole.

May I suggest that we limit ourselves to, let us say, 5 minutes at the first go round in interrogating each of the witnesses. You can ask any one or both of them any questions you want.

Senator DOLE. I want the record to be balanced, because it is not unprecedented for us to speak at length on this side, too. Sometimes our 5 minutes expire before the question comes out. [Laughter.]

We are not intimidated by the strength of the witnesses, and you are both planning to leave at 12 o'clock, or shortly thereafter. I think we have a good arrangement.

It is obvious that neither witness believes that we should have a tax cut or enact a tax cut this year that would be effective this year. That is a correct assumption, isn't it?

Mr. BURNS. That is correct.

Mr. FOWLER. I would amend that simply to say that I think enactment of a tax cut after the election, or early in 1981 to be effective in fiscal year 1981 is what I contemplate. I would urge that that tax cut be noninflationary in character and designed primarily to promote increased business investment.

Senator DOLE. There is some, not urgency, but some indication that a tax cut is needed. Actually we are not really talking about a real tax cut, but tax abatement. We are going to have tax increases next year of some $80 billion, so I do not really think that we can tell the American people that we are going to cut their taxes. It has been suggested the most accurate term is tax abatement.

The Democrats have indicated that they will make some decision by September 3. Governor Reagan indicated a month ago that he felt we should do something this year, which would take effect next year. So I assume that there will be some pressure in both parties to take some action.

One reason is to offset some of the huge tax increases, particularly the social security tax increase. I do not believe that point was touched on in either statement. Does the Committee to Fight Inflation have any proposal to address this problem by way of a rate reduction or an offsetting credit, as some have suggested?

How do we go about helping working men and women who are going to be faced with a $16 to $18 billion increase in social security taxes—and employers, too.

Mr. BURNS. The Committee to Fight Inflation has not had an opportunity, as yet, to consider that question. There is nothing that I can say about that.

However, I do want to make a personal comment at this point. I think there are some facts that you probably are familiar with, Senator, but perhaps not everyone in this room or everyone who will be following these hearings is sufficiently familiar with.

According to the official budget estimates, in fiscal year 1981, social security benefits will rise by $16.8 billion as a result of the 14.3-percent cost of living adjustment that became effective last month. So we will have very substantial increases in the social security benefits next year.

Also in fiscal year 1981, the social security tax for employers and employees will go up by $10.5 billion as a result of the scheduled rise in the tax rate and in the applicable base income.

While it is important to take account of the increase in the social security taxes in the next fiscal year, it is also important, in conjunction with that, to keep in mind the very large increase in social security benefits that is becoming available to our people during the next fiscal year.

Senator DOLE. I am not certain whether Secretary Fowler may have the same information, but the question has been raised as to whether we had ever had a tax cut in an election year before. The record indicates that we have. Dr. Burns has compiled a rather extensive record on that subject.

In fact, Secretary Fowler is aware of a tax increase in an election year, which was unprecedented, and that was in 1968, a very popular move.

Dr. Burns, do you have a list of all the tax cuts in election years?

Mr. BURNS. I had this list compiled very quickly yesterday. I hope it is accurate. It relates to Federal income taxes, going back to 1950. I believe it is accurate. Since much of this I know from personal experience. Let me read the list very quickly.

In 1950, we had a tax increase.

In 1952, we had a slight tax increase.

In 1954, we had a tax cut.

In 1956, an election year, there was no tax increase or decrease.

In 1958, a Congressional election year, the same.

In 1960, an election year, again no tax increase or decrease, just as in 1956.

In 1962, we had a tax cut.

In 1964, an election year, we had a large tax reduction.

In 1966, a congressional election year, we had a tax increase.

In 1968, a Presidential election year, we had a large tax increase.

In 1970, we had no tax legislation. However, in fairness, one should mention that in 1969, toward the end of the year, we had a cut in personal taxes and an increase in business taxes.

Again, in 1972 there was no legislation, but cuts had been enacted in late 1971.

In 1974, no tax change.

In 1976, a large tax cut, and in 1978, a large tax cut.

So the picture is mixed. I had this compiled, I must say because at yesterday's hearing before the House Committee on Ways and Means, one Member of the Congress stated flatly that there is a tax reduction in every election year, and that is what history teaches. He thought we should stop living in a world of fantasy.

I did not think that we were living in a world of fantasy. On the other hand, since my own recollection was inadequate, I had this list compiled.

The CHAIRMAN. Senator Packwood.

Senator PACKWOOD. Mr. Secretary, on page 4 of your statement, you very clearly say: "If a proposed tax cut will risk inflation, oppose it. If it will abate inflation, support it."

Would the Roth-Kemp bill, as we know it, increase inflation?

Mr. FOWLER. I think it would involve a very grave risk of increasing inflation at this time.

Senator PACKWOOD. You would, therefore, vote again it.

Mr. FOWLER. Yes.

Senator PACKWOOD. What about a slight variation?

Mr. FOWLER. I would like to say that before this committee in 1978, I noted in response to questions from Senator Roth that I personally am very sympathetic to, and favor the basic philosophy of the Kemp-Roth bill, but I would urge that we move into it in a very gradual, long-term basis, and that we note that there should be a very precise coupling of the tax increase with a very precise coupling of fiscal action to hold down increases in expenditures, or reduce expenditures accordingly.

I would note also, finally, that I think embarkation on that program, which I am in favor of, should be handled in a manner as to reflect a very conscious concern about not increasing inflation.

Senator PACKWOOD. Mr. Secretary, I will be very surprised if we get any tax cut out of this Congress that either you or Dr. Burns would like if we enact it in the next month or two.

The Republicans and the Democrats are stumbling over each other to get to the starting gate, to get credit for a tax cut, tilted heavily toward consumers. The Republicans basically agree with the Roth-Kemp plan, with some slight variation—make it effective only 10 percent the first year, and start depreciation.

I know this committee is under a mandate—Senator Bentsen is head of the committee that must come up with some tax cut by September 3. I find it hard to believe that the Democrats are going to come up with some tax cut that is more probusiness, or capital formation, than the Republicans.

If we act now, what I am afraid of is that we are going to get a rather large individual tax cut that is inflationary, that cuts our options in 1981 to enact any kind of productivity or capital formation tax cuts, let alone take care of any of the defense needs that Otto Eckstein talks about in his testimony, and most of us share.

I will not ask any more questions, but I don't know if the tax cut is good or bad politics. A general, across-the-board tax cut, tilted heavily toward consumers, is not going to help inflation, is not going to help productivity, and I don't think that it is going to help the country.

Mr. FOWLER. I agree with the thrust of your remarks, Senator Packwood. I would simply like to note that the enactment of the Tax Reduction Act of 1964 occurred at a time when the rate of inflation was around 1.9 percent, or around 2 percent.

There is a vast difference in the atmospheric result of a large tax reduction act in that context from what it would be today when, as Dr. Burns has indicated, we have a rate of inflation running around 13 percent in 1979, and this year ranging up as high as 18 percent, and perhaps down now to about 13 percent.

Senator PACKWOOD. Just let me ask each of you this last question: If you were in the Senate, which way would you vote if faced with a bill that cuts individual income taxes across-the-board 10 percent next year, plus starts a phase-in of the 10-5-3 depreciation over maybe 3 or 5 years.

Mr. FOWLER. I would reluctantly vote against it.

Senator PACKWOOD. Dr. Burns?

Mr. BURNS. I don't know what I would do if I were in the Senate. I know what I would do now. If I were in the Senate, I might then have some of the problems that you gentlemen have.

I do know what I would do now.

My top priority in tax legislation would be to levy taxes on true corporate profits, and thus eliminate the tax on phantom profits that we have at the present time because of our treatment of depreciation for tax purposes on a historical cost basis instead of a replacement cost basis. That would be my No. 1 priority.

My No. 2 priority would be to reduce the corporate tax rate, and eventually get rid of it. Along with that, I would work toward a

reduction of the capital gains tax on individuals and on corporations, particularly the capital gains tax on securities.

I am very much impressed by the experience of Japan, where there is virtually no capital gains tax on securities. The Japanese Government and Japanese business firms take a long-range view. Their treatment of capital gains has been an important force, or at least I am so informed by Japanese businessmen, making for the very high rate of savings and capital formation in that country. That, of course, has a great deal to do with a nation's productivity.

I know Japan moderately well—I have been going there every other year for the past 20 years. On a recent visit I was astonished, to learn that productivity in manufacturing is now advancing at an annual rate of 12 to 14 percent.

Senator PACKWOOD. Let me stop you because about the middle of September, we are not going to be in Tokyo. We are going to be here, and the vote is likely to be on something very similar to what we voted on before—10 percent individual tax cut across the board in 1981, and maybe some form of improved depreciation allowances, I am not sure what form it will take.

If that is the vote, is that good or bad for the country?

Mr. BURNS. As of the present time, I would have doubts about it, yes.

Senator PACKWOOD. Thank you.

The CHAIRMAN. Senator Byrd.

Senator BYRD. I want to say, I don't know of any two individuals in whom I have greater confidence than I do in Joe Fowler and Arthur Burns, both of whom have tremendous records, both in public life and in nongovernmental activities.

I think it is very significant testimony which each of you has given the committee today. It is very much along the line of thinking that I have held to. Last month, I voted against the Republican tax reduction program, and I refused to sign the Democratic resolution mandating this committee to bring in a tax-reduction program. I think that I was one of only three Members of the Senate to take that view.

I have no great problem with the proposal advanced by the Republicans. My thinking was along the line you indicated today as to whether our financial situation is such that we should bring about a tax reduction at this particular time.

However, and that is what I would like to think out outloud with you, and maybe you can help clarify my thoughts.

Every Republican in the Senate has endorsed a tax reduction to be enacted this year, and take effect in 1981, and virtually every Democrat. So, as a practical matter, every Member of the Senate, with only two or three exceptions, has taken the view that there should be tax reduction legislation enacted this year, to become effective next year.

That being the case, certainly the Senate, and perhaps the entire Congress, is in a very awkward position not to take some action with regard to taxes this year. That being the case, I am anxious that we get the best possible tax bill that we can get.

Contrary to what I did last month, I am inclined to support a tax reduction proposal this year. I would hope that it would be geared toward what each has indicated, if I understood you correctly, to

give top priority or first priority to promoting greater business activity. Am I correct in that thinking?

Mr. FOWLER. Exactly.

Mr. BURNS. You are exactly correct.

Senator BYRD. That it should be fashioned more along that line. As I see it, the key to our problem in Government, it is not so much the problem of taxes, it is the key to get Government spending under control. I think Dr. Burns emphasized that in the earlier part of his statement.

Frankly, I see very little activity, and very little interest in the Congress or in the administration in getting Government spending under control. In this fiscal year, as one of you brought out, this Government will have the largest deficit, if you include the off-budget items, in the history of the nation.

Mr. BURNS. A $77 billion deficit.

Senator BYRD. A $77 billion deficit in this fiscal year. Yet, all the news reports, all the congressional oratory, all of the presidential oratory for the last 3 or 4 months has been that we, in Congress, in Washington, in the administration are restraining spending. Yet, the facts show that we will have an unprecedented deficit.

Also the facts show that in this fiscal year, we will have the largest increase in spending in any year in the history of our Nation.

Mr. BURNS. In the next fiscal year, Senator, without a tax reduction, the deficit is projected at $51.5 billion. That figure includes off-budget outlays as it should—The Treasury has to pay the bills whether the Congress calls certain expenditures on-budget or off-budget.

Senator BYRD. That comes on the heels of a $77 billion deficit for this current fiscal year. If we could get spending under control, it seems to me that we could out our tax problems with some relative ease.

My time has run out at the moment, but I want to comment later, and commend the patriotism, and the unselfishness and dedication of the two of you for forming this Committee to Fight Inflation. It is a bipartisan committee that you have put together, and I think that it will be of great importance in focusing public attention on this problem of inflation, and how we in government must respond if we are to get inflation under control.

Thank you.

The CHAIRMAN. Let me address this to Mr. Fowler.

It would seem to me that if we have a tax cut, individuals are not going to get any reduction in their withholding before January 1. If we move, it would be to provide some tax cut that would help offset some of the increase in taxes that will occur because of the increase in social security taxes, and the bracket creep, and the high unemployment that we are experiencing.

The cut would also be to encourage business to buy more equipment, and to move and do the kinds of things that all of us here seem to think we would like to see business doing.

Here is a statement by Mr. Martin Feldstein, who is going to follow you as witness. He holds a responsibility similar to that once held by Chairman Burns. I just want to read this statement from him. He says:

The commitment to a schedule of future tax cuts would give Congress and the Government agencies time to shape their spending plans to the lower level of available revenue. Thus, while an immediate tax cut generally means an increased deficit, precommitted future tax cuts can change incentives without any deficits.

I would be the first to agree that we should not move so rapidly here that we don't know what we are doing, and we have not had the benefit of any advice.

On the other hand, if after we have held some hearings, and we have had a chance to think about matters, and we vote, when we know that the Republic candidate, Mr. Reagan, is going to be in favor of the kind of thing that we are thinking about here, and we had the opportunity to have the advice of the present Secretary of the Treasury, and the advice of the present administration, why do we have to wait until January 1 in order to put a tax cut in place—that is, in order to enact it?

Don't you think that a businessman would be better advised in knowing what he should do with regard to his business decisions, his commitments, and investments, if he could see what the law is, rather than having to guess at what it is going to be?

Mr. FOWLER. I think that that question probably answers itself. I don't think that the businessman today, who reads the press, and who understands something about political life, has much doubt but that, regardless of the outcome of this election, in the period ahead, whether it is 1981, or 1982, or what-not, there is going to be a reduction in personal income tax rates.

What he is doubtful about, today, is whether or not the preponderant share of that tax reduction overall is going to flow to personal income tax reduction, and whether reductions to encourage business investment is going to be at the short-end of the deal.

He is also very doubtful as to whether or not the generalized expression of a need to couple tax reduction with holding down increases in Federal expenditures is going to be realized in light of what Senator Byrd has said. There have been a lot of expressions favoring that, but the hard-bitten decisionmaking to accompany a tax reduction with a hold-back of an increase in government expenditures, that he does not feel is very much set in place. He is skeptical about it.

He, then, knows that the likelihood of the result of a precipitate increase in tax reduction, or a precipitate move to reduce personal income taxes is going to encourage consumption, and run some risk of renewing inflation. He is skeptical about whether or not there is going to be hard rigid action in dealing with Federal expenditures that is necessary to curtail inflation.

So his outlook for the future is not going to be greatly cheered by the mere fact that you include in a tax cut this fall some slow beginnings toward liberalization of depreciation. There is a lot more to it than that.

The CHAIRMAN. I would think that anytime the Congress can muster the support to pass the kinds of tax incentives that business is seeking, particularly with regard to depreciation, the business community would like to see it done.

Mr. FOWLER. I would like to see it done.

The thrust of my testimony is to say, let's have a noninflationary, an anti-inflationary tax cut which is predominantly and primarily directed toward the encouragement of a better environment

for business investment because that will reduce cost, will increase productivity, and is anti-inflationary in both its immediate and long-term impact, if you read the thrust of section 5 of this policy statement.

The CHAIRMAN. Would you have any objection of we put such a bill on the President's desk before January 1?

Mr. FOWLER. I would be perfectly happy to see it.

Mr. BURNS. I would like to associate myself with that comment, and to add a word or two.

The impression that I get from business friends is that they are quite disturbed about the ups and downs in governmental thinking about taxes and about spending. One day the Congress is balancing the budget. The next day a budget deficit of $77 billion is announced.

They are quite confused, and some of them are sufficiently irreverent to say—or at least to think—that perhaps members of the Congress, and of the administration do not know what they are doing. [Laughter.]

That is not a good thing for our country.

As to passing a tax bill this session, along the lines recommended by the Committee to Fight Inflation, I would be delighted. But you know and I know that the probability of that happening is very low. If I am wrong about that, God bless you, and proceed to pass such a bill. [Laughter.]

Senator BYRD. Would the Senator yield for a question at that point?

The CHAIRMAN. Yes, sir.

Senator BYRD. As I understand your response, each of you, to Senator Long, you do not oppose the enactment of a tax reduction bill in 1980, to take effect in 1981, provided that it is a soundly based tax reduction bill. Is that correct?

Mr. BURNS. That is correct, but I would want to go on to say that I would like to have the privilege of interpreting what "soundly based" means.

Senator BYRD. Soundly based, in this case, would be oriented toward creating greater business activity, and thus creating greater job opportunities.

Mr. BURNS. That, but something more. I think the tax proposal by the Committee to Fight Inflation does just that. It recommends a tax reduction concentrating on business for each of the next 5 to 7 years—that tax reduction, in this critical year of inflation, and probably next year, would be minimal and largely symbolic, but would be substantial in later years.

Notice what that would do. It would have virtually no effect on this or next year's budget deficit. It would not increase it. It would not release new fires of inflation. At the same time, it would change the business environment, and give businessmen something to look forward to. They would be living in a different world, a world that they can count on.

Remember that it takes 2, 3, 5 years to put up a new plant or to acquire and install massive new equipment. So you would be releasing forces working in the direction of larger capital investment rather promptly, forces that would serve to improve productivity without busting a budget that is already badly out of shape.

Senator BYRD. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Danforth.

Senator DANFORTH. I just want to make absolutely clear we are on the same track on this, and use about 1 minute of my 5 minutes by restating what I think has already been put by Senator Long and Senator Byrd.

There are at least two ways of reading opposition to passing a tax bill this year. One way would be to say that in the light of facing, perhaps, a 9- to 10-percent inflation rate in 1981, and in the light of facing a $30 billion or up Federal deficit in 1981, any tax bill effective 1981 is per se inflationary and irresponsible and, therefore, we should not pass one.

It is my understanding that that is not your testimony.

Mr. BURNS. That is correct.

Mr. FOWLER. That is correct.

Senator DANFORTH. Your testimony, instead, is that you are concerned, if we pass a tax bill between now and the election, the sort of tax bill we will pass will be political in the worst sense, and will be a demand inducive, inflation inducing tax cut. Is that correct?

Mr. BURNS. That is the risk. That is the danger.

Senator DANFORTH. Let me ask you with respect to the individual portion of a tax cut. All tax cuts that I have ever heard of are partly business, and partly individual. So there is going to be an individual component to a tax cut.

With respect to the individual component, there are a variety of possible ideas. Some people suggest indexing. Some people suggest rate reduction, that is the Roth-Kemp idea. Some people suggest a tax cut which is specific toward savings. Secretary Fowler suggested further reduction on capital gains rates——

Mr. FOWLER. Which I don't think would be a revenue loser.

Senator DANFORTH. Some people suggest other sorts of savings inducers, like exclusion of dividends, and so on. Some people suggest of variety of approaches to offsetting social security increases, including a credit, or the possibility of financing medicare out of general revenue.

I would like your views, in the time allowed, both of your views if I can get them on the relative merits or demerits of these alternatives. Is it simply a matter of choosing between four or five very good alternatives and finding the best, or are some of these really good, and others would be inflationary and injurious to the economy?

Mr. FOWLER. The criteria I would use primarily in selecting them is those that have the minimal impact on the budget deficit. As Dr. Burns has indicated, in the Committee to Fight Inflation's proposal about business tax cut, in the first 2 years it would have a very slight impact. It would more symbolic. It would be more reflective of the longer term policy of this Congress, and the new administration, whoever that might be.

Senator DANFORTH. If we could just assume the same amount of dollars, and think instead in terms of given the same amount of revenue loss projected, the reflow concept. For any of these, I would like your views on indexing, rate reduction, or savings specific type reduction, or the social security credit, or medicare.

Mr. FOWLER. I think all of those would be in the lowest of my priority, and the highest order would be the Committee to Fight Inflation's recommendation in section 5 of its statement about making the beginning of a tax reduction to promote business investment, and second, reduction in the capital gains.

Senator DANFORTH. For the individual?

Mr. FOWLER. The revenues losses from what is in the thrust of that recommendation would compound the budgetary problem, or carry any significant risk of inflation.

Senator DANFORTH. The individual portion, then, would be further capital gains reduction.

Mr. FOWLER. Yes.

Senator DANFORTH. You would tend to oppose indexing of individual rates?

Mr. FOWLER. Yes.

Senator DANFORTH. You would tend to oppose individual reductions?

Mr. FOWLER. Yes.

Senator DANFORTH. You would tend to oppose social security, either the credit or the financing of medicare out of general revenue?

Mr. FOWLER. Yes. I would have, of course, in my mind the likelihood that there would be some action on individual rate reduction. I would hope that the predominant share of tax reduction enacted between now and the first of the year, or the earliest part of the year to be effective in the fiscal year would be in the directions indicated.

Senator DANFORTH. Could you respond to that, Dr. Burns?

Mr. BURNS. Yes, I indeed want to.

First of all let me say that the omission from the report of the Committee to Fight Inflation of any recommendation for a cut in the personal income tax is deliberate. At the present time, if we are to have any reduction, the reduction should focus, in our judgment, on the business side, in the interest of improving the environment in which our businessmen function. We badly need that. Our economy is slipping, and slipping sharply.

Now, I understand perfectly well that in the actual course of writing a tax bill by the Congress, something would be done about the personal income tax as well as business taxes. I regret that, but I recognize it as a fact of political life.

While I am quite opposed to doing anything about the personal income tax at the present time, if the Congress were to move in that direction, I would emphasize bringing the 70-percent maximum tax rate on personal income down to 50 percent. I think the distinction between earned and unearned income is most unfortunate. Also, I would emphasize reducing the capital gains tax, and eventually eliminating it. Of course, I would also recognize that if changes of this kind were made, there would have to be some adjustment of the lower tax brackets.

What I would hope, hope even against hope, is that the Congress would not reduce the personal income tax at the present time when we are or should be so deeply concerned about inflation, and when the deficit is already so enormous.

As for indexing the income tax, I have submitted a letter to Senator Long, in which I indicated that there is a strong majority within our committee, and I am very much a member of that majority, that entirely opposes indexing.

Indexing essentially means that we are judging that inflation is here to stay. That it is an inescapable fact of life, and that it will remain with us. In other words it is too bad, but we might as well make the best that we can of this awful situation, and try to live with it. I have not reached that point of despair as yet, and I don't expect to.

Senator DANFORTH. Thank you.

Mr. FOWLER. I would like to add one note here that neither of us has voiced, but which is implicit in the formation of this committee. At the time we issued our statement, it was in the context of a likelihood that the rate of inflation in the Consumer Price Index, which has somewhat artificial items, would come down from 18 percent to maybe 9 or 10 percent, the so-called basic rate.

That to us is not a solution of the problem of inflation. The real problem starts there, and that is engineering a group of public policies followed over surely a long period of time, 4, 5, 6, or 7 years perhaps, that will ultimately bring that rate of inflation back down from what is referred to generally as the basic rate of 9 or 10 percent to a 1- to 2-percent level, or a very tolerable level.

So we see this battle to fight inflation not as ending with the reduction from 18 to 10 or 9 percent, but beginning with how you get from 9 down to 2 or 1.5, or 2.5 percent.

Senator DANFORTH. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Thank you, Mr. Chairman. I have two questions. One long term, and one short term.

The long term—if you accept that investment is about 10 percent of GNP today, do you think that it is in our interest to increase investment as a portion of GNP? If so, where does that money come from—consumption, Government spending, wherever you might say?

If you don't think that investment need increase above 10 percent of GNP, but rather how to reallocate the components of that 10 percent, how do we disinvest from certain sectors and reinvest in more productive sectors?

Mr. BURNS. I definitely think that our rate of investment in this country should be increased substantially. Bear in mind that much of our industrial capital at the present time is obsolete. Bear also in mind the fact that a good deal of investment that is taking place in industry is mandated by the Government for environmental reasons, and that it does little or nothing to improve the productivity or the financial position of the firms that undertake such investment.

How do you finance the added investment? I think that the proper way, to the extent that we can manage it, is to finance it through savings rather than through new money creation. An environment that is inflationary, we all know, is not conducive to a high rate of saving.

Mr. FOWLER. I have nothing to add.

Senator BRADLEY. Do you think that it is all going to come out of savings, and what part of savings—personal savings, retained earnings, increased depreciation, which?

Mr. BURNS. I would say, in large part, personal savings. I think also that our business firms should be saving more; that is, the dividend payout should be lower. That is what they do with great success in Japan where they have a different kind of tax system that encourages long-range thinking on the part of business firms. Also part of the financing should come out of lower dissaving by our Federal Government.

Senator BRADLEY. So you think that it should come out of saving and reduced Government expenditure?

Mr. BURNS. Yes.

Senator BRADLEY. In making recommendation for the business tax cut, you made several recommendations ranging from reducing the tax on unearned income from 70 to 50 percent, to beginning to phase out the capital gains, to beginning to phase out corporate income tax.

All of these things are not going to happen. I am curious as to what your assumptions are in determining your first two or three priorities?

Mr. BURNS. The first choice is indicated clearly in the policy statement issued by the Committee to Fight Inflation, and which Secretary Fowler and I have cited this morning; namely, a scheduled reduction in business taxes over each of the next 5 to 7 years in order to create a new environment for business planning, innovating and investing. But the reduction should be quite small in this critical year and the next.

That recommendation on which our committee is unanimous, would be the top priority, along with a reduction in due course of the capital gains tax.

Beyond that, Secretary Fowler and I have expressed personal views, each of us speaking for himself only.

Senator BRADLEY. I would like to solicit each of your views, if it is possible, on the decline in productivity in the country since 1965; what you believe to be the major causes of that decline; and whether you see those things rectified through the series of business tax cuts that you advocate?

Mr. FOWLER. I think if you had the text of the policy statement of the Committee to Fight Inflation in front of you, it would answer that question, because following the discussion of the environment for business investment in terms of tax policies, there is another section, section 6, on other measures to increase productivity. If I may, I would just like to read it. It is short.

> We urge that other feasible means be adopted to increase the productivity of our economy. These should include larger private and public outlays for research and development, carefully designed manpower training programs, productivity councils in individual plants, shops, and offices in communities around the country in which employees and employers can pool their ideas for improving the efficiency with which their tasks are discharged, and other means of encouraging cooperative efforts of labor and management in furthering their common interest in greater efficiency.

We don't think the problem ends just with tax policy. We think, however, that the tax policy is a fundamental ingredient in the

total mix. It involves the types of measures that are referred to in this paragraph.

Mr. BURNS. I would just like to add a few words of emphasis on the importance of productivity councils. We had some experience with that after the war, and Japan has had a great deal of experience with it.

In one of our cities in upstate New York, Jamestown, they have set up productivity councils where management people sit down with working people to devise ways and means of getting a job done in less time, or getting a better job done. Senator Javits is thoroughly familiar with that development.

Such a procedure has been enormously successful in Japan. We have tried it on only a very limited basis in our country. I hope very much, and Senator Javits and I have been talking about this for the past 10 years or more, that this idea will spread and will be promoted by Congress, and that our business and labor people will start taking it seriously.

We have labor-management committees that operate on a high level, with top executives of business talking to top union leaders. What we need is groups of people—say 20 in a shop, or a division of a factory—sitting down and working out common problems. That would not only create higher productivity in our country, but it would lessen the adversarial character of labor-management relations that exists in our country. It would create a better social climate, as well as a better industrial climate.

Mr. FOWLER. In that connection, Senator Bradley, I would like to offer an additional document for the record. I noticed with great interest an ad on July 22, a full-page ad in the New York Times, entitled "The United States Must Strengthen Its Competitiveness," and it is a result of the cochairmanship of Senator Ribicoff and several colleagues which is very much along the lines of what Dr. Burns and I are trying to emphasize as what should be the principal focus of tax reductions.

Senator BRADLEY. If you look, you will see that my name is on the list. So I am glad that you agree with this.

Mr. FOWLER. I noticed that it was there, and that is why I brought it up at this point.

Senator RIBICOFF. I am acting chairman while Senator Long is gone. I see that my turn is next.

Both of you, gentlemen, are respected practical men, have dealt with the Congress year in and year out, and you know us pretty well. I would say that what you have got here is oneupmanship between the Republicans and Democrats, and that is the worst way you can legislate. Everybody is trying to make points.

In 42 years of public life, I have never seen such an atmosphere of hysteria and fear by public men running for reelection, but that is what you have got, this year.

So now you are faced with the problem that maybe we should not have a tax cut. I think the country is exactly on all fours with your objective, which is to fight inflation first, and a tax cut second. I don't anticipate that that will happen.

I believe, too, that I sense considerable responsibility among more people in Congress now than before, with the realization of

the problems this country has in the decline of competitiveness, and especially the decline of America's position of no longer being No. 1, and Americans don't like that. That is one thing that we always prided ourselves on, being No. 1, but we are not, and we want to get it back.

Assuming, therefore, that you are going to have a tax cut, and assuming that it will not follow the lines that you say, that we should wait until after election, I don't think that it is being the realm of possibility to act now responsibly.

Mr. BURNS. Do you think that there is enough time, Senator?

Senator RIBICOFF. Let me put it this way. I don't think so, but we are going to have to make the time.

You two men have acted under pressure time and time again in the positions you have been in, and you have mulled over these things day in and day out. I look around this table now, and every man that is here, Republican, Democrat, liberal, conservative, all have a deep sense of responsibility. They know the dangers. They know the problems.

Under the circumstances, let's reason together how can we get a responsible tax bill by October 4, and not wait until after election because the worst damage we can do to the future of our country is to put into place a tax bill, and a tax program that will have reverberations and consequences in future years, and undercut the slow process you are talking about.

Under those circumstances, I think you gentlemen can have a great impact. In looking around this table, I think almost all of us here now are in sympathy with your objectives.

Why don't you, out of experience, instead of just your testimony, which is sound, within the next few days before we sat down to write this bill, knowing that you are going to have to do something for individuals as well as business

I don't think today business is the whipping boy. There is a realization that we have to beat inflation. We have to get productivity and competitiveness up. The only place you are going to get it up is through business, and productivity, and competitiveness.

What type of a tax bill, including what elements, should we be aiming for now to achieve this in future, and doing as little damage as possible? I think that that can be done.

If there are the individuals, I think Senator Danforth posed that problem to you, where do you do it? Social security taxes are rising, that will have an inflationary effect. It will have a detrimental effect upon every wage earner. Should we consider giving the individual his benefits through a tax credit that he will have for the payment of social security taxes, and therefore we do something for the individual, and also for the inflationary pressures of increased Social Security taxes. I that the way to go?

If we have to phase in what you are talking about, beginning after election, what should be in that tax bill? We can do it now, instead of June 1 of 1981. Let's make the attempt. I think everybody around here wants to try.

What I am inviting you to do, and the panelists that will follow you, and almost all of you who will basically be testifying the same way, as I am familiar with what you are advocating, is to address to the committee—you don't have to write a bill, we have staff who

can write it in a bill, but list your priorities of what we ought to be working on to achieve our objectives, and try to avoid acting in an atmosphere of hysteria.

Do you think you, gentlemen, could take a whack at that?

Mr. FOWLER. Senator, I don't think we could add a very great deal to what is in our statement, and what is reflected in the initial policy of the Committee to Fight Inflation.

I think, as Dr. Burns has emphasized, whether it is liberalized depreciation, or increasing the investment tax credit, or reducing corporate taxes, a 5- to 7-year program that is graduated so that the fiscal impact is minimal in the first 2 years, but the thrust of congressional policy is there for the future.

I think a reduction of the capital gains tax, to the level, at least, that this committee and the Senate voted, I believe, 82 to 9 in 1978, an inclusion rate of long-term capital gains of 30 percent, rather than the current 40 percent, would not be a revenue loser of any significance. That is as far as our concrete thinking goes.

Beyond that, I don't know. We would be confronted with choices of other measures, which would entail much more significant revenue losses.

Senator RIBICOFF. That is right. But since you are going to face that, what I am asking you, since there is a timetable in your mind, and the timetable is not going to be adhered to apparently by the Congress, how do we fold in to do the least amount of damage, really—if we can do a lot good, fine, but the least amount of damage to reach your objective with an individual program, and a corporate program.

You say that it is impossible, but we are going to have to do it, and I think that we are going to do it.

Mr. BURNS. I understand your question, Senator, but I find it very difficult to get on the track that you suggest. To propose a tax plan that would minimize damage sounds to me like proposing a minimum of sinning, when I am opposed to sinning. So I find it very difficult to get on your track.

Senator RIBICOFF. Then you are going to have an awful lot of sinners in this Congress.

Mr. BURNS. I do hope that in the course of your deliberations there may be some second thoughts. Now and then, second thoughts are better than initial thoughts.

My impression is, and I may be entirely mistaken, that sentiment in the House is running differently from the sentiment in the Senate with regard to tax legislation. So I don't take it as a foregone conclusion that we are going to have a tax bill within the next few weeks or months.

I want to say one thing more to you. In establishing this Committee to Fight Inflation, we set a certain objective for ourselves. The objective is to try to do our best thinking on what will be good for America not only today—not even principally today—but over the long tomorrow.

We realize perfectly well that the recommendations that we come forward with would have to be adjusted, and perhaps adjusted radically, in the political process. Our feet are on the ground. We would not expect the Congress to adopt more than a few of our

recommendations, and perhaps even those in significantly modified form.

But I think our position so far, compromise is an essential of congressional living, of the governmental process. We, however are out of the Government. We don't have to compromise. We are here to advise you to the best of our ability as to our thinking on what will promote the national welfare, and let the compromising that has to be done, be done by Government officials who have the responsibility.

So I would like to be of help to you, Senator, but I find it difficult, as I stated, to get on the track that you have suggested.

Senator RIBICOFF. We appreciate it, but it looks like the burden is going to be ours, and not yours.

Senator Wallop.

Senator WALLOP. Thank you, Mr. Chairman.

I have to say, as a poor dumb rancher, in the presence of economists of this stature, it is hard for me to proceed.

But can you tell me why there is a bigger revenue loss from any action that we could take than from prolonging and creating a stagnant economy in which nobody has any money to invest in something to produce, or to buy the goods and services that are produced?

Look at General Motors, isn't that the biggest revenue loss that we could have? It is not only their people who are unemployed, but they have a second quarter loss that is a record in their industry in a no-strike quarter?

Mr. BURNS. Senator, I have tried in the testimony that I gave to deal with the question. I have urged that we give the automatic stabilizers and the natural corrective processes that go on during a recession within the private economy, in which I happen to have great faith that we give them a chance to work out their effects, and not rush in with stimulative policies.

We have done that in the past, and because we have done that in the past on the scale that we have, we have gotten into the trouble that we are in. Moreover, the stimulative policies no longer work as they used to.

Senator WALLOP. I am not asking for a stimulative policy.

Mr. BURNS. What are you asking for?

Senator WALLOP. I am asking for a comment as to whether or not the tax structure of America, as it presently is constituted, isn't of and by itself inflationary?

Mr. BURNS. I think the tax structure as presently constituted is a drag on our national economy, and badly needs reform.

Senator WALLOP. If you are a businessman, and you are looking down the road and trying to make some business investment, how can you invest in a productivity or new plant, or efficiency, on the speculation that some kind of a response from a responsible Congress is forthcoming?

Wouldn't you be just totally in line to be sued by your stockholders if you made a decision until you knew what that was?

Why prolong the certainty, and the predictability of what we are trying to do?

Mr. BURNS. Let's see what we are talking about. We are talking about a difference of just a few months, and we are suggesting that

you can write a better tax bill to accomplish the high and constructive purpose that you have in mind—that you are far more likely to do that a few months later than at present. That is the only difference between us.

Mr. FOWLER. The difference between November, December, and September and October.

Senator WALLOP. I don't have a recollection, but I have read a few history books, and if there is a massive change in the government political structure, I suggest that a few months in the wrong session might be more detrimental to the country than trying to proceed on something that would be satisfying to both parties right now.

Productivity councils are a marvellous idea, and I approve of them, but who has an interest in creating more efficiency, or more productivity if they cannot enjoy the fruits of their labor when, I am not saying immediately, but at least predictably enjoy it.

Mr. FOWLER. The principal thrust of our statement here is not the question of timing. We were trying to level with you and say what our judgment was as to what the best timing to get the best results would be.

The principal thrust is, we do need a new direction, and a new restructuring of our tax system, and the planning and the movement along the lines to execute those changes ought to begin now. There is no saying, don't even discuss this subject. No, let's go forward with it.

We just have a feeling, and we may be wrong. You may write a better bill to promote business investment in September and October, and you may vote a more predominant share of tax reduction to promoting business investment that increases productivity in September and October than you would in November and December, but I for one doubt it.

I think that you are much more likely to get the emphasis that we are trying to get in our statement here, which I think from what Senator Ribicoff says reflects the view of a lot on both sides of the aisles——

Senator WALLOP. I am simply trying to echo Senator Ribicoff's request, and ask you if perhaps you might not rethink your reticence to provide us with a rather more specific answer to the question that he asked in the hope that there might be now, at last, a responsible bypartisan effort to rescue a sick country.

Senator RIBICOFF. Senator Bentsen, do you want to ask some questions?

Senator BENTSEN. Since I was not here to hear the statements of these two gentlemen, I am not going to ask questions. But I do want to, just because they both happen to be good friends of mine, to state my very high regard of Chairman Burns, and Secretary Fowler, and their contribution to our country. I look forward to reading your statements.

Mr. FOWLER. Thank you.

Mr. BURNS. Thank you.

Senator RIBICOFF. On instruction from the chairman, who had to go to the Press Club to make a speech, and took other members of the committee with him, it was his suggestion that we recess, after everyone has asked questions here, until 2 o'clock.

Senator DANFORTH. Could I ask one short question, Mr. Chairman?

Senator RIBICOFF. Certainly.

Senator DANFORTH. Gentlemen, if we were faced by political necessity, and it was going to come to pass that we would pass a tax bill which would be effective January 1, and it would have in it x number of dollar revenue loss for either individual rate reductions, or in the alternative a social security tax offset, which of the two would either most prefer, or least disfavor?

Mr. BURNS. I will take the first, the individual rate reduction. I would not tamper with social security.

Senator DANFORTH. This would simply be an income tax credit for social security taxes paid.

Mr. BURNS. That is one way of describing it. I think what you are then doing is financing the social security system through general tax revenue—or more precisely, through general tax revenue in part, and also through borrowing in part.

Senator DANFORTH. Secretary Fowler?

Mr. FOWLER. I would flip a coin.

Senator DANFORTH. Would you be happy or very upset when you are flipping the coin?

Mr. FOWLER. I don't think that it matters very much. I share Dr. Burns' view that I would hate to see this particular situation become a precedent for a movement in terms of financing social security. I do not think that that is wise.

Senator DANFORTH. Thank you.

Senator BRADLEY. Mr. Chairman, could I ask one question?

Senator RIBICOFF. Let me ask this one question first.

I hope I have not inconvenienced Mr. Stein, Mr. Eckstein, and Mr. Feldstein, because it is late. Senator Packwood indicated that he would be more than willing to remain and listen to the panel.

You have been around the Senate for a long time. I don't know how many more people will be back. Personally, I have to get a 1 o'clock plane back to Connecticut, so I personally will not be back. Whether you would rather go on now, or whether you would rather come back at 2 o'clock, is your decision. What would you, gentlemen, rather do?

Mr. STEIN. We would rather have the bird in the hand.

Senator RIBICOFF. Would you be willing to stay?

Senator BENTSEN. I can stay until 12:40, and then I must leave, or I can come back at 2.

Senator RIBICOFF. My feeling is, these men have come here, and we take a lot of their time. They are willing to come and testify to a skeletonized committee.

Whoever the last man is, would you please recess or adjourn until Monday.

Senator BRADLEY. Mr. Chairman, I just wanted to ask one question.

Senator RIBICOFF. Senator Bradley.

Senator BRADLEY. I don't think that either one of you gave me a specific percentage of GNP you think investment should be. What is the target?

Mr. BURNS. I am not very good at numbers, Senator. It ought to be significantly higher, and I would like to see it at least 12 percent.

Senator BRADLEY. Thank you.

Mr. FOWLER. That would express my point of view. It should be significantly higher, but I mistrust numbers on occasions like this, where I would pull it out of the air. But it should be significantly higher.

Senator BRADLEY. Thank you.

Mr. FOWLER. Over a long period of time, too.

[The prepared statements of the preceding panel follow:]

STATEMENT ON SOME KEY ISSUES IN FISCAL POLICY BY ARTHUR F. BURNS, SCHOLAR IN RESIDENCE AT THE AMERICAN ENTERPRISE INSTITUTE

SOME KEY ISSUES IN FISCAL POLICY

Our country finds itself once again in the midst of a recession, and the members of Congress are naturally concerned about the steps that could wisely be taken to limit the decline of economic activity and to speed economic recovery. That, I take it, is the major reason for holding hearings on tax policy at this time.

Let me remind you at the outset that the recession did not start suddenly. Its coming had been expected for many months in governmental as well as business circles. Throughout 1979 signs kept multiplying that forces of recession were gathering in our country. Housing starts and automobile sales declined last year and so too did their auxiliary trades—such as the lumber industry and the rubber tire industry. Sensitive indicators of the labor market in manufacturing industries—notably, a shortening of the workweek, a reduction in overtime work, and a decline in the rate at which individuals were quitting jobs—signaled that economic expansion would soon end. Industrial production, taken as a whole, moved sidewise throughout 1979. Moreover, during much of last year the real volume of orders received by manufacturers was tending to slip, while delays in filling orders were becoming less frequent. At the same time, interest rates were moving up with extraordinary rapidity; output per hour in the nation's workshops was turning down; workers' real incomes were eroding; and even the nominal profits of corporations, properly reckoned, were declining.

There was nothing mysterious about these harbingers of recession. The erosin of workers' real incomes, the sharp rise in interest rates, the slump in the homebuilding industry, some part of the decline in automobile sales, the decline of productivity, the slippage of corporate profits—all these disturbing developments reflected the economic imbalances bred by last year's raging inflation.

For a time, to be sure, the widespread and growing expectation that inflation would continue in the future prevented over-all production and employment from declining. Consumers, in particular, kept spending rather freely, often beyond their income, because they felt that goods could still be acquired at bargain prices relative to what would have to be paid later. There are limits, however, to consumer buying power; these limits could not be stretched indefinitely; they were already being strained toward the end of last year; and the new credit restrictions imposed by the Federal Reserve this March prevented their being stretched further. As the record stands, the recession that got under way in January is still, with us. And as so frequently happened in the past—most recently in 1974 and 1975—the widespread unemployment that is again afflicting our country was brought on principally by inflation.

Recessions inevitably cause hardships to many businesses and their workers, and that is why they are so troublesome. But we must not lose sight of the fact that a recession is normally a temporary and passing development, and that the lasting consequences of inflation can be much more serious to a nation. The galloping inflation that our country experienced last year and in the early months of this year was not an isolated phenomenon. On the contrary, it was the latest installment of an ominous chapter in our nation's history.

From the earliest days of the Republic until the end of the 1930's our country avoided persistent, cumulative declines in the purchasing power of its currency. In fact, during the century and a half prior to 1939 measures of both wholesale and consumer price levels moved down in about as many years as they moved up. However, in the forty-year stretch since then, the general price level has gone up almost without interruption—consumer prices in 38 years and wholesale prices in

35 years. in terms of annual figures, the consumer price index has risen steadily since 1955, the wholesale price index since 1963. These unbroken strings of increases—sixteen years for wholesale prices and twenty-four years for consumer prices—are wholly without precedent in American history. Their cumulative effect is registered in a devastating decline of the purchasing power of the dollar.

At present, our consumer price level is almost six times as high as it was in 1939. Still more ominous is the fact that while the price level has risen at widely varying rates from year to year, the general trend—particularly since the mid-1960's—has been toward an accelerating pace of inflation.

The damage that this great revolution in prices has already caused in our country is all around us. Inflation has eroded the real value of everyone's money earnings and monetary assests. It has created large and wholly arbitrary redistributions of income and wealth. It has deprived people of effective means of planning for their future and of providing against the contingencies that arise in life. It has been destroying the self-respect of many of our citizens by forcing them onto the welfare rolls. It has been reducing the efficiency of financial markets and of the workshops of our economy. It has been weakening business innovation and capital investment by multiplying risks, driving up interest charges, and causing taxes to be paid on a phantom portion of profits. It has been making our economy more vulnerable to recessions. it has been weakening the economic security that Congress sought to build through massive social legislation. It has been reducing the value of the dollar abroad as well as at home, thus diminishing our country's power and prestige in the international arena. In short, persistent inflation has been undermining our nation's economic, moral, and political strength.

I have been emphaizing the longer-run effects of inflation because I sense that some citizens, both within and outside the Federal government, are beginning to forget that inflation has been—and still is—our nation's Number One economic problem. In the course of a recession the rapidity of price advances usually abates and that is also happening now. But we must be alert to the danger that this slowing will lead to complacency about inflation, and that the concurrent rise in unemployment will again lead to highly stimulative fiscal and monetary policies. By traveling that road in recent decades we have brought on the stagnation and malaise that of late has afflicted our economy.

In view of the danger that inflation poses for our nation's future, a number of citizens who have had extensive governmental experience in handling economic and financial issues recently established a Committee to Fight Inflation. The Committee is thoroughly bipartisan in its make-up. Its members, now all in private life, represent diverse backgrounds. Five are former Secretaries of the Treasury, two are former Chairmen of the Federal Reserve Board, one is a former Chairman of the Council of Economic Advisers, one is a former Under Secretary of the Treasury, and the remaining four are former members of Congress who had major responsibilities in the economic and financial area. What this group has in common is the conviction, born of a shared experience stretching over the last three decades, that inflation poses a major threat to the stability of our economic. social. and political system.

About a month ago the Committee to Fight Inflation issued its initial policy statement. The program for fighting inflation recommended by the Committee covers a wide range of policies, but I shall concentrate this morning on the fiscal area that is the subject of these hearings.

The Committee is deeply concerned about the manner in which Federal finances have been managed in recent decades. Since 1950 the budget has been in balance in only five years. Since 1970 a deficit has occurred in every year. Budget deficits have thus become a chronic feature of Federal finance; they have been incurred when business conditions were poor and also when business was booming. Not only that, but the deficits have been mounting in size—a trend that becomes more worrisome when "off budget" outlays, which have increased rapidly since their emergence in 1973, are included, as they indeed should be, in the budgetary calculation. This persistent pattern of deficit financing has contributed powerfully to the impetus of inflation and to the rapid spread of inflationary psychology.

In view of this development the Committee to Fight Inflation recommends a revision of the budget process that would make it much more difficult to run deficits. The Committee's proposal would require "a balanced budget unless a deficit is authorized by something more than a simple majority—say, two-thirds—of each house of Congress. Such a measure would demonstrate to the public that the Congress is finally ready to take stern and responsible action to end the persistent deficits that have nourished our inflation." The Committee recognizes that deficits can be eliminated either by raising taxes or by holding down expenditures, but it

expresses the firm belief that "the national interest would now be best served by restraints on expenditures."

In developing its program for fighting inflation the Committee has been especially mindful of the great importance of changing the environment for business investment. Let me quote again from the Committee's policy statement: "Inflationary pressures have been fostered in recent years by a flattening-out of the trend in the output of goods and services per manhour, and most recently by an absolute decline in productivity. Our country needs urgently to encourage productivity-enhancing capital investments and, more generally, a greater willingness by business firms to innovate and assume risks. The Congress should promote these objectives by scheduling reductions in business taxes in each of the next five to seven years—the reduction to be quite small in the first two years but to become substantial in later years. This sort of tax legislation, supplemented in due course by reduction in the capital gains tax, would not run up the budget deficit in this critical year or next; it would thus scrupulously avoid fanning the fires of inflation. Its passage would, however, release powerful forces to expand capital investment, thereby improving the nation's productivity and exerting downward pressure on prices later on." Such tax legislation, I might add, would also help in the more immediate future by improving prospects for useful jobs.

Limitations of time have made it impossible for me to canvass further the thinking on taxes by members of the Committee to Fight Inflation. From this point on, I am on my own. Fortunately, Secretary Fowler, the distinguished Vice Chairman of the Committee, is with me, and he will amplify or perhaps amend my comments in whatever ways he sees fit.

In addition to what I have already said as Chairman of the Committee to Fight Inflation, I urge the Congress in the course of its deliberations on tax policy to keep the following considerations in mind.

First, the sacrifices imposed by the on-going recession on many of our families and businesses are the price that our nation is paying for letting inflation run riot.

Second, both inflation and recession are only the outward expression of numerous difficulties besetting our economy in recent times—among them, the increasing reliance on government for the resolution of economic and social problems, the flattening out of the trend of industrial productivity, the increasing cost and uncertain dependability of energy supplies, the growing burden of taxes despite persistent budget deficits, the tension in labor-management relations, the depression in true corporate profits, the loss of competitiveness by some of our key industries, and the proliferation of government regulations. Tax policy can alleviate some—but by no means all—of these problems.

Third, however regrettable the human aspects of recession may be, it is now helping to moderate inflationary pressures by forcing businessmen to eliminate waste and concentrate production in more efficient installations, by making it necessary both for them and their employees to work harder, by slowing here and there the upward climb of wages and prices, and by causing an actual decline of prices in numerous commodity markets.

Fourth, in the course of a recession the private economy tends on its own to generate forces of recovery. These include the improvements in efficiency already mentioned, the working-off of excessive inventories, and the emergency of a better financial environment, that is, lower interest rates, greater availability of credit, and often higher stock prices.

Fifth, these natural corrective forces are reinforced by stabilizers built into our economy. As income from production declines during a recession, much of the decline is offset by increases in unemployment compensation and other transfer payments, by relative stability in dividend payments, and by lower income tax payments of both individuals and businesses. Meanwhile, employment in the greater part of our economy—government and the various service trades—is hardly affected by recession.

Sixth, we can reasonably count on the automatic stabilizers and the corrective processes internal to the private sector to lead to economic recovery. In any event, we should give those processes a fair opportunity to work, keeping in mind that if significant fiscal stimuli are now legislated, they will undercut the dampening of inflationary pressures that is underway. When the government can be counted on to respond vigorously to any signs of recession, both labor and management are relieved from the necessity of making hard choices that would probably result in slowing the rise of prices.

Seventh, governmental attempts at fine-tuning the economy have rarely worked as expected. Economic forecasting is at best a primitive art. Time and again, stimulative fiscal actions taken by Congress have had their main effect only after a recession had run its course.

Eighth, anti-recession measures, whether of a fiscal or monetary character, have worked more poorly in recent time than they did two or three decades ago. The responsiveness of the economy to such measures has changed because of the growing expectation of the public that inflation is here to stay. With fears of inflation dug deep into our national psychology, attempts at short-run stimulation of the economy are widely interpreted to mean that new forces of inflation are being released. This tends rather quickly to drive up interest rates, encourage speculative activities, and produce attacks on the dollar in foreign exchange markets.

Ninth, in view of the bearing of the level and structure of Federal taxes on the future of our economy and our nation's role in the world, the Congress should focus on the kind of tax system that will best serve the nation's long-run needs, instead of attempting to use the tax system for short-run countercyclical objectives. If Congress yields once again to short-range concerns, we can be quite certain that prices will again be rising more rapidly at the start of the next economic recovery than in the one that preceded it, that inflation will have gained new momentum , and that our economic and social troubles will not diminish.

Tenth, an election year is generally a poor time for tax legislation. Not only that, but this session of Congress is well along and will soon come to an end. There is hardly enough time for the careful deliberation that constructive tax legislation requires.

Eleventh, it is nevertheless essential that tax planning get underway promptly, so that constructive legislation can be acted on after the election. This will be an enormously difficult task. The burden of Federal taxes borne by our citizenry has been rising and is now about as heavy as at the peak of World War II. Even so, our government has been running huge budget deficits—in fact, a record-breaking deficit in current dollars is projected for this fiscal year. Even more troublesome than the level of taxation is the bias against personal saving and business capital investment built into our tax structure. Unless that bias is corrected, our economy will continue to stagnate, the standard of living in our country may deteriorate, and social tensions will multiply.

Twelfth, and this is my final comment, the reconciliation of various desirable tax objectives with larger spending on defense and budgetary balance cannot be accomplished in any one year, nor can it be done without some sacrifices by the American people. Our country is in great need of a stable, consistent, long-run fiscal policy. The state of confidence among members of the business and financial community has been badly shaken by the frequent and extraordinary shifts concerning Federal expenditures, taxes, and borrowing requirements that have been projected officially during the past year. To carry out intelligent planning, businessmen in particular, but not only they, deserve a stable as well as a sound fiscal policy from their government. The recommendation by the Committee to Fight Inflation of legislation that would schedule reductions in business taxes over the next five to seven years, but do so in a way that protects the budget, would go a considerable distance, in my judgment, in rebuilding confidence in the economic future of our country and its role in the world.

STATEMENT OF HENRY H. FOWLER

My name is Henry H. Fowler.

I am a General Partner in Goldman, Sachs & Co., an investment banking and securities brokerage firm at 55 Broad Street, New York, N.Y.

By way of background, the record should show that I served as The Under Secretary of the Treasury from January 1961 to May 1964, by appointment of President John F. Kennedy, and as Secretary of the Treasury from April 1st, 1965, to December 20th, 1968, by appointment of President Lyndon B. Johnson.

My service as The Under Secretary and General Deputy to Treasury Secretary C. Douglas Dillon, included a major involvement in working within the Treasury and the Administration and with the Congress and its Committees on the formulation and enactment of the tax programs of the early Sixties which emphasized tax reduction and reform. These included the Revenue Act of 1962, which instituted the Investment Tax Credit and the Tax Reduction Act of 1964, which enacted the largest reduction in the history of taxation on personal and corporate income taxes.

Subsequently, as Secretary of the Treasury, I worked on the various tax bills of 1965 and 1966, and the Revenue Act of 1968, which included the temporary 10% surtax increase which, coupled with a mandated reduction and ceiling on expenditures, resulted in the only surplus in the Budget in the last two decades.

I appear here today as Vice Chairman of a newly organized Committee to Fight Inflation, described in his testimony today by our Chairman, Dr. Arthur Burns.

I do so because of a conviction that the decisions in this and the next Congress on fiscal policy and tax issues will determine whether the United States is to rid itself of its now chronic addiction to a raging inflation. For more than a decade this inflation has been and continues to be destructive of our national values, our currency, our economic and political system, and our position of world economic leadership.

At the outset, may I associate myself fully with the statement of Dr. Arthur Burns, particularly as it develops and reflects sections of the initial Policy Statement of the Committee to Fight Inflation, issued on June 22nd, which relate to the tax issue before this Committee.

In addition, I should like to offer my own personal comments. As Dr. Burns noted, since the invitation to appear before this Committee was received, we have not had an opportunity to consult sufficiently with the other members of the Committee to Fight Inflation and formulate a joint statement for submission to your Committee other than the initial Policy Statement that Dr. Burns offered for the record. Therefore, the observations that follow are my own.

The Committee to Fight Inflation is fairly bipartisan in its makeup and, yet, its 13 founding members unanimously approved the Policy Statement. It embodied shared convictions, born out of experiences shared over the last few decades, in which each of the 13 members held important economic and financial responsibilities in the Congress or the Executive Branch, or the Federal Reserve System.

The Policy Statement sets forth a program composed of seven distinct but interrelated policies. We believe that each and every one of these elements of policy must be followed persistently and consistently if the United States is to restore the non-inflationary growth economy which the attainment of our national objectives requires.

Decisive action by the tax-writing committees of the Congress along the lines outlined in the sections of the Committee's Policy Statement on "Fiscal Policy" and "The Environment for Business Investment" is particularly essential to this restoration of a non-inflationary growth economy. These sections are especially relevant to the questions uppermost in these Hearings—the advisability of the enactment this year of a tax cut effective January 1st, 1981—the form, composition and size in both fiscal 1981 and subsequent years of any tax cut—how its enactment can be developed so as to become an initial phase in a broader restructuring of the income tax system.

There is an inescapable conslusion to be drawn from the Committee's Policy Statement as it relates to fiscal policy and tax cutting in the contemporary environment.

It is that the overriding objective of budgetary policy and tax legislation at this time should be to reduce inflation and provide a strong fiscal plank in an anti-inflationary program.

Any tax cut should be primarily an anti-inflationary tax cut and a part of a long term restructuring of the tax system to encourage job creating business investment and increase productivity.

Your Committee will properly wish to be advised as to the effect of any tax cut on existing unemployment, the current recession, high interest rates, low levels of capital investment, wide swings in housing construction, the position of the dollar and other facets of the economy.

An anti-inflationary tax cut and fiscal program will yield lasting jobs in the private sector, minimize the risks of a new and worse recession sometime in the future, result in lower levels of interest rates, increase job-creating and productivity-increasing capital investment, strengthen the dollar, and avoid the damaging swings in housing construction that have characterized this past decade.

Therefore, I hope that your decision on tax action will make its impact on the reduction of inflation the primary and overriding test. If the weight of the evidence is that a proposed tax cut will risk an increase in inflation or fail to reduce inflation, then oppose it. If the weight of the evidence is that the primary purpose and effect of a proposed tax cut is to reduce inflation, then support it.

In according this priority to anti-inflationary tax and fiscal policy, your Committee and the Congress would be following the objective counsel of economic and financial authorities of the other industrialized democracies, as expressed in the recent Communiques of the OECD, the recently released World Economic Outlook of the staff of the International Monetary Fund, and the Declaration of the Venice Summit released on June 24th. In the latter document it was said: "The reduction of inflation is our immediate top priority and will benefit all nations. Inflation retards growth and harms all sectors of our societies. Determined fiscal and monetary restraint is required to break inflationary expectations."

The application of this priority to an anti-inflationary fiscal and tax policy in the present situation, characterized by both a national election campaign and the emergence of a clearly discernable recession, will require nerve, courage and a willingness to allow natural forces and our built-in stabilizers to effect more natural economic recovery before resorting to that degree of emergency stimulation that risks an increased inflation when it becomes fully effective.

I would urge that you forego hasty resort in the middle of a Presidential and Congressional Election Campaign to a quickie tax cut, heavily weighted to increase demand and consumption by a reduction in personal income tax rates.

Instead, I would urge that you opt at this time for a tax cut decision—final decision—deferred until after the Election. Then, in a more objective atmosphere, the Congress can set about to develop and enact a more carefully crafted anti-inflationary tax reduction that will be a component of a comprehensive anti-inflationary fiscal policy, envisaged by Section 2 of the Policy Statement of the Committee to Fight Inflation, and give adequate primacy to the creation of an environment for business investment along the lines set forth in Section 5 of that Policy Statement.

The Congress can do so with the guidance and objective participation of a President and his advisors who over the next four years will share with the Congress a long term responsibility for restoring and maintaining a healthy non-inflationary growth economy.

By following a timetable that calls for tax reduction decisions after the Election or early in 1981, to be effective for the calendar year 1981, Congress can provide the steadiness and consistency in fiscal policy that breeds confidence. It can repel either pessimism about the longer term future or expectations of a renewed inflationary surge.

What the nation needs is as Dr. Burns has indicated a comprehensive fiscal policy with a long term direction that embarks on a long term policy of tax reduction in proper context with concerns about budget deficits and inflation.

The scale and size of a tax reduction enacted after Election or early in 1981, can be more properly and realistically integrated with budget expenditure decisions. The economy can be put on a more assured path to a balanced budget, than would be the case of a tax reduction enacted in the current environment of political campaigning and wide swings in estimates for both federal expenditures and revenues in fiscal 1981. To act precipitately on a tax reduction under current conditions would be to ignor the impact of fiscal policy on inflation. To move the economy towards a durable pattern of non-inflationary growth, the nation must have a comprehensive fiscal policy that:

(a) does not enact tax reduction out of context with inflationary concern;

(b) moves steadily in the direction of an era of balanced federal budgets by holding down expenditure increases rather than increasing taxes;

(c) achieves and maintains that balance while allocating a sizeable share of the increased revenues that flow from increased growth to reducing the burden of taxes on the taxpayer;

(d) assures that a far greater share of the tax reduction goes to creating a better environment for business investment and personal savings for capital investment than has characterized the past.

This brings me to a few concluding remarks about the composition of any tax cut and the implementation of Section 5 of the Policy Statement of the Committee to Fight Inflation.

You will note its proposals that the Congress "schedule reductions in business taxes in each of the next five to seven years—the reduction to be quite small in the first two years but to become substantial in later years."

You will also note its observation that "this sort of tax legislation, supplemented in due course by a reduction in the capital gains tax, would not run up the budget deficit in this critical year or next; it would thus scrupulously avoid fanning the fires of inflation."

Please also note that the Committee to Fight Inflation has not voiced any choices as to the mix or composition of the reductions in business taxes it proposes. Yet that does not imply that the choices are easy and not deserving of critical and considered examination by the Congress. Liberalizing depreciation allowances, increasing the investment tax credit, cutting corporate income taxes, all constitute separate options with strong supporting cases.

Or may be some combination of them might be more effective in achieving the non-inflationary growth goals envisaged by Section 5 of the Policy Statement.

I would challenge any one to read carefully the Special Issue of Business Week of June 30th, 1980, on "The Re-Industrialization of America", and, particularly, pages 127-131, and conclude that they are not difficult decisions—not to be taken lightly

or in haste in the composition of tax cutting for creating a better environment for business investment.

Finally, I would urge that any tax reduction, enacted in the near term future, include a further reduction in the capital gains tax.

The reasons advanced in support of the reduction of the percentage of capital gains taxable as ordinary income in the Revenue Act of 1978, from 50 percent to 40 percent, justify at least further reduction to 30 percent. This was the level recommended as long ago as 1963 by President Kennedy, in his Tax Message of January 4th of that year. Its enactment is long overdue for the reasons stated in my testimony before this Committee on August 22nd, 1978, and that of many other witnesses in those Hearings.

Moreover, although not quite two years have elapsed since the Revenue Act of 1978, the positive results of a reduction in the capital gains tax in that Act more than justify a further decrease at least to the 30 percent inclusion level. The detailed factual case, supportive of this conclusion, will be submitted I would think during the course of these Hearings by representatives of the Securities Industry Association and other witnesses. They will demonstrate that the removal of tax disincentives in the capital gains tax cut does work, and it appears that higher capital gains realizations and related tax receipts generated by the 1978 capital gains tax reduction may offset most of the initial receipts lost by lowering the effective tax rates on capital gains.

I would suggest that this Committee request the Treasury Department to submit the actual figures on 1979 Income Tax Returns, showing the exact determination of the impact of the 1978 changes in the long term capital gains tax rules on realizations from revenue from that source.

In addition, I would urge the exploration of other supplementary tax reduction measures such as those exempting capital gains from taxation if rolled over into new investment.

Senator BENTSEN [presiding]. Gentlemen, thank you very much for your patience, and we are very pleased to have you.

Do we have any plane problems, where somebody feels that they should speak first?

[No response.]

Senator BENTSEN. All right, Mr. Stein, if you would proceed, we will start with you.

STATEMENT OF HERBERT STEIN, FORMER CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. STEIN. Thank you, Mr. Chairman.

I am pleased to have the opportunity to present my views on the difficult and delicate question of tax reduction.

A decision at this time to reduce taxes would, in my opinion, be unwise. Such a decision will reduce the Federal revenues, below what they would otherwise be, for years to come. Congress should not do that unless it has reasonable assurance that the reduction of revenues will be consistent with sound budgetary and economic policy. That assurance is not available today.

After this morning's discussion, I would like to distinguish my position from that of the two who spoke before me. I am not saying that I know we need a tax cut, but that you should wait until after November 4 to do for various reasons.

My position is not that we should wait and then do it, but that we should wait because I think that after we wait, and have considered the problem adequately, you may very well decide not to do it. My present view would be that on the basis of the information now before us, we should not do it either before the election, or after the election. I am not sure that anybody is going to be very much different after the election than he is before the election.

The big problem is national security. I believe that the country needs, and will discover that it needs, a much larger increase of

national defense expenditures than is contemplated in the administration's budget, or in congressional action to date.

The Congress should be sure that it does not seriously weaken the possibility of meeting our defense needs by cutting the revenue before the defense needs have been carefully assessed.

The great danger is that we will create a situation where the revenue is inadequate and where provision for the national security is squeezed by a combination of reluctance to raise taxes, reluctance to cut non-defense spending, and reluctance to run large deficits.

The consequences of failure to provide adequately for the national security would be enormously more serious than the loss of one or two-tenths of a percentage point in the rate of economic growth that might result from failure to make the best tax cut at the earliest possible moment.

There is no urgency which requires a decision to cut taxes before there has been thorough evaluation of our budget requirements for the next several years, including our defense requirements. In March, I proposed to the Senate Budget Committee that it should establish a subcommittee on paying for survival, which would recognize our possible defense needs and consider ways to finance them. Unfortunately, that advice was not taken.

I believe that this committee or the Senate Budget Committee should initiate a reconsideration of our medium-term budget outlook, in light of our defense needs, to serve as a background for a decision on taxes. If Congress will not do that, it should wait and leave the opportunity for a new President to offer a new budget consistent with his view of the defense and non-defense needs.

The budget revisions just submitted by President Carter show an excess of revenues over expenditures in fiscal year 1984 of $34 billion, aside from the yield of the gasoline tax increase and withholding on interest and dividends, which the President proposed, and which the Congress gives no signs of enacting. That would seem to leave room for a tax reduction, which would be equal to about 7.75 percent of the revenues expected from the individual income tax in 1984. Such a conclusion would, however, be wrong for several reasons:

One. The new budget includes an increase of defense spending in real terms of 19 percent between fiscal 1980 and fiscal 1984, reaching a level equal to 5.7 percent of GNP in fiscal 1984. This rise is slow and the level attained is low, in light of the growing vulnerability of our defense posture.

I would suggest as a basis for financial planning that we will want to get defense spending up to 7.5 of GNP, about half way between our current ratio and the ratio of the Eisenhower years. That by itself would convert the apparent surplus of $34 billion to a deficit of $46 billion, before any tax reduction.

Two. The budget shows an increase of non-defense expenditures in real terms of less than one percent per annum between fiscal 1980 and fiscal 1984. This is by historical standards an extraordinarily small rate of increase. I am sure it would be possible to cut non-defense expenditures below that projection, but it will not be easy. The cuts will not be large, and we would not count on large

cuts without more evidence of commitment by the administration and the Congress than we have yet seen.

Three. The revenue estimates in the new budget revisions assume an average inflation rate of 8.7 percent between fiscal 1979 and fiscal 1984. That is much too high to be accepted as the goal of national policy. If we succeed in getting on the path of less inflation the revenue will be less, in real terms, because there will be less inflation creep.

It would be presumptuous for me to present an alternative budget. But until there is an alternative budget from a qualified source there will be grave doubt about the consistency of net tax reduction with our defense, economic, and budgetary requirements.

Several arguments are made for a decision now to cut taxes, and I will comment briefly on each of them.

1. There are some people who claim that a reduction of income tax rates across the board would raise, not reduce, the revenue. If this were true the case, for cutting taxes would be irresistible. There is, however, no convincing evidence that it is true.

2. The country is in a recession, and the standard text book prescription for a recession is to cut taxes. But this standard prescription looks irrelevant or dangerous today. The process of reducing inflation involves as an apparently inescapable byproduct a transitional period of economic slowdown and unemployment. It is not clear that the current recession will be deeper or longer than is inescapable if the effort to cure inflation is to have any chance of success.

Tax reduction at this stage is likely to confirm the common impression that the Government will not stick with its anti-inflation effort long enough to succeed. The result would be to set the stage for another wave of inflation. We would be left to face the problem of getting inflation down later, in still more difficult circumstances and at a cost of still more unemployment. The potential benefits of a tax cut now as a response to this recession are uncertain, and may be negative. They do not justify endangering our long run budget position.

3. The point is often made that if we do nothing, tax burdens will rise as a result of existing legislation and the inflation creep. This is thought to justify or require a tax cut, which in this context is called not a tax cut. But that conclusion does not follow. We start with a large budget deficit which we do not want to continue forever and we have expenditure increases in prospect. Cruel as it may be to say it, in these circumstances the tax increases now ahead of us are necessary.

4. My doubts about the wisdom of a tax cut are predicated on the belief that it is important to plan to balance the budget in 1983 and 1984 in ordinary economic conditions. It is, of course, possible to disagree with this. Several observations must be made about this issue.

First, I am not concerned about small amounts and I would not maintain that the difference between balancing the budget, and running a deficit of $5 or $10 billion is serious.

Second, if the choice is between balancing the budget and having an enlarged defense program, we should certainly prefer the enlarged defense program. If, however, the decisions to cut taxes is a

decision to run a deficit of, say, $40 or $50 billion or ore under ordinary economic conditions in 1983 or 1984 I would prefer to give the tax reduction.

The negative effects on economic growth from the deficit, which would crow private investors are out of the capital markets would outweigh the favorable effects of the tax reduction.

5. The inflation has seriously distorted the tax system. It has greatly increased the tax burden on the income from capital investment by raising the cost of replacing capital above depreciation recognized for tax purposes. It has raised individual taxpayers into brackets where they pay higher tax rates than were intended by Congress, rates which impair incentives to work, save, and take risks.

There is a strong case for correcting these distortions of the tax system, which are inequitable as well as impediments to economic efficiency and growth. But this is not a case for deficits or for net tax reduction. It is a case for revision of the tax structure, to reduce the particular taxes that have these adverse effects and raise others which do not, or have them in smaller degree.

For example, I believe there would be a substantial benefit from imposing a high gasoline tax—of at least 50 cents a gallon—and using the revenue it yields to reduce individual and corporate income taxes.

My own view of the situation is that we can make substantial reduction of the parts of the tax system that are most unfair and most harmful to economic growth, while meeting our defense needs and avoiding enormous, depressing deficits only if we will use alternative sources of revenue, such as a gasoline tax, on a large scale.

I recognize that everyone may not share my view of the need for a large increase of defense spending, of the substantial but limited possibility of cutting non-defense spending, of the importance of balancing the budget and the desirability of restructuring the tax system. But I find it hard to imagine disagreement with my initial point. We should not make a commitment to substantial tax reduction until we have a clearer picture of future budget requirements and more explicit agreement on future budget policy than we now have.

Thank you.

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

I think I should note, of course, that you are now with American Enterprise Institute, and the University of Virginia, and a former chairman of the Economic Advisors.

Mr. STEIN. That is right.

Senator BENTSEN. Now, we will proceed to hear from Dr. Otto Eckstein.

Dr. Eckstein, we are very pleased to have you.

STATEMENT OF OTTO ECKSTEIN, PRESIDENT, DATA RESOURCES, INC.

Mr. ECKSTEIN. Senator Bentsen, let me ask that you enter in the record my full statement, and let me here only make a few very summary comments. Also I hope that the committee will not be

discomforted by some disagreement with the previous panel, or indeed with my good friend, the previous speaker.

I think from a straight economic point of view, the tax or tax policy has very rarely been as clear, and the answer as clear as it is at the moment. The economy is in recession. The recession is quite severe. The tax system is scheduled to go through a $49 billion collection of tax increases. The energy price drag on the economy in 1981 will be $81 billion.

So it would take a very, very brave set of economic policymakers, even regardless of how keen on fighting inflation, to let all of those tax increases, and all of that energy purchasing power drain proceed at a time when the economy is in recession with no immediate prospect of getting out of it.

However, our forecasts do say that by early next year the GNP will begin to show increases, and Dr. Burns is certainly correct every cycle has many common features, and certainly one of those is the self-correcting tendency of inventories to decumulate and finish, and of course the easing of financial conditions does lead to the recovery of housing.

But the recession is not over. The inventory correction lies almost entirely ahead. The decline in business capital investment lies ahead, so the recession will surely stretch on through the end of this year, and perhaps in the next.

So from a short-run point of view, we really are taking a major chance in letting these enormous tax increases occur in the midst of a fairly severe recession. But there was a conflict between long and short-run goals, I would go along with everybody else who appears here and say, it is the long-run problem that matters.

But the fact is that even in the long-term situation, the case is very clear. We all agree, I know of no observers anywhere who quarrel seriously with the proposition that we must raise capital formation, that we must accelerate productivity, that we must improve our international competitive position.

Furthermore, as far as I know, every serious student agrees that the one way we can accomplish that central goal of economic policy of the 1980's is by corporate tax reform, and that depreciation, and perhaps investment credits are well established devices used repeatedly by Presidents Eisenhower, Kennedy, and Nixon, and each time with success.

So we know what we have to do. We know that the recession poses a unique opportunity to do it, and to do it now. So you then really have to ask yourself, how do we wind up in the situation where the perfectly obvious somehow, apparently, cannot be done.

I think there are two or three sets of argument, and some of them have some merits and some of them don't. Let me first deal with the economic argument that to the tax cut now, rather than 9 months from now, which I think is the realistic choice, will reignite inflation.

While I think to speak of reigniting inflation is to look at roaring fireplace and say, you put one more piece of paper and it will reignite. The inflation is continuing. There is no question that there is a flashpoint here, but we are way past it.

It is true that the inflation will be worsened by accelerating this tax reduction by 9 months. The difference is a fraction of one-tenth

of 1 percentage point, and even that is only true for 2 or 3 years because by year 3 the benefits you are getting out of the extra productivity and the extra capital formation will fully offset that minuscule inflation effect that you would get by speeding it up a little bit.

So I really think that the inflation issue is not a good argument for waiting from doing what we all know we must do on the supply side of the economy, and get productivity rolling again.

On the political side, there of course you are better equipped than I to consider whether the tax cut enacted in August or September of 1980 is so much worse than a tax cut that would be enacted in January, February, or March of 1981.

For one thing, no one knows who the players will be in January, February, and March of 1981, and I am especially puzzled by the opposition of the administration not to enact the tax cut that it wishes, considering that at this time it is in office.

Let me give you a kind of a minimum, and in this I am responsive to the questions of Senator Ribicoff, on what I think you should do. If you tell me that you cannot do that this year, then I say, by golly, wait, because then, indeed, perhaps in 1981 we have a chance at a better tax cut.

I think the minimum that you should do now, or else forget it until next year, is this: First, you should cut taxes in toto by about $30 billion. The $30 billion would offset $30 billion out of the $49 billion of the swing in the full employment budget. So it would leave the budget swing to a tightness, and leave a sizable full employment budget surplus, even at an unemployment rate definition of 6.1 percent.

Second, I think you should try for a 50-percent devotion of those $30 billion to corporate reduction through depreciation reform, not quite as ambitious as 10-5-3, but the Treasury or maybe our own staff could give you a version of 10-5-3, which would distinguish among classes to a degree that would not be as generous to buildings, and would not treat all equipment as if it wore out in 5 years, and that would cost a more reasonable sum.

Indeed, you could not in 1 year accomplish the $15 billion reduction by that measure. You would have to modify the approach somewhat. You might even initially have to supplement the phasing in of the depreciation reform with a business tax break that might give some credit for social security taxes, or perhaps a bit more of the investment tax credit itself.

If you tell me that you cannot do 50 percent at this juncture, but you can do 40 percent, I would say, go ahead. If you tell me that you can only go back to the historical 33 percent-67 percent split between businesses and households, then I say, wait, because you are accomplishing not enough in terms of our long-term problems to make the speeding up or the getting it over with now worthwhile.

On the personal side, I would say that it is very, very difficult to prove that one kind of personal tax reduction is more effective than another. So it really is a matter of the income class that you favor, and there are some differences there between Republicans and Democrats, to whom you will give the tax break.

My own sense of it, and I did serve in a Democratic administration, is that if you devote half of the tax cut to business, you have already done quite a bit for the property holding classes of the country, and you should then devote the other half of the tax cut to the working people who, indeed, have suffered the largest increases in the burden of taxation.

The burden on the median worker in this country has risen by over 50 percent in the last 15 years. We have been fairly generous to the people at the bottom of the scale, and fairly generous to the people at the top, but we have left out the $12,000 to $24,000 a year family that earns its income from wages. The social security credit that is now one of the many proposals now in the air, would be favorable to that group, so why not do it.

You can do it in other ways, if you don't wish to mention the words social security in connection. Obviously, the Treasury in about 10 minutes could give you a rate schedule which could accomplish the same thing.

Where do I wind up? I wind up, really, in leaving the judgment to you. If you can give me the $30 billion cut, preferably 50 percent, or at least 40 percent for business, most of it for depreciation, investment credits, things that will get productivity going, then I say, for God's sake do it, because the logic on economic grounds has never been simpler, except perhaps at the very bottom of the 1975 recession.

If you can't do that, then, well, by golly, let's wait, maybe we will do better with changed personalities, politics forgotten after election, as some people now believe.

Senator BENTSEN. Thank you, Dr. Eckstein.

Let me say to the members of the committee that Dr. Eckstein is president of Data Resources, and many of you, I am sure, have met him. He has done a substantial amount of work for the Joint Economic Committee, and has developed a very interesting and helpful econometric model, isolating the demand side and truly measuring the supply side, which was quite helpful to us.

Our next witness will be Dr. Martin Feldstein, who is a professor of economics at Harvard University, and one who has taken quite a leadership role in some of our new thinking on economics today.

STATEMENT OF MARTIN FELDSTEIN, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Mr. FELDSTEIN. Thank you, Mr. Chairman.

I have a brief statement, and I will read part of it. First let me just summarize my own position.

I think there is a clear conflict now that has come out in the discussion already between the requirements of good tax policy, and a correct concern about exacerbating inflation by a larger deficit in 1981 and 1982.

I do believe that we need to cut tax rates on individuals, and on businesses in particular, in order to reduce current disincentives for saving, investment, and personal effort. Frankly, those changes are needed just to give people back a larger share of the money that is theirs, and that they have been losing because of inflation's impact.

The next 2 years are also crucial for reducing inflation, and bigger deficits will make that much harder, and will make the conduct of monetary policy much harder. But I think there is a solution to this conflict. Indeed, I think there are two quite different but compatible solutions, and that is what I emphasize in the statement.

First, as I will explain, by enacting now a series of tax cuts for the future, aimed particularly at savings and investment, but also including broad rate cuts, I think we can achieve the immediate effects on incentives that we want. The revenue loss however, is essentially postponed to the future.

I think that this is not a case for postponement and gradual phase in of the incentive effect. It is a case for phasing in rate reductions in a way that postpones the deficits, while giving us the favorable incentive effects now.

The second aspect of the solution is to emphasize saving incentives. As you know, and as the whole discussion has gone this morning, in the short run an increase in government deficits, and for that matter an increase in private investment, would add to demand and be inflationary. But an increase in savings in the next couple of years would reduce demand, and offset that inflationary impact.

So to the extent that the policies are capable of stimulating private savings, and I think this can readily be achieved by a precommitted phase in of the sort that I will describe, we need not worry so much about exacerbating inflation.

That is quite apart from the longer run supply side effects that result from increasing the capital stock, and increasing productivity. There is a good old fashioned Keynesian argument that says that if we have more savings in 1981 and 1982, we will have less inflationary pressure on the economy.

Let me turn to the first half of my prepared statement. I think that these hearings are uniquely important because of the vast increase in tax receipts that inflation has produced, and can be expected to go on producing in the next few years. You can use this expanded revenue by enacting now a multiyear program of tax cuts that will reduce some of the existing strong disincentives to capital formation.

If this is done in the right way, I emphasize that, such a multiyear tax cut could bring immediate increases in investment, saving and individual effort without any unwanted increases in the Government deficit, either now or in the future.

I want to explain how a precommitted series of tax cuts can have that desirable effect. I will give some examples but I will be happy to return to this either in the questions, or privately with you or members of the staff to work out more in more detail.

The most important thing to consider when thinking about a tax cut strategy is that all important economic decisions are based on expectations about the future. What matters for current actions—investment, savings, the choice of jobs—is not the current tax rates but the tax rates that are expected in the future.

Congress can therefore improve current incentives without any increase in the current deficit by enacting now a schedule of future tax cuts. These precommitted tax cuts can be financed as they

occur out of the automatic revenue increases produced by inflation, and out of the savings that could result from a slowdown in the growth of Government spending.

Indeed, the very commitment to a schedule of future tax cut could give Congress and the Government agencies time to shape spending plans to the lower level of available revenue. Thus, while an immediate tax cut generally means an increase in the deficit, precommitted future tax cuts can change incentives without such deficits.

Consider the problem of stimulating individuals to save more, which I think really is the central one. Today, the combination of inflation and high tax rates makes the real after-tax return negative for many individuals. To stimulate saving, the key requirement is, therefore, to raise the real after-tax return that savers can expect to receive in the future on additions to their assets.

One simple and direct way to achieve this would be to treat interest and dividends like capital gains. That is, excluding 60 percent of all interest and dividends from taxable income. But, of course, if this were done in 1981, all at once, the revenue loss would probably exceed the increased saving.

The Government's borrowing to make up for that revenue loss would absorb more than all of the increased saving, so that the amount available for investment in plant and equipment would actually go down rather than up.

But what if a 60-percent exclusion of dividend and interest were enacted now, with its effective date postponed until 1985? The Government would clearly lose no revenue in the next 4 years. But households would have a strong incentive to start saving more immediately in order to have more assets on which to take fuller advantage of the lower tax rate when it became effective.

I think starting with a small exclusion in 1981, and allowing it to rise gradually until 1985 would make the prospect of the full future exclusion more credible and more visible, and wouldn't change the fundamental point that the initial immediate increase in saving can be very substantially greater than the current increase in the deficit.

This same idea of a precommitted tax cut can work to stimulate investment. Consider the effect of a major cut in the corporate tax rate, say, from the current 46 percent to 36 percent, that is enacted now with an effective date in 1985. Although there would be no change in tax rates from 1981 through 1984, firms would have a substantial incentive to increase their investment spending immediately because investments made during the next 4 years would benefit from depreciation at the high tax rates, while the subsequent profits when they came on stream would be subject to lower tax rates. Again, I think a gradual phase-in would make this more credible and more visible.

The key idea of stimulating investment without concurrent deficits is feasible. Indeed, that is exactly what would happen if one moved from the current system of historical depreciation, to an indexed system of depreciation. It self-phases in, and there would be very little revenue loss in the first year, and substantial revenue loss later, but there would be an immediate incentive for substan-

tial investment. By comparison, 10-5-3, which I think is a reasonable compromise, has more front-loading of the revenue loss.

For personal rate cuts, a slow but certain phasing-in would also achieve most of the benefits of the large immediate rate cut without a large revenue loss. An individual who is trying to decide whether to change jobs, to relocate, to invest in training, or just to work harder in the hope of better promotions, will look at future tax rates rather than adjusted current tax rates.

Because a gradual phase-in could be financed by automatic inflation tax windfalls, and by a gradual reduction in the growth of Government spending, tax rates could be reduced by at least 30 percent over a few years without any deficits.

In short, the supply side tax-cut goal of increasing incentives without budget deficits can be achieved in this way without depending on any miraculous short-run response by the labor supply or productivity. And to the extent that increases in individual effort and in capital accumulation raise national income over time, there will be greater tax revenues with which to finance either Government spending or further tax reductions.

I have emphasized that the extra tax revenue that inflation will produce can be used to finance real tax cuts. As you know, because of the progressivity of the tax schedule, each 10-percent increase in total personal income raises individual tax collection by about 16 percent and, therefore, provides the possibility of a 6-percent real rate cut without any reduction in the ratio of personal taxes to personal income.

In other words, one could plan over a period of 4 or 5 years to cut personal rates by 25 percent, without any reduction in the ratio of personal taxes to personal income.

Pruning the share of personal income that goes to Federal personal taxes—not even counting the social security payroll tax—back to the ratio of 15 years ago would permit an additional real tax cut of 16 percent. In other words, we have had an increase of 16 percent in the share of personal income going to personal taxes over that period.

Cutting the effective tax rate on corporate capital income back to where they were 15 years ago would reduce that revenue by nearly 30 percent. In other words, there has been an increase of more than 30 percent over that period in the effective tax rates on capital income.

The total tax cut, combining inflation givebacks and real reductions, can easily be between 30 and 40 percent over the next 4 years. I think that this really does provides a unique opportunity for a series of tax changes that reduce the disincentives in the current tax structure. It is crucial not to let this opportunity be wasted in either increased Government spending, or simple across-the-board reductions in personal rates.

As to whether this should be done now, or after the election, I think as my colleague, Otto Eckstein said, you are a better judge about the feasibility of a tax cut of this form. If all we could get now would be a one-shot personal rate cut, I would favor postponement. But I tend to be an optimist, and hope that you can do better than that even in the short time.

Thank you.

Senator BENTSEN. Thank you very much.
I will recognize Senator Packwood.

Senator PACKWOOD. Herb, your position is clearly no tax cut now, and probably no tax cut next year. Is that right?

Mr. STEIN. Yes. If I thought that the Congress would enact something like a very large gasoline tax that would provide room for other things, but if not, no.

Senator PACKWOOD. Otto Eckstein, if the tax cut that we enact now is not a minimum of 40 percent business reductions, and preferably 50 percent, you would not recommend a tax cut now?

Mr. ECKSTEIN. That is correct, Senator.

Senator PACKWOOD. Marty, if within the next few weeks, we are faced with what we had before on the floor—a 10-percent individual tax cut plus a phase-in of 10-5-3, but for the first couple of years it is a very low phase-in and tremendous individual reductions—would your position on that also be no?

Mr. FELDSTEIN. I would have to see what the phase-in looked like. Coupled with a phase-in of 10-5-3 it may produce, depending on just how it is done, incentives to postpone investment rather than to do it sooner.

Senator PACKWOOD. Jack might be able to give you the exact phase-in, because I believe he was a cosponsor of it. Basically, you had roughly $20 billion in individual revenue losses for the first couple of years, and around $2 to $3 billion on the depreciation loss.

Mr. FELDSTEIN. I don't think the revenue loss is the key issue on the phase-in of 10-5-3.

Senator PACKWOOD. I understand that.

Mr. FELDSTEIN. If it were not 10-5-3, but an indexation of depreciation, which would also have a very low revenue loss for the first couple of years, then I would accept that fact because I would basically think that that together with a tight monetary policy would work out to increase investment in the business sector.

Senator PACKWOOD. In the first couple of years, what percent of the tax cut in fiscal 1981 and fiscal 1982 should be business, does not bother you so much.

Mr. FELDSTEIN. I don't look at the revenues so much as I look at the incentives. I think you can have very little revenue loss, and still have very powerful incentives.

Senator PACKWOOD. Let me ask you this question.
I don't see where the particular incentive is to reduce individual tax cuts. I am not sure what it produces in terms of investment incentives.

Mr. FELDSTEIN. In terms of investment incentives, it doesn't. In terms of job choice, effort, and willingness to accept responsibility, I think that it does affect incentives.

Senator PACKWOOD. What if we were going to have a large individual tax cut, effective January 1, 1981, but no withholding during that year, so that the immense Treasury loss came in the second year?

Mr. FELDSTEIN. Don't change the withholding.

Senator PACKWOOD. No change in withholding, means that the Treasury will be faced with a huge repayment of overpayment of taxes in April 1982, but you have no immediate loss in 1981.

Mr. FELDSTEIN. To some extent that would ease the inflationary pressure. To some extent people would act on the knowledge that they were going to get that refund.

Senator PACKWOOD. I am taking your theory of certainty, that they know it is coming, and they will count on it, and plan for it.

Mr. FELDSTEIN. If they know that it is coming and they don't have any shortage of liquidity, or they can borrow against it, then, you don't accomplish anything by postponing the rebate. People will essentially spend that rebate in advance.

Senator PACKWOOD. Now I am confused. As long as people could count on it, it would not be as inflationary as immediate tax cuts, but it was the certainty that was critical.

You might as well make it effective immediately, because you are no better off.

Mr. FELDSTEIN. I think you gain very little in terms of the antiinflationary pressures by a 1-year postponement of the actual cash receipt.

Senator PACKWOOD. OK.

Thank you, Mr. Chairman.

Senator BENTSEN. Thank you very much, Senator.

Let me apologize to you, gentlemen, I have another commitment that I have to make.

Senator Danforth, go ahead, because I have to go.

Senator DANFORTH. Thank you, Mr. Chairman.

Following up on the comments of Professor Feldstein, back in 1978, when we were going through the drill then of what kind of tax cut we should have, Senator Javits and I were proposing a phased corporate rate cut which would extend over a period of several years, and it would knock-off, maybe, a couple of points from the corporate rate a year, down to 40 percent, or 42 percent, or however low we could go.

The theory behind that was exactly as stated by Professor Feldstein. Business investments are made with a view toward down-the-road rate of return. In fact, he may have given us the idea.

Then as we were thinking about it, there was at least some thought, and it was never really analyzed in any great depth, but could it work the other way also, granted that the certainty would not be there. The original thought was, could there be a surcharge on the income tax to pay for the cost of excess Government spending. That is, if it were geared to imbalance in the budget, or whatever, you could have an item on the income tax return in April which required a separate computation to finance excessive government spending. So you would have a highly visible item on the income tax return forcing the taxpayer to make the computation, and to fill out the check, and having denominated as an excess Government spending tax.

Then there was a further gloss on that proposal that was proposed by Senator Nunn, as I recall, which was, if you are going to do something like that, why not have a phased tax cut over a period of years. However, each year's phase-in would be contingent on certain spending restraints by Congress. What do you think of that, and I would like just anybody's thoughts on that.

Mr. FELDSTEIN. I don't think I can predict how Congress would react to that, and that is really what the question is.

Senator DANFORTH. No, I am just asking three economists how they view the concept as being.

Mr. FELDSTEIN. If you take away the predictability of, let us say, the corporate rate cut because you have made it contingent upon the good behavior of Congress in restraining its spending, then I think you lose the advantage of getting the predicted increase in investment based upon the expectation of the rate cut. Only as it materializes will it begin to have any effect, so I don't think you really gain much by a phase-in of that sort.

The real advantage would be as incentive to Congress to curtail its spending increases, and I don't want to guess how that would work out.

Mr. ECKSTEIN. Senator, on this issue, I side with Dr. Stein rather than Dr. Feldstein.

I don't believe that it is possible to persuade the American people that the Government will follow a certain fiscal policy year after year, regardless of what legislation you pass, quite independent of the inability of one Congress to commit the next.

The uncertainties that we have in the world, our relationship with the Soviet Union, and a variety of other problems with OPEC, and so on, really make it unknowable what a fiscal problem is going to be 2 or 3 years down the road.

I don't believe that you can create a happy dream world where you can tell business that this is what is going to happen 4 or 5 years down the road, when they do their arithmetic, and then they accelerate or delay whatever it is.

There are other uncertainties in this life besides the variations that the Congress, for no good reason, might do to the tax system. So I am very skeptical of expectational arguments.

I think there is a short-run expectational argument here, though, of delay. I do believe that the way we are now going about this tax debate, where we are creating a situation of raising everyone's hope that tax cuts will come 9 or 12 months from, is going to hurt investment in the short run.

If you were the purchaser of an automotive fleet, or if you were the undertaker of very large, very costly capital projects, you could not ignore the fact that an investment credit, or a depreciation reform is being held out to you if you wait. I do believe the Congress may have to face the issue of what it will tell the public before it goes home about what it is going to do, so that it will not have a disincentive effect on investment over the next 9 months.

Senator DANFORTH. What do you think about this other concept of the phase-in or contingent phase-in of the excess spending?

Mr. ECKSTEIN. If you can tell me what excess spending is?

Senator DANFORTH. It is just an idea, but suppose you were to say, well, the deficit is X dollars, and we are going to recover that.

Mr. ECKSTEIN. If you really are going to require the budget indirectly to be balanced every year by automatically raising taxes to make up whatever deficit we have stumbled into, then of course you would be in the world of the rigidly annually balanced budget, which would work better than a lot of what we have done.

Again, if you are dealing with an international crisis with the Soviet Union or OPEC, it can become a very destructive feature.

Mr. STEIN. I think one's attitude to this kind of proposal depends very much on your attitude toward public spending. I think a couple of years, I would have been one of those who thought, anything you cut out of the Government is a gain, and the more we can constrain the Senate to cut anything out of the budget, the better off we are.

But once you become concerned, as I am and I think many people are now, with our security problem, and with the thought that our great danger is that we will spend too little for the national defense, rather than too much, you have to become rather cautious and discriminating about the kinds of pressures you put on the expenditure side of the budget.

So if you would revise your plan to say that we will give a tax cut in proportion to the extent to which nondefense spending falls short of 14 percent of the GNP, I would be happy with that. If you are going to make it rigidly felt around the total budget, I would be afraid of the way the defense program would fare in a Congress which is rather divided between doves and hawks.

Senator DANFORTH. Let me ask you one other question.

Assuming that there is going to be a tax cut, and assuming that *x* dollars, whatever you want to assume, will be for individuals. That is the given you have to work with. What should be done with that individual component?

I think Professor Eckstein indicated that he favored the social security credit, or something like that. But the various ideas would include indexing; they would include rate cuts across-the-board; they would include saving specific tax cuts, for example, capital gains reductions or exclusions for interest and dividends. In the social security area, they could include either the credit or the financing of medicare out of general revenues. Maybe there are other possibilities also.

Supposing we had the 50-percent individual cut. Supposing we had, let us say, $30 billion total, and $15 of that was going to be for individuals, how would you rate those?

Mr. STEIN. I would favor the indexing. The distribution of the increased tax burden as a result of inflation has no basis in equity, or in any congressional decision, and the fairest thing is to correct that first.

Mr. ECKSTEIN. I think it is basically a social policy question rather than an economic question. I have lots of sympathy with getting rid of the rates above 50 percent which I believe are a form of self-deception. You have to weigh the entire tax package, and given the fact that we would like to give half of the tax package to a tax cut, I would be inclined to then devote the other half to a kind of tax break that helps middle-income workers.

Mr. FELDSTEIN. I would definitely not offset the social security. I think that the social security program is becoming more costly, and it is important that people understand that they are paying a high payroll tax to sustain these high levels of benefits.

If they don't see that, if it is disguised by camouflaging it with a concurrent just offsetting, or greater than offsetting increase in income taxes, then I don't think we will get the pressure for the kind of reforms that are appropriate in the social security area.

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To the extent that something could be done specifically to focus the personal cut on savings, I think that that is a real plus. As I indicated that would be useful from the anti-inflationary point of view in the short run, and from a capital formation point of view in the long run.

When you get down to the general rate cutting, I think indexation is the direction to be going over the long run. However, but I do think there is a case for rate reduction before that, particularly at the high end. So I would like, ideally, to see more done particularly at these top rates. I think even the so-called 50-percent limit on earned income is very far from effective. Some of the revenue loss could be used in tightening up, in making more effective that actual limit on earned income.

Senator DANFORTH. If we are faced with a choice between rate cuts and the social security credit, and it may well come down to that. Marty, you would favor the rate cuts, I take it?

Mr. FELDSTEIN. In a sense, it seems to me the social security credit would be done as a rate cut. So how you tell them apart really just depends on the issue of timing and the exact structure of the rate cut. I would like the social security extra withholding to come in and be noticed on January 1. If you gave rate cuts, which in effect offset it, but which did not take effect April 1, that would still help people to notice the extra withholding.

Senator DANFORTH. That could be done.

Mr. FELDSTEIN. Sure.

Senator DANFORTH. In fact, that is the way that it would work. It would be a credit for 10 percent of social security, or whatever. You pay your social security tax, but you just get it back in your income tax.

Mr. FELDSTEIN. I think that principle is a bad one. I think actually linking it and telling people that we have now done an end run to general revenue for social security is a bad thing. I thought that the alternative was simply to change the rate structure for the income tax to offset this increase.

Senator DANFORTH. So you would favor a rate cut. There is a question of, in fact, how you divide it up.

Mr. FELDSTEIN. I would favor a rate cut, but I would also favor not doing it concurrently just for this educational value of having people realize that they are paying these extra taxes for social security.

Senator DANFORTH. Otto, you would favor the social security?

Mr. ECKSTEIN. I would favor a change in the income tax rate schedule. It is a cleaner way, and I do believe that it is better to have social security stand on its own. My concern is more with the incidence among income classes. Most people when they say a rate cut really a proportionate rate cut, or working on the top rates.

Most of these rate changes do not do much for the typical median worker. So I am really concerned on targeting some of the money on people——

Senator DANFORTH. You would have a rate targeted toward the median income.

Mr. ECKSTEIN. The $12,000 to $22,000 worker.

Senator DANFORTH. As opposed to computing the credit on the basis of *x* percent of social security annually?

Mr. ECKSTEIN. Yes.

Senator DANFORTH. Do you have an opinion, Dr. Stein?

Mr. STEIN. I would favor the rate cut. I don't like the thought of what Marty calls the end run. I think if you are going to go to the general revenue financing of the social security system, you should face that and make a decision, and not make a tax expenditure out of it.

Anyway, I don't think we should do that. I think that the route by which these middle income people got such high tax burdens, aside from social security, was the inflation, and indexing will at least keep them from another step in that direction.

Senator DANFORTH. How about financing medicare out of general revenues, would that solve your problems?

Mr. STEIN. Where is the general revenue?

Senator DANFORTH. Isn't it the same for any kind of tax cut? You have a revenue loss for tax cuts. It is another version, isn't it, except instead of increasing the social security taxes by so much, you finance medicare out of general revenue.

Mr. STEIN. It is another label you paste on social security rate cut.

Mr. FELDSTEIN. It is really just designed to hide from the public the fact that the OASDI part has become more expensive.

Senator DANFORTH. That is right.

Mr. FELDSTEIN. That does not seem to be very efficient.

Senator DANFORTH. But I mean, first of all, there is a difference between health insurance and old age and survivors insurance? Not everyone gets sick. It isn't really linked to medical care, and it is not necessarily linked to wages, or how much make, or how long you have been in a particular job.

I take it that there would not be any particular enthusiasm for that approach.

Mr. FELDSTEIN. Apparently not. [Laughter.]

Senator PACKWOOD. During the period the witnesses have been testifying, almost everyone has talked about foreign competition, and that some of our European trading competitors don't tax capital as heavily.

I notice in the OECD bulletin that almost all of our major trading competitors, save Japan, tax a much higher proportion of taxes in relation to the gross national product than do we. In fact, in most of the European cases, it is somewhere between 9 and 20 percent more than we do.

However, is it true that they heavily tilt their taxes, toward consumption taxes, and that middle and lower income people would pay a higher proportion of income in taxes in those major trading competitors than in the United States?

I don't know how they can have lower capital gains, and less taxes on capital, and tax more of their national product without somehow tilting their taxes toward the lower end of the scale.

Mr. FELDSTEIN. I think that this is what they do, and they tilt it toward consumption rather than savings within any given income class.

Senator PACKWOOD. Anything you tilt toward consumption is bound to tilt toward the middle income, and the lower income classes in terms of the quantity of money that it produces.

Mr. FELDSTEIN. You know, the amount of money that the capital gains tax collects is very small. The amount that we collect on dividend income is relatively small. There would be some tilting, but you could, in effect, tax luxury items, as many of these countries do, and collect the same revenue from upper-income classes without specifically taxing savings.

Senator PACKWOOD. Would a worker in a steel factory in Germany be more likely to pay more of his or her total income in taxes than a steel worker in the United States, counting your State, local and Federal taxes?

Mr. ECKSTEIN. I would doubt it.

Senator PACKWOOD. You would doubt it?

Mr. ECKSTEIN. I think the biggest difference, certainly in a country like France, is that employers pay much larger charges on their payrolls. That is, some activities which here are private, there are public, and they are heavily financed out of employer taxes.

Now, of course, these are taxes on payroll, and such that are passed forward in higher prices. So they do tend to have a higher burden of indirect taxes which get into higher prices.

I think the level of taxes between the United States and the continental countries, either of business or of higher income individuals, is not as different as we sometimes think. All these countries, really, have tax systems that are quite burdensome.

Senator PACKWOOD. Herb?

Mr. STEIN. I cannot add anything to this kind of evidence, except to express a skepticism about the frequent allegation that there is a great difference between us and the rest of the world in rates of productivity growth which can easily be explained by these tax differences, because the tax differences have existed for a long time, and it is hard to see quantitatively that they explain what is going on here.

Mr. FELDSTEIN. I think that it is true that our taxes on capital income have moved up very substantially in the last 15 years because of the interaction of inflation and our tax system in a way that has not affected the French, and even the English, because they have much more accelerated depreciation rules and don't tax capital gains, let alone nominal capital gains. They have avoided some of this very sharp increase.

I think that the difference, although I don't know it to be a fact, an effective tax rate on capital income has really changed a lot in the last 15 years, and with it the incentives for investment.

Mr. ECKSTEIN. But those statements are only true if you go through rather synthetic calculations which restate profits and the depreciation for inventory valuation, and so on. If you look at the actual revenues collected, certainly on corporations, the percentage of in relation to the GNP or in relation to stockholder reported earnings has plummetted.

Mr. FELDSTEIN. But you must not look at and think just of the corporations as taxpayers. You have to look at their creditors, and shareholders who are paying a large part of the tax.

What has happened, as I am sure you know, is that there has, in effect, been a reduction, or a shift in the tax burden from the corporations to their creditors to a large extent.

Senator PACKWOOD. That is what I was trying to conclude. If this OECD chart is right, Germany taxes about 42 percent of the gross national product. We tax about 32 percent of it. If somehow, they don't tax capital formation as heavily, they have got to be taxing something else. I don't know what it is, or how they tax it.

Mr. ECKSTEIN. They don't have our defense burden, we know that.

Senator PACKWOOD. That is right.

Mr. ECKSTEIN. They do count as taxes, however, other things that in this country do not count as taxes. That is, the medical system is much more elaborate. The general social services are more elaborate. The utilities are public and subsidized. So they are really collecting back through charges of this sort, and taxes related to these functions.

Senator PACKWOOD. That we often have business perform here. Conversely, you have Japan down at 20 percent, but their business provides a lot of things that would otherwise be provided by a government, and they absorb the cost, they have a very, very high proportion of their wage and fringe benefits, which gives a low percentage of gross national product that is taxed.

Mr. ECKSTEIN. That is right, Senator.

Senator PACKWOOD. Thank you very much.

[The prepared statements of the preceding panel follow:]

STATEMENT OF HERBERT STEIN, UNIVERSITY OF VIRGINIA AND AMERICAN ENTERPRISE INSTITUTE*

I am pleased to have the opportunity to present my views on the difficult and delicate question of tax reduction.

A decision at this time to reduce tax rates would, in my opinion, be unwise. Such a decision will reduce the Federal revenues, below what they would otherwise be, for years to come. Congress should not do that unless it has reasonable assurance that the reduction of revenues will be consistent with sound budgetary and economic policy. That assurance is not available today.

The big problem is national security. I believe that the country needs, and will discover that it needs, a much larger increase of national defense expenditures than is contemplated in the Administration's budget or in Congressional action to date. The Congress should be sure that it does not seriously weaken the possibilty of meeting our defense needs by cutting the revenue before the defense needs have been carefully assessed. The great danger is that we will create a situation where the revenue is inadequate and where provision for the national security is squeezed by a combination of reluctance to raise taxes, reluctance to cut non-defense spending and reluctance to run large deficits. The consequences of failure to provide adequately for the national security would be enormously more serious than the loss of one or two tenths of a percentage point in the rate of economic growth that might result from failure to make the best tax cut at the earliest possible moment.

There is no urgency which requires a decision to cut taxes before there has been thorough evaluation of our budget requirements for the next several years, including our defense requirements. In March I proposed to the Senate Budget Committee that it should establish a Subcommittee on Paying for Survival, which would recognize our possible defense needs and consider ways to finance them. Unfortunately, that advice was not taken. I believe that this Committee or the Senate Budget Committee should now initiate a reconsideration of our medium-term budget outlook, in light of our defense needs, to serve as background for a decision on taxes. If Congress will not do that it should wait and leave the opportunity for a new President to offer a new budget consistent with his view of the defense and non-defense needs.

The budget revisions just submitted by President Carter show an excess of revenues over expenditures in Fiscal Year 1984 of $34 billion dollars, aside from the

*The views expressed here are personal and do not necessarily reflect the opinion of the American Enterprise Institute which, as an organization, takes no position on policy questions.

yield of the gasoline tax increase and withholding on interest and dividends, which the President has proposed. That would seem to leave room for a tax reduction, which would be equal to about 7¼ percent of the revenues expected from the individual income tax in 1984. Such a conclusion would, however, be wrong for several reasons:

1. The new budget includes an increase of defense spending in real terms of 19 percent between fiscal year 1980 and fiscal year 1984, reaching a level equal to 5.7 percent of GNP in fiscal year 1984. This rise is slow and the level attained is low, in light of the growing vulnerability of our defense posture. I would suggest as a basis for financial planning that we will want to get defense spending up to 7½ percent of GNP, about half way between or current ration and the ratio of the Eisenhower years. That by itself would convert the apparent surplus of $34 billion to a deficit of $46 billion, before any tax reduction.

2. The budget shows an increase of non-defense expenditures in real terms of less than one percent per annum between fiscal year 1980 and fiscal year 1984. This is by historical standards an extraordinarily small rate of increase. I am sure it would be possible to cut nondefense expenditures below that projection. But it will not be easy, the cuts will not be large and we should not count on large cuts without more evidence of commitment by the Administration and the Congress than we have yet seen.

3. The revenue estimates in the new budget revisions assume an average inflation rate of 8.7 percent between fiscal year 1979 and fiscal year 1984. That is much too high to be accepted as the goal of national policy. If we succeed in getting on the path of less inflation the revenue will be less, in real terms, because there will be less inflation creep.

It would be presumptuous for me to present an alternative budget. But until there is an alternative budget from a qualified source there will be grave doubt about the consistency of net tax reduction with our defense, economic and budgetary requirements.

Several arguments are made for a decision now to cut taxes, and I will comment briefly on each of them.

1. There are some people who claim that a reduction of income tax rates across the board would raise, not reduce, the revenue. If this were true the case for cutting tax rates would be irresistible. There is, however, no convincing evidence that it is true.

2. The country is in a recession, and the standard text book prescription for a recession is to cut taxes. But this standard prescription looks irrelevant or dangerous today. The process of reducing inflation involves as an apparently inescapable by-product a transitional period of economic slowdown and unemployment. It is not at all clear that the current recession will be deeper or longer than is inescapable if the effort to cure inflation is to have any chance of success. Tax reduction at this stage is likely to confirm the common impression that the government will not stick with its anti-inflation effort long enough to succeed. The result would be to set the stage for another wave of inflation. We would be left to face the problem of getting inflation down later, in still more difficult circumstances and at the cost of still more unemployment. The potential benefits of a tax cut now as a response to this recession are uncertain and may be negative; they do not justify endangering our long-run budget position.

3. The point is often made that if we do nothing tax burdens will rise as a result of existing legislation and the inflation creep. This is thought to justify or require a tax cut. But that conclusion does not follow. We start with a large budget deficit which we do not want to continue forever and we have expenditure increases in prospect. Cruel as it may be to say it, in these circumstances the tax increases now ahead of us are necessary.

4. My doubts about the wisdom of a tax cut are predicated on the belief that it is important to plan to balance the budget in 1983 and 1984 in ordinary economic conditions. It is, of course, possible to disagree with this. Several observations must be made about this issue. First, I am not concerned about small amounts and I would not maintain that the difference between balancing the budget and running a deficit of $5 or $10 billion is serious. Second, if the choice is between balancing the budget and having an enlarged defense program, we should certainly prefer the enlarged defense program. If, however, the decision to cut taxes is a decision to run a deficit of, say, $40 or $50 billion or more under ordinary economic conditions in 1983 or 1984 I would prefer to give up the tax reduction. The negative effects on economic growth from the deficit, which would crowd private investors out of the capital markets, would outweigh the favorable effects of the tax reduction.

5. The inflation has seriously distorted the tax system. It has greatly increased the tax burden on the income from capital investment by raising the cost of

replacing capital above the depreciation recognized for tax purposes. It has raised individual taxpayers into brackets where they pay higher tax rates than were intended by Congress, rates which impair incentives to work, save and take risks. There is a strong case for correcting these distortions of the tax system, which are inequitable as well as impediments to economic efficiency and growth. But this is not a case for deficits or for net tax reduction. It is a case for revision of tax structure, to reduce the particular taxes that have these adverse effects and raise others which do not, or have them in smaller degree. For example, I believe that there would be a substantial benefit from imposing a high gasoline tax—of at least 50 cents a gallon—and using the revenue it yields to reduce individual and corporate income taxes.

My own view of the situation is that we can make substantial reduction of the parts of the tax system that are most unfair and most harmful to economic growth, while meeting our defense needs and avoiding enormous, depressing deficits only if we will use alternative sources of revenue, such as a gasoline tax, on a larger scale. I recognize that everyone may not share my view of the need for a large increase of defense spending, of the substantial but limited possibility of cutting non-defense spending, of the importance of balancing the budget and of the desirability of restructuring the tax system. But I find it hard to imagine disagreement with my initial point. We should not make a commitment to substantial tax reduction until we have a clearer picture of future budget requirements and more explicit agreement on future budget policy than we now have.

A Program of Tax Reductions—Testimony by Martin Feldstein*

Thank you, Mr. Chairman. I am very pleased to be with your committee again. I think that the current hearings are uniquely important. This should not be just another tax cut to stimulate employment. There is a unique opportunity at the current time to legislate a program of tax reductions that can have a profoundly positive effect on the economy in the decade ahead.

I say that the opportunity to reshape the tax system is now "unique" because of the vast increase in tax revenue that inflation has produced and can be expected to go on producing in the next few years. Congress can use this expanded revenue by enacting now a multi-year program of tax cuts that will reduce some of the existing strong disincentives to capital formation and production. And if this is done in the right way, such a multi-year tax cut should bring immediate increases in investment, saving and individual effort without any unwanted increases in the government deficit, either now or in the future.

In my brief prepared statement, I will explain how a series of precommitted tax cuts can have this desirable effect without unwanted deficits. I will give some examples of using precommitted tax cuts to encourage saving, business investment, and personal effort. I would be pleased to discuss specific ideas in more detail either during the question period or later.

EXPECTATIONS AND INCENTIVES

The most important thing to consider when thinking about a tax cut strategy is that all important economic decisions are based on expectations about the future. What matters for current actions—investment, saving, the choice of jobs—is not the current tax rates but the tax rates that are expected in the future.

Congress can therefore improve current incentives without any increase in the current deficit by enacting now a schedule of future tax cuts. These precommitted tax cuts can be financed as they occur out of the automatic revenue increases produced by inflation and out of the savings that could result from a slowdown in the growth of government spending. The commitment to a schedule of future tax cuts would give Congress and the government agencies time to shape their spending plans to the lower level of available revenue. Thus while an immediate tax cut generally means an increased deficit, precommitted future tax cuts can change incentives without any deficits.

Consider the problem of stimulating individuals to save more. Today the combination of inflation and high tax rates makes the real after-tax return negative for many individuals. To stimulate saving, the key requirement is to raise the real after-tax return that savers can expect to receive in the future on additions to their assets. One simple and direct way to achieve this would be to treat interest and dividends like capital gains—i.e., excluding 60 percent of all interest and dividends

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*Professor of Economics, Harvard University. The views expressed here are my own and should not be attributed to any organization.

from taxable income. Of course, if this 60 percent exclusion were allowed all at once in 1981, the revenue loss would probably exceed the increased saving. The government's borrowing to finance this revenue loss would then absorb more than all of the increased saving—and the amount available for investment in plant and equipment would actually be reduced.

But what if the 60 percent exclusion were enacted now with its effective date postponed until 1985? The government would clearly lose no revenue in the next four years. But households would have a strong incentive to start saving more immediately in order to have more assets on which to take fuller advantage of the lower tax rate when it becomes effective. Starting with a small exclusion in 1981 and allowing it to rise to 60 percent by 1985 would make the prospect of the full future exclusion more credible without changing the fundamental point that the immediate increase in saving can be substantially greater than the concurrent increase in the deficit.

The same idea of a precommitted tax cut can work to stimulate investment. Consider the effect of a major cut in the corporate tax rate—say from 46 pecent to 36 percent—that is enacted now with an effective date in 1985. Although there would be no change in tax rates from 1981 through 1984, firms would have a substantial incentive to increase their investment spending immediately because investments made during the next four years would benefit from depreciation at high tax rates while the subsequent profits would be subject to lower tax rates. Again, a gradual phase-in of the tax rate reduction would increase the credibility and visibility of the future rate reductions.

There are other ways to stimulate investment with little or no decrease in tax revenue. Replacing the existing historic cost depreciation method with an indexed depreciation system for all future investment would immediately raise the after-tax yield on all prospective projects. Indeed, at the current high rate of inflation, indexed depreciation would offer a greater stimulus to investment than the Conable-Jones 10–5–3 plan for accelerated depreciation. Indexed depreciation would involve no immediate revenue loss and the future revenue losses would rise only slowly as the eligible capital stock grew.

For personal rate cuts, a slow but certain phasing-in would also achieve most of the benefits of a large immediate rate cut without a large revenue loss. An individual who is deciding whether to change jobs, to relocate, to "invest" in more schooling or training, or just to work harder in the hope of better promotions will look at future tax rates. Because a gradual phase-in could be financed by the automatic inflation tax windfalls and by a gradual reduction in the growth of government spending, tax rates could be reduced by 30 percent over a few years without any deficits.

The supply side tax-cut goal of increasing incentives without budget deficits can be achieved in this way without depending on a miraculous response of labor supply or productivity. And to the extent that increases in individual effort and in capital accumulation raise national income over time, there will be greater tax revenues with which to finance either government spending or further tax reductions.

INFLATION GIVEBACKS

I have emphasized that the extra tax revenue that inflation will produce can be used to finance real tax cuts. Because of the progressivity of the tax schedule, each 10 percent rise in total personal income raises individual income tax collections by about 16 percent. This permits a 6 percent cut in tax rates without any reduction in the ratio of total tax collections to personal income. Over just four years, the cumulative tax reduction could be nearly 25 percent from this source alone.

Pruning the share of personal income that goes in federal personal taxes—not even counting the Social Security payroll tax—back to the ratio of 15 years ago would permit an additional real tax cut of 16 percent. Cutting the effective tax rate on corporate capital income—including corporate profits, dividends and interest—back to where it was 15 years ago, would reduce that revenue by nearly 30 percent or more than $35 billion at 1979 levels.[1] This $35 billion is itself more than 12 percent of the total corporate and personal tax collections.

The total tax cut—combining inflation givebacks and real reductions—can easily be between 30 and 40 percent over the next four years. This provides a unique

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[1] M. Feldstein and L. Summers ("inflation and the Taxation of Capital Income in the Corporate Sector," *National Tax Journal*, 1979) estimate the effective tax rate in each year and its relation to the inflation-induced distortions in the measurement of capital income. See M. Feldstein and J. Poterba ("State and Local Taxes and the Rate of Return on Nonfinancial Corporate Capital," Nation Bureau of Economic Research Working Paper No. 508, 1980) for an update of these calculations through 1979.

opportunity for a series of tax changes that reduce the disincentives in the current tax structure. It is crucial not to let this opportunity be wasted in increased government spending. It is important also that the tax cuts specifically stimulate saving and investment and are not limited to across-the-board reductions in personal rates.

Although this means that a major reduction in personal rates—like the 30 percent Roth-Kemp proposal—would take more than three years, such a rate reduction should remain a key goal of tax reform. Congress would do well to commit itself now by legislation to a specific plan for giving back all of the future tax increases that result from inflation: Any of these givebacks that are not used to stimulate saving and investment would be applied to across-the-board tax rate reductions until all current rates are reduced by 30 percent. This would have the advantage of dividing the feasible tax reductions between capital formation incentives and personal rate cuts without sacrificing the goal of general rate reduction. When the 30 percent rate cut has been achieved, an automatic annual bracket rate adjustment could keep inflation from raising the relative tax burden.

COUNTERCYCLICAL TAX CUTS

Although this is a uniquely good time to begin a series of precommitted tax cuts focused on strengthening incentives, much of the public discussion is only about an old-fashioned countercyclical tax cut. The advocates of such a policy seem to have forgotten that economists and forecasters just don't know enough to use tax cuts to attenuate the business cycle. For a tax cut to reduce the current rise in unemployment, it would have to have been passed last year, long before the beginning of the recession was clearly in sight. A tax cut now would probably have its impact in 1981 and 1982 when the recession is past and the economy is expanding. Of course, the recession may potentially be worse than it now looks and output may continue to fall well into 1981. But we know too little about just where the economy is now going—and about the magnitude and timing of the impact of a tax cut—to recommend a countercyclical reduction in taxes.

The experience of the past thirty years shows that attempts at countercyclical fiscal policy have actually worsened the business cycle—expansionary policies overstimulating the economy and fiscal contractions deepening the recessions. The lesson of this experience is that attempts at fiscal stabilization should be avoided in the short swings of the business cycle and saved as the ultimate economic weapon to be unleashed only if the economy falls into a deep and protracted depression. That is not a reason to avoid a tax cut now but it does imply that the current tax cut should be aimed at long-run goals rather than at the current recession.

SURVIVAL AND SUCCESS

I believe that our nation's economic survival and success in the 1980's will depend on the type of tax system we have. Now is the time to begin a serious restructuring that will restore incentives for saving, investment and individual effort. A firm legislative commitment to a gradual phasing-in of these tax changes can provide a major stimulus to current capital formation and individual productivity without any unwanted increase in the government deficit.

Senator PACKWOOD. The committee stands adjourned.

[Whereupon, at 1:15 p.m., the committee adjourned, to reconvene at 10 a.m., Monday, July 28, 1980.]

TAX CUT PROPOSALS

MONDAY, JULY 28, 1980

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

The committee met, pursuant to recess, at 10:35 a.m., in room 2221, Dirksen Senate Office Building, Hon. Russell B. Long (chairman of the committee) presiding.

Present: Senators Long, Bentsen, Bradley, Baucus, Dole, Packwood, Roth, Danforth, and Durenberger.

The CHAIRMAN. The committee will come to order.

We are very pleased to have with us today the Chairman of the Federal Reserve Board, who has served both this Nation and his fellowmen in many other responsibilities. We are certainly happy to have you today, Mr. Volcker, and we will appreciate the benefit of your advice with regard to the monetary and fiscal aspects of the problems that face us at this moment.

We appreciate your being here, and we will have a better audience of Senators as the hearing goes along.

STATEMENT OF PAUL VOLCKER, CHAIRMAN, FEDERAL RESERVE BOARD

Chairman VOLCKER. Mr. Chairman, I submitted to the committee a rather multipurpose statement reviewing monetary policy and some other aspects of economic policy. I don't know that any purpose is served by my reading the whole statement.

The section on monetary policy emphasizes the need for financial discipline in general, and in particular argues that the Federal Reserve needs and intends to reduce over time the growth in money and credit as part of the effort to deal with this inflation that has gripped the economy for some years.

It argues that unless we come to grips with the inflationary problem, the prospects for sustaining growth, and for working down the level of unemployment and keeping it down will not be very good. We have to deal with inflation for a period of time as we move ahead on other problems.

One section of the statement deals directly with the tax issue. I will read that if it is helpful to the committee.

After emphasizing the intention of the Federal Reserve to work toward lower levels of monetary growth over time, I note, at the bottom of page 8, that the general nature of the potential problems and dilemmas for 1981 and beyond is clear enough. These are important questions, not just for monetary policy but for the full armory of public policy.

The Federal Reserve targets for the monetary aggregates are designed to be consistent with, and to encourage, progress toward price stability without stifling sustainable growth. But if recovery and expansion are accompanied by inflation at current rates or higher, pressures on interest rates could develop to the point that consistency of strong economic expansion with reduced monetary growth would be questionable.

Obviously, a satisfactory answer cannot lie in the direction of indefinitely continued high levels of unemployment and poor economic performance. At the same time, ratifying strong price pressures by increases in the money supply offers no solutions. That approach could only prolong and intensify the inflationary process—and in the end undermine the expansion.

The insidious pattern of rising rates of inflation and unemployment in succeeding cycles needs to be broken. With today's market so much more sensitized to the dangers of inflation, economic performance would likely be still less satisfactory if that pattern emerges again. The only satisfactory approach must lie in a different direction—a credible effort to reduce inflation further in the period ahead, and policies that hold out the clear prospect of further gains over time, even as recovery takes hold.

We are now in the process of seeing the inflation rate, as recorded in the consumer and producer price indices, drop to or below what can be thought of as the underlying or core rate of inflation of 9 to 10 percent. That core rate is roughly determined by trends in wages and productivity.

We can take some satisfaction in the observed drop of inflation and the damping of inflationary expectations. But the hardest part of this job lies ahead, for we now need to make progress in improving productivity or reducing underlying cost and wage trends—as a practical matter, we have to do both—to sustain the progress.

The larger the productivity gain, the smoother will be the road to price stability—partly because that is the only way of achieving and sustaining growth in real incomes needed to satisfy the aspirations of workers. Put in that light, the importance of a concerted set of policies to reconcile our goals—not simply relying on monetary policy alone—is apparent.

While those other policies clearly extend beyond the purview of the Federal Reserve, they obviously will bear upon the performance of financial markets and the economy as the Federal Reserve moves toward reducing over time the rate of growth in money and credit.

In that connection, I recognize the strong conceptual case that can be made for action to reduce taxes. Federal taxes already account for a historically large proportion of income. With inflation steadily pushing income tax payers into high brackets, and with another large payroll tax increase to finance social security scheduled for 1981, the ratio will go higher still.

The thesis that this overall tax burden—and the way our tax structure impinges on savings and investment, costs and incentives—damages growth and productivity seems to me valid. Moreover, depending on levels of spending and the business outlook next year, the point can be made that the implicit and explicit tax

increases in store for next year will drain too much purchasing power from the economy, unduly affecting prospects for recovery.

But I must also emphasize there are potentially adverse consequences that cannot be escaped. To ignore them would be to jeopardize any benefits from tax reduction, and risk further damage to the economy.

Whatever the favorable effects of tax reduction on incentives for production and productivity over time, the more immediate consequences for the size of the Federal deficit, and potentially for interest rates and for sectors of the economy sensitively dependent on credit markets, need to be considered.

Many of the most beneficial effects of a tax reduction depend upon a conviction that it will have some permanence, which in turn raises questions of an adequate commitment to complementary spending policies and appropriate timing. We are not dealing with a notion of a quick fix over the next few months for a recession of uncertain duration, but of tax action for 1981 and beyond at a time when Federal spending levels, even for fiscal 1981, appear to be a matter of considerable uncertainty, with the direction being movement higher.

Experience is replete with examples of stimulation, undertaken with the best motives in the world, that has turned out in retrospect to have been ill timed and excessive. Given the demonstrable frailty of our economic forecasting, it takes a brave man indeed to project with confidence the precise nature of the budgetary and economic situation that will face the Nation around the end of this year.

Moreover, an intelligent decision on the revenue side of the budget implies knowledge of the spending priorities of an administration and a Congress, a matter by the nature of things can only be fully clarified after the election.

For all the developing consensus on the need for supply side tax reduction—and I share in that consensus—some time seems to me necessary to explore the implications of the competing proposals and to reduce them to an explicit, detailed program for action.

I have emphasized the need to achieve not only productivity improvement but also a lower trend of costs and wages. Despite its importance, I have seen relatively little discussion in the current context of how tax reduction plans might be brought to bear more directly on the question of wage and price increases.

The continuing sensitivity of financial markets, domestic and international, to inflationary fears is a fact of life. It adds point and force to these observations and questions. Tax and budgetary programs leading to the anticipation of excessive deficits and more inflation can be virtually as damaging as the reality in driving interest rates higher at home and the dollar lower abroad.

I believe it is obvious from these remarks that a convincing case for tax reduction can be made only when crucial questions are resolved—questions that are not resolved today.

The appropriate time for decision seems to me late this year or early 1981. Fiscal 1982 as well as fiscal 1981 spending plans can be clarified. We will know if recovery of business is firmly underway. There will have been time to develop and debate the most effective way of maximizing the cost cutting and incentive effects of tax

reduction, and to see whether a tax program can contribute to a consensus—a consensus that has been elusive in the past—on wage and pricing policies consistent with progress toward price stability. To go ahead prematurely would surely risk dissipating the potential benefits of tax reduction amid the fears and actuality of releasing fresh inflationary forces.

Those are the comments that I make on tax policy specifically, Mr. Chairman. The rest of the statement alludes to other economic policies that go beyond the tax area.

The CHAIRMAN. I believe that you are familiar with the views of Mr. Arthur Burns, who served previously as Chairman of the Federal Reserve. Are you familiar with his views?

Chairman VOLCKER. I am familiar with his views in general terms. I did not read his testimony, but I think I am familiar with the general thrust of what he had to say.

The CHAIRMAN. Basically, his attitude was that he was opposed to a tax cut at this time because he does not think that if you pass one at this moment, it would be likely to do the kind of things that he thinks would be best for the country.

On the other hand, his view seemed to be that if you could pass a tax bill that would increase productivity and increase investment, he would favor such a bill whether you passed it now, or whether you did after the election, or whether you did it next year. He favors that kind of measure, and he thinks that we ought to pass it.

His only objection is that he thinks that the chances of passing that kind of a bill between now and the election are not good. If it started out to be that kind of a bill, it probably would not stay that way by the time it got through the Senate and the House of Representatives.

I would like to know what you think about his views.

Chairman VOLCKER. I think he was distinguishing, if I understand correctly, a tax cut which was pretty much pinpointed on the investment side, and its consequences for productivity and incentives arising through the business investment process. I do think these are worthwhile, even essential, goals as I said in my statement. In that sense, I am in favor of it, too.

If one was talking about a tax cut of relatively minor dimensions in the fiscal sense, which might be important on the productivity side, but confined to a very limited amount in terms of its fiscal consequences, I would be hard pressed to say that that kind of a tax cut is undesirable. I think that it is fundamentally desirable, and if its fiscal consequences could be held to a small enough amount, the timing issue does not loom as critical as I emphasize in my statement; there I am really referring to a much larger tax package.

If I am correct—although I did not hear his testimony, but I talked to him several weeks ago—he was talking about a tax cut that might not even be effective in fiscal 1981 but legislation that would schedule some tax cuts for the years beyond. That kind of thing does not have any immediate fiscal consequences; and depending upon the precise nature and dimensions of the proposal, I would not have any strong objection.

I would question its feasibility at this time, and I wonder whether you would not get a more appropriate package by waiting to see if a larger package is feasible next year.

The CHAIRMAN. Thank you very much, Mr. Volcker.

We usually go by the early-bird rule here in this committee, and I asked the first question because I was the first one here. Senator Packwood was next on the scene, therefore, I call on the Senator from Oregon.

Senator PACKWOOD. Mr. Chairman, if we were forced to vote in the Senate on a specific proposal that was a 10 percent across-the-board individual income tax cut next year, with some modicum of business tax cuts, perhaps in the depreciation area, obviously the revenue loss would be heavily tilted initially toward individuals, your recommendation would be to vote against that kind of a tax cut now?

Chairman VOLCKER. Now? Yes; my recommendation would not be to pass that type of a tax cut now.

Senator PACKWOOD. Second question—on page 13, you state and I quote. "I believe it would be a serious mistake to seek relief from our present problems by retreat to protectionism." You are talking about the dependence on foreign oil.

Is there any possibility that we might have to consider some kind of import limitation if we encourage companies to turn to coal and other domestic resources which would be higher in cost than OPEC oil if they chose to dramatically cut their prices?

Chairman VOLCKER. I was not thinking particularly of the oil or energy situation. I am not really aware of the kind of situation you are describing. My general impression is—maybe wrongly in some cases—that so far as utilities are concerned, if they really made the conversion and had sufficient time to do it, coal at present is cheaper than oil.

Senator PACKWOOD. For the present.

Chairman VOLCKER. Yes; and for the foreseeable future.

Senator PACKWOOD. With oil at present prices.

Chairman VOLCKER. Yes; with oil at present prices, and even allowing for some increase in coal prices.

Senator PACKWOOD. I was thinking more of a significant decrease in oil prices. I don't think that OPEC is going to want to see their world market undercut by coal, if indeed we have enough coal to export to a great portion of the industrialized world. But the rest of the world's problem is their problem.

Do we have to give any guarantee to those who are making investments in coal, to produce it, transport it, and burn it, so that they will not be tempted by long-term contracts from OPEC countries at lower oil prices?

Chairman VOLCKER. I can only give you a very tentative answer, Senator, because you are in an area that is outside my direct expertise. I would not have thought so; you are raising a possibility here that is perhaps a more optimistic one than I would have thought, that there is the chance of a very significant decline in the price of imported oil in real terms.

I happen to believe—maybe it's just a gut instinct of pessimism—that that price has to go up forever. That is perhaps wrong. If we really had a concerted program—and we see some signs of progress

certainly here and in other countries—there is some point at which the oil price would to be too high. But I would not have thought many people were worried about the real price coming down so significantly in the next decade as to make the concern you have a real one.

If it is a real one among the utilities, and if it is justified upon analysis, then I suppose one would have to think about the kind of issue you are raising. But I have not been aware that that is a problem.

Senator PACKWOOD. No other questions, Mr. Chairman.

The CHAIRMAN. Senator Danforth.

Senator DANFORTH. Mr. Volcker, the latest projections of the administration predict for 1981 inflation at a rate of 9 or 10 percent, and about a $30 billion deficit in the Federal budget. If those projections are correct, do you believe that it is possible to devise any sort of tax cut effective for 1981 which is responsible?

Chairman VOLCKER. I would have to say, yes; but I think that kind of projection shows the dilemma, if you will. The administration has a relatively high inflation projection, which is accounted for, as I understand it, in part by their assumption of a gasoline-tax increase which may add a half a percent or to their projection. Nevertheless, it is a high inflation estimate.

If you are facing that kind of inflation, and you consider the possibility that it could be even higher, I do not see that as the backdrop necessary for supporting a general tax reduction. That does not mean that somebody could not shoehorn in what Chairman Long was talking about earlier, a tax reduction pinpointed toward the investment side.

Senator DANFORTH. What I am asking you is assuming the ideal, from your standpoint. Would it be possible to develop, theoretically anyhow, an ideal tax cut which could be enacted even given a 9- or 10-percent inflation rate, and a $30 billion deficit.

Chairman VOLCKER. The 9- or 10-percent inflation bothers me, Senator. I would like to have some prospect that it is going to be lower than that. We may be talking, as a practical matter, about a fairly narrow range of projections, but I would like some feeling that inflation is on the way down, not on the way up. If we could achieve that, and the deficit number were reflecting primarily the effects of recession, then the deficit number itself, perhaps, could be swallowed.

But that has to be against a background of a declining inflation rate, against a background of the prospect that spending trends are not basically off track from what is necessary for an essentially balanced budget once we get through the recession period. I don't have that assurance at the moment, and I don't have the assurance or the confidence—I should not say confidence; the Federal Reserve is certainly working in the direction against inflation—from that kind of inflation number that we have the essentials in place.

Senator DANFORTH. So your answer would be, no.

Chairman VOLCKER. No, under the particular assumptions you gave me. But I don't say impossible, under somewhat different assumptions.

Senator DANFORTH. But we have to operate under the assumptions that are given.

Chairman VOLCKER. That is right. Those are the assumptions you have today.

Senator DANFORTH. So that even if you could imagine the wisest possible tax-reduction bill, and the most responsible, possible amount allocated in the most effective possible way between business and individuals, your answer would be, no.

Chairman VOLCKER. I don't know what amount you are assuming on that tax bill.

Senator DANFORTH. You name it.

Chairman VOLCKER. I could imagine some tax program small enough in its impact on the fiscal position of the Government, but nonetheless effective and useful to do, yes.

Senator DANFORTH. So given the assumptions that we are working with, you could imagine the possibility of a tax bill effective in 1981?

Chairman VOLCKER. Yes.

Senator DANFORTH. You would like to fill in the amounts, and the distribution, but that is what I am asking you to do.

Chairman VOLCKER. To be clear, I am not saying a $35 billion tax cut.

Senator DANFORTH. No, sir. That is my next question. My next question is, if it is possible to have one effective in 1981, what would you view as being the responsible amount, the responsible distribution between business and individual, and the responsible form that it would take.

Chairman VOLCKER. Given the limitations that I see on revenue loss, and under the particular assumptions that you described—and I am not saying that those assumptions could not be changed and improved; I think that that is one of the possibilities, and I would hope those assumptions look somewhat different 4, 5, or 6 months from now—then as far as I would want to go now is to say that if you can tailor a very pointed tax program wholly toward the investment problem that ought to be the ambit of your discussion.

Senator DANFORTH. Wholly toward the investment, both business and individuals?

Chairman VOLCKER. I am thinking essentially about business in this case. I don't think you can cut individual taxes in a way that is meaningful without a big revenue loss.

Senator DANFORTH. Even, let us say, a capital gains reduction?

Chairman VOLCKER. Let me exclude capital gains reduction from comment. I am thinking of a general income-tax reduction—a general reduction in rates, or something like that. You can always talk about changing some particular provision of the individual income tax that does not cost much money and that may be useful. But I am really talking about a meaningful individual tax reduction outside the capital gains area.

You gave me a particular set of assumptions, with things then just the way they are now, and a relatively pessimistic inflation forecast. I would hope that it would not look quite the same in some months, as I said.

Senator DANFORTH. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Mr. Volcker, you said you could not conceive of any individual tax cut. If there were going to be an individual tax

cut, whether it was the best of all possible worlds or not, what is your view of an income-tax credit against social security taxes to offset the increase that goes into effect in January?

Chairman VOLCKER. I have thought about that a great deal, Senator, and it is an attractive proposition from the cost-saving standpoint. It is the one kind of individual and corporate tax reduction, presumably in this case, that would lead to some direct impact on that inflation rate.

After thinking about it a great deal, I can only give you my personal—and, I suppose, political as well as economic—philosophy. I don't quite find myself able to recommend that the link between the payroll tax and social security benefits be broken, and I think that is what you are talking about, given the shape that the trust funds are in and the future need for financing for social security. So attractive as that looks, I cannot quite bring myself to recommend it for that reason, which is extraneous to the macroeconomic problem.

Senator BRADLEY. But from a macroeconomic standpoint, in your judgment is it a reasonable approach if we can overcome the trust fund trauma?

Chairman VOLCKER. From the macroeconomic standpoint, it looks good.

Senator BRADLEY. In these hearings, everyone from administration witnesses to any number of economists has talked about the state of the economy, and pointed to one positive sign, the fact that there has been over $14 billion in long-term obligations made in the last 4 to 6 months.

As Chairman of the Federal Reserve, those obligations are made because the interest rates are coming down. It is a constant tradeoff for you between fighting inflation, and maintaining a stable dollar.

Do you expect that the people who went out in the long-term bond market made a good judgment about the path of the economy in the next 6 months to 1 year, or do you think they got in under the wire before the deluge descended?

Chairman VOLCKER. I am religious about not forecasting interest rates, Senator. But let me comment on the basic point that you are raising.

I think there are a variety of somewhat encouraging signs in the economy that may not be a lot more than straws in the wind at this point, but nonetheless are consistent with the thesis that, in important part, due to the easier conditions markets and declining interest rates, there are kind of self-generating forces in the economy at work to bring recession to an end, and get the recovery launched. You see it in the housing market; you see it to some degree in retail sales; automobile dealers are not as hard pressed as they were on the credit front.

You referred to the extent of bond financing that is going on, at the same time. While this is constructive, markets remain terribly sensititive to the possibility of renewed inflation, which is why you hear discussion of the kind of threat that you mention. Of course, any increase in the Federal deficit necessarily, through its impact on the credit markets, adds to potential pressures on interest rates. I don't think that it is wholly a coincidence that the bond market

has leveled off and, in fact, gone up a bit in rate in recent weeks, coincident with the talk about tax reduction.

So when you talk about large-scale tax reduction at this point, I think you have to consider what that does to the credit markets, and whether that is not impairing developments which are moving in the direction of business recovery, creating more favorable conditions for housing and for business investment as well.

Senator BRADLEY. What you are saying is, if the Congress looks at a tax cut as an antirecession measure, the effect of a tax cut, perhaps directly proportional to the size, might be to raise interest rates and create tightness in markets just at a time when they were beginning to loosen up on their own.

Chairman VOLCKER. I think you can be pretty sure that interest rates would be somewhat higher than they would otherwise be, which involves a forecast of what they would otherwise be. A tax cut is not for free in that sense.

Senator BRADLEY. Would you say that a business tax cut might have the opposite effect? We refer here to productivity tax cut. Maybe you can help me, What is a productivity tax cut, in your view? What do you think would get the biggest bang for the buck—corporate reductions, capital gains reduction, investment tax credit, liberalized depreciation?

Chairman VOLCKER. You have a situation where a variety of approaches could be taken, and you have mentioned most of them. They have differing consequences in the short-run, and in the long-run they may have differing psychological consequences.

In terms of getting a bang in the short-run, I think most economists would say that the investment tax credit, or liberalized depreciation on current investment, would give you the greatest incentive and the greatest stimulus per dollar of revenue loss in the short run. In the long run, it does not make so much difference.

There are other differences between the approaches. A corporate tax cut will affect all corporate business, obviously, and investment tax credit affects strongly those businesses that make big capital investments; each of those affects investment in a different way.

It seems to me partly a question of where the political consensus lies, as well as the economic consensus. It is partly a question of how these different things affect investment in what has been an inflationary climate, and the rising replacement cost of investment.

I am inclined to think—but I don't think my views carry special weight in this area—that the depreciation approach does make a good deal of sense. That is not arguing for the 10-5-3 explicitly. That particular approach has problems; it is particularly favorable toward specifically lived investments, and has a large cumulating revenue loss over a relatively short period of time.

I have no problem with depreciation as a component of a tax cut.

Senator BRADLEY. So among the various business components, a business component that would have the largest cumulative revenue loss might indeed have that perverse effect on the market as well?

Chairman VOLCKER. I think any approach that has a relatively large revenue loss will tend to create that problem.

Senator BRADLEY. Thank you.

Senator BENTSEN [presiding]. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Volcker, I don't know if I precisely heard your answer in response to Senator Danforth's question. Assuming that the economic indicators are somewhat at the beginning of 1981 what they are today, and if you could fashion the tax package that you think would be most appropriate for the country, what would that contain in terms of the size of it, and the shape of it?

Chairman VOLCKER. Senator Danforth gave me a few limited assumptions, which I suppose are not enough for me to work on very definitively.

The way I answered him, or the way I intended to answer him, if I inferred correctly from his assumptions, was that we have not got much room for a large tax reduction next year. If that is correct, you had better begin thinking, in terms of a pinpointed, investment only, kind of approach.

Maybe his assumptions, or what I read into them, are too pessimistic. I hope they are too pessimistic; they are his assumptions and not mine. But if you tell me that the inflation rate is rising and not falling, that there is no prospect of the budgetary position looking any better, then I have trouble recommending an across-the-board tax decrease.

One of the things that he did not mention specifically, but just let me pin it down, is that a lot depends upon what the spending plans are. While the nature of things is never crystal clear, I suppose that it is particularly cloudy right now. You don't know what kind of a Congress, or what kind of an administration, you will have after November.

Senator BAUCUS. Let's assume a slight increase in unemployment, and inflation roughly where it is today, give or take a half a percentage point, given those conditions, and assuming no significant changes in spending patterns, whatever that means.

Chairman VOLCKER. Whatever that means, precisely.

Senator BAUCUS. Then you what?

Chairman VOLCKER. I don't think I can be pinned down to saying how big a tax cut, with another half percent off the inflation rate, without knowing what the spending plans are, without knowing what the business outlook is at that time, without knowing how much recovery we have in fact had, if we have had any. I think that you will just have to wait and see, and that is what I would urge you to do.

You are not talking about a tax cut, as I understand it, that is going to be effective now anyway, so let's wait and see how things look when it would become effective.

Senator BAUCUS. Just so I understand you further, your reluctance to act this year, as I take it, is based upon the sensitivities of the economy and, I guess, inadequacy of information, or is it because it is an election year, is that your reason?

Chairman VOLCKER. No, it is not. My sensitivity is not primarily because it is an election year. But it is one element that makes it peculiarly difficult to have a great sense of conviction about spending trends in 1981 and 1982, more difficult than usual. It is always difficult, but it is more so than usual now, when you have presumably competing philosophies at work.

Senator BAUCUS. What is different now than what the case will be in the next year?

Chairman VOLCKER. I don't know how the economy is going to look at that point. I think you have quite a different situation if, indeed, these straws in the wind showing recovery materialize into actual recovery by the end of the year or if, in contrast, you find that business spending has been affected by what has happened so far, that you have had declines in capital spending over that period, that you have had some inventory reduction, that you have an appreciably high level of unemployment.

Senator BAUCUS. Why won't these same concerns be raised?

Chairman VOLCKER. Pardon me?

Senator BAUCUS. Why won't these same questions be raised next year about the next 6 months?

Chairman VOLCKER. You are always in a situation of having to make a judgment about the next 6 months. But here, it seems to me, you are in a specific situation where—I may be wrong—most of the talk has been about a tax cut that is not going to become effective for 6 months anyway.

If you were asking me for my advice on a tax cut effective over the next 6 months, that is a different question, but I don't think that it is the question that is being presented here.

Another element in this situation that I might mention is the question of the whole wage-price approach. I think that that is somewhat of an open issue at the moment. We have had several years of wage-price guidelines being raised. I would hate to see a situation in which, next fall, we would have both a sizable tax cut and a guideline with a further increase in wages.

That seems to me building up a situation for the economy not very far down the road filled with the difficulties of large budgetary deficits, rising inflation rates as recovery gets underway. It is a situation that bodes ill in my judgment for sustaining a recovery. That is another element that I would be concerned about, and that I don't know about at this point.

Senator BAUCUS. Thank you very much.

Thank you, Mr. Chairman.

Senator BENTSEN. It is now my turn.

Mr. Chairman, in looking at a tax cut and interest rates, the Joint Tax Committee projects a $47 billion increase in taxes next year under present law, and the Congressional Budget Office is talking about upward of $80 billion increase in taxes.

Then we get the statement that if we talk about a tax cut that we are going to trigger an increase in interest rates, possibly.

We have had amazing liquidity in the market for absorbing a very substantial amount of long-term funding for corporations, which have done their best to switch out of short-term commitments into long term, and that may have been what has held part of the interest rates where they are.

Chairman VOLCKER. There is no question about that.

Senator BENTSEN. It may have pumped them up. So it is not necessarily just the talk about a tax cut.

Chairman VOLCKER. I did not mean to mean to imply that. There has been a huge amount of financing——

Senator BENTSEN. An incredible amount. I understand $14 billion since March, and more coming.

Chairman VOLCKER. I think that this discussion has been one element affecting the climate in the market.

Senator BENTSEN. It is hard to measure that, that is true.

Isn't the sophistication of the market enough? Cannot we structure it, when you got all the way from a $47 billion to an $80 billion increase, where we are saying we are just moderating the increase, but we assure no net cut in taxes?

Chairman VOLCKER. I agree with that.

The trouble is, I think, Mr. Chairman, and all I am essentially saying is, it is impossible or very hard to look at the revenue of the budget and the tax side of the budget without some appraisal of what is going on on the expenditure side.

You know that we have had one balanced budget in the last year, or something like that.

Senator BENTSEN. That is right.

Chairman VOLCKER. We now have a $60 billion deficit, or slightly more, forecast for this year. The pattern for last year and most recent years has been that as the year wears on, the deficits get bigger and bigger, rather than smaller and smaller, compared to what the projection was at the beginning of the year. This has had something to do with both the inflationary process, and the congestion in the credit markets when we have not been in the midst of recession.

I think that it is bound to look a little bit ominous when the Congress and the administration were talking about a balanced budget only 4 months ago, and now that balanced budget appears to be about a $40 billion deficit.

Senator BENTSEN. Yes, but it is a deficit that is due to recession.

Chairman VOLCKER. To the extent that this is due to the recession, I would discount it; I think that is quite right. But it is not all due to the recession.

Senator BENTSEN. I am not sure about that part. I think I might quarrel with you. I think the Congress has shown an incredible discipline going into an election.

Chairman VOLCKER. I agree with that, too.

Senator BENTSEN. I have really been amazed at the President. Historically, you don't try to hold down spending, and cut the percentage going into an election. Whether that is good politics or not remains to be seen. We will not know until November.

Chairman VOLCKER. I think there is that side of it. I think in that sense this is quite an impressive performance. If that can be carried through, in fact, to next year's budget and the budget resolution that has not been passed yet, and if the recession picture, for a variety of reasons, is not quite as gloomy as Senator Danforth projected, maybe you can put together a package that will be very useful.

The basic intellectual case for a tax reduction is very good; I just don't think all the conditions are there yet.

Senator BENTSEN. Let me tell you the problem we have. If we wait—almost everyone is talking about January 1, 1981, for the tax cut to be effective. If we wait until next year, you will have a new Congress organizing and assigning people to this committee and

other committees, starting all of these hearings over again. When do we get it passed? Well, we will probably get it passed, if we are lucky, in July.

That is historically what happens. We are out of this recession, or on the way out of it, and I don't believe any tax cut we pass now is going to shorten the recession. But I think it can change the quality of that recovery.

Chairman VOLCKER. I agree with that.

Senator BENTSEN. This happened to us in the past. We will pass one that is a cut across the board, as we are coming out of the recession, that will put more money into people's pockets, and there we kick up inflation some more. That is what we ought to try to avoid, if we can.

If we could pass it now, and I don't know if we can——

Chairman VOLCKER. I suppose I come to a somewhat different conclusion based on the set of facts that you set forward. I am in a position of not being at all certain, as I emphasized, that the conditions are in place, or that we will have them in place at the end of the year, to justify a large tax cut. Therefore, the prospect that you outline does not bother me as much as it may you because I am not sure that we are going to have the conditions in effect to pass it anyway.

I would also hope, although you inevitably have a much better feel for this than I, that if you were in a situation where the conditions seemed clearly in place, that it would not take you until next July to act. It is not impossible that, indeed, this committee can perhaps put something together before or shortly after November.

Senator BENTSEN. I don't argue against that at all.

Chairman VOLCKER. It is the degree of consensus that can be achieved prior to the decision, go or no go, that I think is helpful.

Senator BENTSEN. I don't argue at all about the possibility of doing it after election, but I do think that if we try to do it next year, we are looking at probably July, as much as I would like to see it otherwise.

Chairman VOLCKER. I am not really pleading for delay, certainly not delay for delay's sake. I am pleading for delay until the conditions antecedent seem to be clearly in place. I don't judge that as the case at the moment.

Senator BENTSEN. My time is up.

Senator DURENBERGER. Thank you, Mr. Chairman.

A couple of questions, Mr. Chairman, that relate to getting the economy moving, and so forth. I heard your comments relative to depreciation and investment tax credit, and so forth.

Would you compare that kind of an approach to where the money comes from, to some changes that have been proposed regarding the taxation of unearned income. For example, reducing the top rate from 70 to 50 percent, separate taxation of unearned income?

Chairman VOLCKER. I don't know quite how to comment on the point of where the money comes from. I suppose, in attacking the investment problem directly—let us say, through depreciation or investment tax credit—the recipients of the tax reductions are the very ones you hope to affect most directly in terms of their invest-

ment activity; the tax reduction itself gives them some of the money to invest, so you are not talking about a market process.

I suspect you probably get more stimulus this way per dollar of revenue loss in any event.

Senator DURENBERGER. You get more from which?

Chairman VOLCKER. From the direct stimulus to invest through depreciation or investment tax credit, rather than through a reduction in tax rates. I don't want to underestimate the potential importance to incentives over time of a reduction in tax rates. I think that it is a hazy area where no one's judgment is going to be very precise. We have not had a lot of experience with that, at least changes of a size that are identifiable.

I speak with a certain amount of caution, but I would suspect that the influence would be more diffuse and less apparent in the short run, certainly, than from the more pointed investment stimulus.

Senator DURENBERGER. Let's look beyond tradeoffs, and look at the long term, and look at affecting behavior, so to speak. What is your opinion on reduction in the unearned interest rate, will it change the behavior of that particular group of investors?

Chairman VOLCKER. I would assume that it would have to. I think in general we tax the savings and investment process very heavily. We tax income when it is earned; we tax it again after it is saved and producers more income; we have double taxation of dividends; we have a relatively high capital gains tax; we permit the deduction of interest payments, while including interest earned on the income side.

I think there are a variety of things in the Tax Code that inhibit the savings and investment process; what you point to is probably one of them. The choice you basically face is which one is the priority one to attack, because there are so many that could be attacked. It is a difficult decision; but what you mention is not the only area that can be attacked.

Senator DURENBERGER. You mentioned the deduction side, and let me ask you another sort behavioral question, if I may, that relates to consumption taxes. One example would be Al Ullman's favorite, which he is not talking about much any more in Oregon, the VAT. Another would be somehow decrease the deduction for interest paid on borrowed money. Where do you feel we ought to be going in that whole area of either taxing consumption, or removing some of the benefits of consumption.

Chairman VOLCKER. Let me differentiate a conceptual answer from what may be a practical answer. Going some distance in that direction over a period of time would be helpful in correcting the bias to which I just referred. As a practical proposition in the short run—short run here being more than the next 6 months—that involves such a fundamental change in the direction of tax law that I suspect it will need a whole lot of debate before you can make significant moves.

There is one element that bears very heavily on the value-added tax approach, and that is that it is rather directly inflationary in how it appears in the indices. Until you get a more favorable backdrop, in terms of general inflationary pressures, for that reason alone it is kind of a dangerous course to push. For that,

among other reasons, it does not seem to me practical in the time frame that you are talking about.

But if you ask me whether those approaches should not be looked at with some sympathy over a period of time, I would want to look at them.

Senator DURENBERGER. Thank you.

The CHAIRMAN. I believe we understand each other. Let me just see if I can zero in on this one sentence at the top of page 14 of your statement. You say. "I sense the essential objectives are widely understood and agreed—the need to wind down inflation even as recovery proceeds." Let me read on, and emphasize the next words. "The importance of restoring productivity and increasing incentives for production and investment."

It seems to me that these items which you put in second order of priority to me are extremely important at this point. I think that in your statements, to the effect that you believe that you can get inflation down to about the bedrock of 9 and 10 percent, you explain why you think that is as low as you can get it——

Chairman VOLCKER. I don't mean to say that that is as low as we can get it; we are practically there, but that is not good enough. If we say that that is good enough, and that we don't have to get it any lower than that, I will make an unambiguous prediction that it will then turn out to be higher, and that you are going to end up in the next cycle with a still higher rate of inflation. That is what we must avoid.

The CHAIRMAN. But elsewhere in your statement, on page 10, you refer to the "underlying or core rate of inflation of 9 to 10 percent. That core rate is roughly determined by trends in wages and productivity."

As I understand it, it is your view that if the present trends of labor continue to insist on more, and of management to give the nonunion labor the same type of pay raises that they give the union labor, if those trends are going to continue, then that will give you a core of 9 to 10 percent inflation.

Chairman VOLCKER. That is correct.

The CHAIRMAN. You say that you hope to get inflation down to that point, but getting it below that is beyond your capacity and mine, as I understand you. It is up to somebody else.

Chairman VOLCKER. It is not beyond our capacity; if we say that it is all up to somebody else, we will never get it down.

We are saying, at the Federal Reserve, that we are going to aim at a money supply which is most consistent with a lower inflation rate than that. I hope you aim at a tax and revenue program that will be consistent with that money policy for getting a lower rate of inflation.

There are many other things that could be done in the regulatory area, and in the energy area, and in the trade area. But I guess what I am saying is, we have to get that rate down, and it is going to be much harder from now on than it has been to go from 15 or 18 percent to the 9 and 10. Now the real challenge begins.

We can use a boost on the productivity side. I want that as much as you or anybody else could want it. But don't kid yourself; productivity takes some time to stimulate. You will have had a glorious result if the rate of productivity growth increases by 1 or

1.5 percent as a result of any tax action you take. I think that would be beyond the expectations of almost all economists. That in itself would be enormously helpful, but it is not going to cure this problem. It is easy to offset that in terms of the inflation generated through other policies.

I want to see an environment in which we get that advantage, which is enormously important over time. But I don't want to see that chance thrown away and even discredited by a tax action coming in an environment in which other forces are pushing in the other direction.

The CHAIRMAN. My thought, Mr. Chairman, is that if we are not going to do whatever it takes to modernize our plants, and to have the productive equipment that we need, and if we pursue the trade policies that we have been pursuing up to now——

Chairman VOLCKER. I agree.

The CHAIRMAN. If you put those things together, and recognize that you are powerless to make labor settle for less than what they believe would be a fair cost-of-living increase, as is the way things have been going, then we are going to put all kinds of people out of work, and we are going to have to quit producing automobiles, steel, and various other things, and this Nation is going to be in a bad fix.

Chairman VOLCKER. Let me put the point the other way around, and maybe you would agree with it.

I agree with the importance of doing what you would like to do, presumably through tax reductions of various kinds. I put high priority on that effort. To me that implies a priority to bring about the conditions that make that prudent and successful.

So let's work on those other things. Let's look at the budget, and do what we can to have a spending program that is consistent with what you want to do with taxes. Is it really impossible to get some kind of consensus that wages ought to begin going down the other way? It is not in the interest of labor to have it spiral up, to not have the tax reduction and not have the productivity growth, because they are not getting any real income out of that.

Let's reach the consensus on your committee—I can only just wish you Godspeed—as to the approach that is most effective in improving incentives, in improving productivity. Let's get all those conditions in place, and then let's go ahead, because it is urgent that we do. I just don't think that you have these conditions in place at the moment. I am not saying that you cannot have them in place in a matter of, literally, months.

The CHAIRMAN. Mr. Chairman, I cannot do anything about the mineworkers insisting on and getting a pay raise that exceeds their productivity, nor can anybody on this committee. I will not be at the table to negotiate with them. I can't do anything about the teamsters, and the automobile workers, and the railroad workers saying, "Either you pay us what we think is appropriate under the circumstances, or we are going to shut the country down."

About all I can do is what little I can in my area to help with the problem. I think that it is the same thing for all Members of the Congress.

Chairman VOLCKER. Let me put it this way: All you can do is get prepared. But if nobody does those other things you are talking about, then we are in trouble. Somebody had better do them.

The CHAIRMAN. I congratulate you for doing your job the best you can, even though you can't do much about those things.

Chairman VOLCKER. I can't do anything about it in the sense you are talking about; that is, I cannot do anything directly about the spending. We can't do anything directly about the wages. But I don't accept an answer that nobody can. I hope we can keep the money supply under control; that is our job.

The CHAIRMAN. You served with distinction in the Treasury Department for many years. You were there when I was trying to pass some of those tax bills that did a lot for the country. Those tax bills were designed to help move the economy, and make it more productive. It seems to me that we are going to be needing more of that. We will be needing more productivity plus what you can do on your end to try to control inflation.

We Democrats are instructed by our caucus to report out a tax cut bill. Basically, our caucus said that we should try to report a tax cut that would not be inflationary, that would stimulate thrift, that would stimulate productivity. My understanding is that you are not really opposed to that. You don't want to do it at the moment, I guess.

Chairman VOLCKER. I am not opposed to the basic concept. I think that it may be a little bit an illusion, certainly in today's context, that you can have a big tax cut that is not inflationary in some sense. We may have a little difference of opinion.

I think you can shape it so it has maximum impact on productivity incentives and all those other things. But I think it is up to somebody to create the conditions that make your action responsible. I would like to see that done; that is the only sensible course for economic policy to take, in my opinion, and that is the best course.

It is not all under your control, but I don't think that it is an adequate answer to say that you are going to go ahead willy-nilly, regardless of whether those other conditions are in place, because then it may be counterproductive.

The CHAIRMAN. May I point out, Mr. Chairman, that I am not one of those who want to go ahead willy-nilly. I am one of those who want to hold a hearing, and invite various people to come up here to give us the benefit of their advice. I am glad that we have their advice. Then if we sense that it is appropriate, it seems to me that we should go ahead.

Chairman VOLCKER. There is nothing about your course to which I can take exception at this point. I am just looking toward the end product.

The CHAIRMAN. Any further questions, gentlemen?

Senator ROTH. Yes, Mr. Chairman.

The CHAIRMAN. Senator Roth.

Senator ROTH. I am sorry I missed the earlier proceedings, Mr. Chairman.

I would like to ask you a question. If it were possible to hold down spending at the same time we provide tax cuts aimed at productivity, would that be a desirable approach in your judgment?

Chairman VOLCKER. Yes. If you can show me and the American people a budget consistent, with the tax cut, and, adjusting for the recessionary influences, in a balanced fiscal position, you are a long way toward home.

Senator ROTH. What I have propose, in my legislation is that we limit Federal spending the first year to 21 percent of GNP, and to drop it 1 percent a year until we reach a level of 18 percent. Actually, I think President Carter, when he campaigned, endorsed the same approach.

What I am concerned about is that unless we do that, you are never going to rein in spending. I have been in the Senate 10 years, and every year I hear that we are going to balance the budget next year.

Chairman VOLCKER. That is right.

Senator ROTH. My next question is: Are you concerned about the vast increases in taxes that are on the books now?

Chairman VOLCKER. Yes. I am concerned in general that we have permitted, advertently or inadvertently, the tax rates to increase over a period of time—not only the absolute level, but the way the various taxes are imposed. I think that it is doing us a disservice in terms of this productivity problem.

Senator ROTH. For example, taxes are now scheduled to almost double by 1985, much of which I think we need back in the private sector to try to do something about productivity.

Chairman VOLCKER. I don't disagree with the general point you are making. Without necessarily accepting the figures that you used your basic point about looking at the tax program in conjunction with the expenditure outlook is the way to go about it.

Senator ROTH. I think that we are in agreement, Mr. Chairman, that if we are going to get this country turned around, we have got to move on both fronts.

Chairman VOLCKER. That is right.

Senator ROTH. We have to limit spending, and return tax revenue in a form that will do something about productivity.

Chairman VOLCKER. The problem that we have, it seems to me, is illustrated by what happened in the current fiscal year. We are increasing spending in this fiscal year by 17 to 18 percent, as I recall. You can cite all the horrendous increases in taxes, and I think that they are undercutting productivity and growth, but you have quite a different situation when you look at the expenditure side of the budget and find that it is going up 18 percent. That is not consistent with great progress in reducing taxes. It is not even consistent with not permitting taxes to go up. And that is the problem.

The current projection for the next fiscal year is substantially less, even with some impact of recession. I suppose a lot of people have a certain amount of skepticism, given the recent pattern, as to whether the current projections for next year's budget are going to be realized. They could be realized, and if there were more confidence in that, then you could begin looking at how much of that scheduled tax increase could be offset.

Senator ROTH. The thing that bothers me is that for years we have been talking about reining in spending. I might say that I have been one of the leaders in that activity. But it never happens.

Of course productivity goes down. We throw more people out of work, and that automatically calls for more spending, and loss of income on the part of the Federal Government.

So it seems to me that somewhere along the line we have got to decide whether to continue on this present course, or do we take a gamble toward real growth.

Chairman VOLCKER. I can understand the frustration. I can understand the pattern to which you refer. You also can understand, from my perspective, my saying that that effort is either not worthwhile or not practical; for us just to jump into cold water and take our chances on a tax reduction without other conditions being put in place is a dangerous course. You might get some heart arrest when you jump into the cold water.

Senator ROTH. Many of us have been proposing a limit on spending. Many people, to be perfectly candid, that talk about balancing the budget are not interested in restraining spending, if you check their votes. Their votes are not there.

Many people, in my judgment, in this Congress are really trying to protect the big spending, and the big revenue on the books. Their talk about balancing the budget is a smokescreen. That is what worries me.

As I understand it, Japan is spending currently as much on investment in plants and equipment as we are with half as many people. There are those who predict that by the end of the century, they will have an economy larger than ours. I think this has tremendous implications, if we don't somehow get off this course, to our country and its future.

Chairman VOLCKER. I don't disagree with that analysis, but in the end, a big tax reduction is going to have a big impact on the deficit, which will in turn impact on the credit markets, which will in turn impact on inflationary expectations. Unless that side of the equation is looked at, you will not get the beneficial effects from the tax reduction that you and I hope for. That is my only concern.

Senator ROTH. What I am saying there, I agree that we ought to be moving on the spending side. I just wish those who are talking about balancing the budget would recognize that we need their vote in holding down spending. This talk that nothing can be done in that area is not true to fact.

It is difficult, I agree, but we would be better off if we use a few years of restraint in spending, if we are really going to get the economy expanding again.

Chairman VOLCKER. I agree with that.

Senator DANFORTH. Mr. Chairman.

The CHAIRMAN. Senator Danforth.

Senator DANFORTH. Mr. Volcker, it is easy to listen to somebody, and filter out the things that he is saying which you don't want to hear, and highlight the things which you do want to hear. Let me see if I am misrepresenting you or your position.

You think that a large tax cut without comparable spending cut, or substantial spending cut, is dangerous and inflationary.

You believe, however, that given what you now estimate will be the conditions of the economy in 1981, and given what you believe about the spending policy, it is possible to enact a responsible tax bill keyed to investment effective January 1..

You believe that the business component should be depreciation.

You believe that individual rate reductions of any substantial size would be inflationary.

You believe that social security credit justifiable from a macroeconomic standpoint. However, you don't like breaking the linkage between payroll taxes and social security benefits.

You believe that a capital gains reduction would encourage investment, and would not be inflationary.

Is that a fair statement of your position?

Chairman VOLCKER. I don't want to simply say, yes, on so sweeping a statement. I will restate that, and I think that what I say will resemble much of what you say. But let me restate it a bit.

Based upon what I now know in terms of spending, and my concern that spending may actually rise in ensuing budget resolutions or estimates rather than decline and based upon what I don't know about wage trends and negotiations and about the strength of business recovery by the end of this year, I do not want to suggest—and I think it would be counterproductive for Congress at this time to enact—a sizable tax reduction; I mean something in the $25-, $30-, $35-, $40-billion range.

I do think that a tax reduction potentially as large as that could be useful by January 1. I certainly think, even more urgently, a strictly investment-oriented tax reduction, with a much smaller revenue loss, could be useful. In the former case, of the sizable tax reduction, that could be useful provided that we have further assurance on the budgetary restraint side, that we see the spending go down rather than up, that we have some evidence that there is reason to believe that this core inflation rate of 9 or 10 percent is over the hump and beginning to decline, rather than to further increase.

If the business picture is not ideal on its own—but we can evaluate it at that time—then I think you begin to have the conditions that make more than a very limited investment-oriented tax approach prudent, and possible, and consistent with the objectives that are sought.

Senator DANFORTH. Let me restate Senator Packwood's question in a different form. If you had to vote now—if you could not wait, you had to vote—on a tax cut of $25 billion or less revenue loss, divided 50-50 between corporate cuts and individuals, the corporate portion being exclusively depreciation, and the individual portion being exclusively capital gains reduction, how would you vote?

Chairman VOLCKER. I would vote no for that big a tax cut now. I don't think you would need that big a tax cut if it were just confined to depreciation and capital gains. I don't think you would have that big a revenue loss without a much more sweeping proposal in those areas than anyone has yet proposed. I think that that may be a little inconsistent, as I understand it, but I would not vote now for that big a tax cut.

Senator DANFORTH. How much would you vote for?

Chairman VOLCKER. I will enter into the danger of answering all those hypothetical questions as it may perhaps clarify the point.

If you told me I had to vote yes or no, last chance, for some form of tax reduction aimed directly at the business investment problem—whether depreciation, investment tax credit, reduction in the

corporate tax rate in future years—with a revenue loss in the first year of zero or $1 to $5 billion or something like that, if it were my only chance to vote on this, I might be inclined to say yes, but I think that that is contrary to the facts.

I don't think that is the best way to go about it. You probably would have a better impact all around with a more comprehensive package. I suspect that it would be more politically realistic. Let's wait and see whether those conditions are put in place for a more balanced and larger package.

But if I were presented with the simple statement, "This is your last chance. You lose a modest amount of revenue, but we have an effective bill in terms of what one can do with that very modest revenue loss," under those conditions I might be tempted to vote yes. But I don't see why you have to be faced with those conditions.

Senator DANFORTH. Thank you.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Thank you, Mr. Chairman.

Two quick questions. Earlier you said that the Federal Reserve was going to do its part in fighting inflation, and that your money supply targets are not aimed at the level of the bedrock inflation of 9 to 10 percent, but much lower.

Chairman VOLCKER. I would not say much lower.

Senator BRADLEY. What is the level and duration you see present money supply targets aimed for?

Chairman VOLCKER. It would be fine if we could get that core inflation rate down 1 or 2 percent. The important thing now, in the near term—and I think it should begin to go faster once you begin turning it around—is to get the trend turned around and get some sense that it can be turned around.

Once it gets turned around, in the face of business recovery, I think the prospects for subsequent years will be much more favorable. Let's see if we could be talking next year about an 8-percent rate; that would be fine.

Senator BRADLEY. What does that mean for Federal Reserve policy in the way of money supply targets, how fast will they grow?

Chairman VOLCKER. It is the consensus of the committee, stated publicly, that we want to be looking toward a reduction in the ranges that we have this year.

Senator BRADLEY. Which is?

Chairman VOLCKER. We have several M's. They run from 3.5 to 6 percent, 6 to 9 percent depending upon which M you look at. Presumably, we would be looking to make those a little lower.

The problem you have is that there is no mechanical relationship between those numbers and the inflation rate. What we do know is that with that kind of money supply growth, if we have both the recovery and a rise in the inflation rate, so that the nominal GNP is increasing for both reasons, we will have a potential problem.

If you have recovery and a declining inflation rate, then you have got the prospect of reasonable credit availability. With a declining inflation rate there is no necessary corollary of a rising interest rate. It depends very much on what is happening to the inflation rate.

Senator BRADLEY. You are going to keep a brake on it.

Chairman VOLCKER. We are going to keep a certain amount of pressure on to get the inflation rate down.

Senator BRADLEY. One other question. We talk a lot about productivity tax cuts, productivity, and the elements of productivity. One of the things that we refer to, and that all of the talk today has been related to about business tax cuts, is increasing investment in plant and equipment.

Comparatively we are far below the Japanese at 20 percent, the Germans at 15; we are at 10.

Chairman VOLCKER. Right.

Senator BRADLEY. Do you think that if our long-run goal is to increase competitiveness and to increase productivity we have to increase our investment as a percentage of the GNP above 10 percent? If so, what level? Where is this going to come from?

Chairman VOLCKER. I don't think anybody can give you an accurate answer and say, any particular level is precisely right.

Senator BRADLEY. Should it be more than 10 percent?

Chairman VOLCKER. I think that it should be more.

Senator BRADLEY. By how much?

Chairman VOLCKER. The 1 to 2 percent would make quite a difference, because that extra 1 to 2 percent on the top, so to speak, of a certain amount of investment that goes on just to replace things that are wearing out—for environmental reasons or a lot of other reasons—is presumably a marginal increase that is going to be helpful in terms of productivity and growth.

Senator BRADLEY. Given our present GNP, that 2 percent increase results in about a $50 billion increase in investment in nonresidential fixed investment. Where does that come from?

Chairman VOLCKER. You would like to see most of it come, I think, in the relationship between Government expenditures and receipts. That is what we are talking about when we talk about that deficit in major part.

In other words, if you get $50 billion in increased investment, which would be quite significant, and if you can take it out of the Government deficit, you are home free.

Senator BRADLEY. You would say, take it out of there and not out of savings?

Chairman VOLCKER. I don't want to exclude the increase in personal saving. I think that it would be desirable, in fact, if some of it came from increased savings. Out of the whole process, you hope to get more income, so it does not imply, over a period of time, less consumption. It might, in the short run, as the savings rate improved. Those two avenues, I don't think, are inconsistent. Some of that increase in investment would, I presume, come out of each.

Senator BRADLEY. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

Just one quick question. I think all of us agree that it would be helpful to reduce spending. The rate has increased in spending, particularly as Senator Roth has pointed out. I think that we all agree that it is difficult.

Some want increases for various social programs, and others think we ought to have increases in defense. I think everybody

agrees, and recognizes that there are significant pressures to increase defense spending.

My question really is, to what degree is a defense spending increase inflationary compared with other forms of Federal spending? I have heard that it is more inflationary, is that correct?

Chairman VOLCKER. That point is often made. I think it is hard to carry that point very far, depending upon what other type of Government spending you are comparing that to. If you are comparing it with some highly productive form of Government spending, you get one answer. I don't think there is that high a volume of productive, efficient Government spending.

Senator BAUCUS. So it is the productive spending in terms of producing products that is more inflationary, is that correct?

Chairman VOLCKER. I think one could argue that to the extent you are either putting products on the market that people want or enhancing the efficiency with which the economy works, you have a less inflationary type of spending. But those components don't look terribly large in Government spending at the present.

Senator BAUCUS. Thank you.

The CHAIRMAN. Thank you very much. We appreciate your appearance here today.

Chairman VOLCKER. Thank you.

[The prepared statement of Mr. Volcker and report follow:]

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Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

on Monetary and Related Policies

I am pleased to be here today to review the conduct of monetary policy and to report on the Federal Reserve's economic objectives for the year as a whole, as well as its tentative thinking on policy goals for 1981. Our so-called "Humphrey-Hawkins Report" has already been distributed to you. I would like simply to add some personal perspective this morning on the course of monetary policy, in the context of the economic prospects and choices facing us with respect to other policy instruments.

Seldom has the direction of economic activity changed so swiftly as in recent months. Today the country is faced simultaneously with acute problems of recession and inflation. There have been unprecedented changes in interest rates and the imposition and removal of extraordinary measures of credit restraint. The fiscal position of the Federal Government is changing rapidly.

In these circumstances, confusion and uncertainty can arise about our goals and policies, not just those of the Federal Reserve, but of economic policy generally. Therefore, I particularly welcome this opportunity to emphasize the underlying continuity in our approach in the Federal Reserve and its relationship to other economic policies, matters that are critical to public understanding and expectations.

The Federal Reserve has been, and will continue to be, guided by the need to maintain financial discipline -- a discipline concretely reflected in reduced growth over time of the monetary and credit aggregates -- as part of the process of restoring price

stability. As I see it, this continuing effort reflects not simply a concern about the need for greater monetary and price stability for its own sake -- critical as that is. The experience of the 1970's strongly suggests that the inflationary process undercuts efforts to achieve and maintain other goals, expressed in the Humphrey-Hawkins Act, of growth and employment.

As you know, our operating techniques since last October have placed more emphasis on maintaining reserve growth consistent with targeted ranges for the various Ms, with the implication interest rates might move over a wider range. Those targets were reduced this year as one step toward achieving monetary growth consistent with greater price stability. For several months after the new techniques were introduced in October, the various aggregates were remarkably close to the targeted ranges.

At that time, and for months earlier, you will recall widespread anticipations of recession. Nevertheless, reflecting a variety of developments at home and abroad -- including an enormous new increase in oil prices, Middle-Eastern political volatility, and interpretations of adverse budgetary developments -- there was a marked surge in the most widely disseminated price indices and in inflationary expectations in the early part of this year. Those expectations in the short run probably helped to support business activity for a time; in particular, consumer spending relative to income remained very high, with the consequence of

historically (and fundamentally unhealthy) low savings rates and high debt ratios. Speculation was rife in commodity markets.

Spending and speculative activities of that kind are ultimately unsustainable. But they carried the clear threat of feeding upon themselves for a time, contributing among other things to a further acceleration of wage rates and prices. In that way, inflation threatened to escalate still further in a kind of self-fulfilling prophecy, posing the clear risk that the subsequent economic adjustment would be still more difficult.

Credit markets reflected these developments and attitudes. Bond prices fell precipitously. Long-term money -- including mortgages -- became difficult to raise. Partly as a consequence, short-term demands for credit ballooned in the face of sharply rising interest rates, at the expense in some instances of further weakening business balance sheets. That heavy borrowing also was reflected in acceleration in the money and credit aggregates during the winter.

An attempt to stabilize interest rates by the provision of large amounts of bank reserves through open market operations to support even more rapid growth in money would probably have been doomed to futility even in the short-run, for it could only have fed the expectations of more inflation. It would certainly have been counter-productive in terms of the overriding long-term need to combat inflation and inflationary anticipations. Instead, consistent with our basic policy approaches and techniques, the

Federal Reserve resisted accommodating the excessive money and credit growth.

During this period of rising inflation and interest rates, the Administration and the Congress also appropriately and intensively reviewed their own budget planning. Coordinated with the announcement of the results of that broad governmental effort and the decision of the President to invoke the Credit Control Act of 1969, the Federal Reserve announced on March 14 a series of exceptional, temporary measures to restrain credit growth, reinforcing and supplementing our more traditional and basic instruments of policy.

The demand for money and credit dropped abruptly in subsequent weeks, reflecting the combined cumulative effects of the tightening of market conditions, the announcement of the new actions, and the rather sudden weakening of economic activity. In response, interest rates within a few weeks fell about as fast -- in some instances faster and further -- than they had risen in earlier months. Growth in the aggregates slowed, and for some weeks M-1A and M-1B turned sharply negative.

There is no doubt in my mind that these lower levels of interest rates can play a constructive role in the process of restoring a better economic equilibrium and fostering recovery. Indeed, there is already evidence -- if still tentative -- that homebuilding and other sectors of the economy sensitive to credit costs and availability are benefitting. Meanwhile, progress is being made toward reducing consumer indebtedness relative to

income and toward restructuring corporate balance sheets as bond financing has resumed at a very high level. The sharp improvement in credit market conditions has been accompanied by slower rates of increase in consumer and producer prices, helping to quiet earlier fears of many of an explosive increase in inflation.

The suddenness of the change in market conditions has, however, raised questions in some minds as to whether the interest rate declines were in some manner "contrived" or "forced" by the Federal Reserve -- whether, to put it bluntly, the performance of the markets (together with the phased removal of the special credit restraints) reflects some weakening of our basic commitment to disciplined monetary policy and the priority of the fight on inflation. These perceptions are not irrelevant, for they could affect both expectations and behavior, most immediately in the financial and foreign exchange markets, but also among businessmen and consumers.

The facts seem to me quite otherwise.

Growth in money and credit since March has certainly not exceeded our targets; the M-1 measures have in fact been running below our target ranges. Bank credit has declined in recent months; while the decline in commercial loans of banks can be explained in part by exceptionally heavy bond and commercial paper issuance by corporations, there is simply no evidence of excessive rates of credit expansion currently. In these circumstances, it is apparent that interest rates have responded -- and have been

permitted to respond -- not to any profligate and potentially inflationary increase in the supply of money, but to changes in credit demands, and (so far as long-term interest rates are concerned) to reduced inflationary expectations.

It is in that context -- with credit demands reduced and growth of credit running well within our expectations and targets -- that the special credit restraint programs simply served no further purpose. Those measures were invoked to achieve greater assurance that credit growth would in fact slow, and that appropriate caution would be observed in credit usage. The special restraints are inevitably cumbersome and arbitrary in specific application. They involve the kind of intrustion into private decision-making and competitive markets that should not be part of the continuing armory of monetary policy; their use was justified only by highly exceptional circumstances -- circumstances that no longer exist. Our normal and traditional tools of control (which in fact have been solidified by the Monetary Control Act passed earlier this year) are intact and fully adequate to deal with foreseeable needs.

Neither the decline in interest rates nor the removal of the special restraints should be interpreted as an invitation to consumers or businessmen to undertake incautious or imprudent borrowing commitments, or as lack of concern should excessive growth in money or credit reappear. That is not happening now.

But markets (and the public at large) remain understandably extremely sensitive to developments that might aggravate inflationary forces. As we saw only a few months ago, consumers and businessmen will react quickly in their lending and borrowing behavior to that threat.

While the recent easing of financial pressures helps provide an environment conducive to growth, we should not be misled. A resurgence of inflationary pressures, or policies that would seem to lead to that result, would not be consistent with maintenance of present -- much less lower -- interest rates, receptive bond markets, and improving mortgage availability. We in the Federal Reserve believe the kind of commitment we have made to reduce monetary growth over time is a key element in providing assurance that the inflationary process will be wound down.

I noted earlier the money stock actually dropped sharply during the early spring. In a technical sense, working on the supply side, we provided substantial reserves through open market operations during that period, but commercial banks, finding demands for credit and interest rates dropping rapidly, repaid discount window borrowings as their reserve needs diminished. In general terms, it seems clear that, at least for a time, the demand for money subsided (much more than can be explained on the basis of established relationships to business activity and interest rates) apparently because consumers and others hastened debt repayment at the expense of cash balances and because the earlier interest rate peaks had induced individuals to draw on

cash to place the funds in investment outlets available in the market.

As the Report illustrates, M-1 growth has clearly resumed, and the broader aggregate M-2 is now at or above the mid-point of its range. In the judgment of the Federal Open Market Committee, forcing reserves on to the market in recent weeks simply to achieve the fastest possible return to, say, the mid-point of the M-1 ranges may well have required early reversal of that approach, have been inconsistent with the close-to-target performance of the broader aggregates, and therefore led to unwarranted interpretations and confusion about our continuing objectives. Depending on the performance of the broader aggregates and our continuing analysis of general economic developments, the FOMC is in fact prepared to contemplate that M-1 measures may fall significantly short of the mid-point of their specified ranges for the year.

I have emphasized the Committee's intention to work toward the lower levels of monetary expansion over time. In reviewing the situation this month, the Committee felt that, on balance, it would be unwise to translate that intention into specific numerical targets for 1981 for the various Ms at this time. That view was strongly reinforced by certain important technical uncertainties related to the introduction of NOW accounts nationwide next January, as well as by the need to assess whether the apparent shift in demand for cash in the spring persists.

At the same time, the general nature of the potential problems and dilemmas for 1981 and beyond is clear enough; these are important questions, not just for monetary policy but for the full armory of public policy.

The targets for the monetary aggregates are designed to be consistent with, and to encourage, progress toward price stability without stifling sustainable growth. But in the short-run, the demand for money (at any given level of interest rates) tends to be related not to prices or real output alone, but to the combined effects of both -- the nominal GNP. If recovery and expansion are accompanied by inflation at current rates or higher, pressures on interest rates could develop to the point that consistency of strong economic expansion with reduced monetary growth would be questionable.

Obviously, a satisfactory answer cannot lie in the direction of indefinitely continued high levels of unemployment and poor economic performance. But ratifying strong price pressures by increases in the money supply offer no solution; that approach could only prolong and intensify the inflationary process -- and in the end undermine the expansion. The insidious pattern of rising rates of inflation and unemployment in succeeding cycles needs to be broken; with today's markets so much more sensitized to the dangers of inflation, economic performance would likely be still less satisfactory if that pattern emerges again. The only satisfactory approach must lie in a different direction -- a credible effort to reduce inflation further in the period ahead, and policies that hold out the clear prospect of further gains over time, even as recovery takes hold.

We are now in the process of seeing the inflation rate, as recorded in the consumer and producer price indices, drop to or

even below what can be thought of as the underlying or core rate of inflation of 9 to 10 percent. That core rate is roughly determined by trends in wages and productivity. We can take some satisfaction in the observed drop of inflation, and the damping of inflationary expectations. But the hardest part of this job lies ahead, for we now need to make progress in improving productivity or reducing underlying cost and wage trends -- as a practical matter both -- to sustain the progress.

The larger the productivity gain, the smoother will be the road to price stability -- partly because that is the only way of achieving and sustaining growth in real incomes needed to satisfy the aspirations of workers. Put in that light, the importance of a concerted set of policies to reconcile our goals -- not simply relying on monetary policy alone -- is apparent. While those other policies clearly extend beyond the purview of the Federal Reserve, they obviously will bear upon the performance of financial markets and the economy as the Federal Reserve moves toward reducing over time the rate of growth in money and credit.

In that connection, I recognize the strong conceptual case that can be made for action to reduce taxes. Federal taxes already account for an historically large proportion of income. With inflation steadily pushing income tax payers into higher brackets and with another large payroll tax increase to finance social security scheduled for 1981, the ratio will go higher still. The thesis that this overall tax burden -- and the way our tax structure impinges on savings and investment,

costs and incentives -- damages growth and productivity seems to me valid. Moreover, depending on levels of spending and the business outlook next year, the point can be made that the implicit and explicit tax increases in store for next year will drain too much purchasing power from the economy, unduly affecting prospects for recovery.

But I must also emphasize there are potentially adverse consequences that cannot be escaped -- to ignore them would be to jeopardize any benefits from tax reduction, and risk further damage to the economy.

Whatever the favorable effects of tax reduction on incentives for production and productivity over time, the more immediate consequences for the size of the Federal deficit, and potentially for interest rates and for sectors of the economy sensitively dependent on credit markets, need to be considered.

Many of the most beneficial effects of a tax reduction depend upon a conviction that it will have some permanence, which in turn raises questions of an adequate commitment to complementary spending policies and appropriate timing. We are not dealing with a notion of a "quick fix" over the next few months for a recession of uncertain duration, but of tax action for 1981 and beyond at a time when Federal spending levels, even for fiscal 1981, appear to be a matter of considerable uncertainty, with the direction of movement higher.

Experience is replete with examples of stimulation, undertaken with the best motives in the world, that has turned out in retrospect to have been ill-timed and excessive. Given

the demonstrable frailty of our economic forecasting, it takes a brave man indeed to project with confidence the precise nature of the budgetary and economic situation that will face the nation around the end of this year. Moreover, an intelligent decision on the revenue side of the budget implies knowledge of the spending priorities of an Administration and a Congress, a matter that by the nature of things can only be fully clarified after the election.

For all the developing consensus on the need for "supply side" tax reduction -- and I share in that consensus -- some time seems to me necessary to explore the implications of the competing proposals and to reduce them to an explicit detailed program for action. I have emphasized the need to achieve not only productivity improvement but also a lower trend of costs and wages; despite its importance, I have seen relatively little discussion in the current context of how tax reduction plans might be brought to bear more directly on the question of wage and price increases.

The continuing sensitivity of financial markets, domestic and international, to inflationary fears is a fact of life. It adds point and force to these observations and questions. Tax and budgetary programs leading to the anticipation of excessive deficits and more inflation can be virtually as damaging as the reality in driving interest rates higher at home and the dollar lower abroad.

I believe it is obvious from these remarks that a convincing case for tax reduction can be made only when crucial

questions are resolved -- questions that are not resolved today. The appropriate time for decision seems to me late this year or early 1981. Fiscal 1982 as well as fiscal 1981 spending plans can be clarified. We will know if recovery of business is firmly underway. There will have been time to develop and debate the most effective way of maximizing the cost-cutting and incentive effects of tax reduction, and to see whether a tax program can contribute to a consensus -- a consensus that has been elusive in the past -- on wage and pricing policies consistent with progress toward price stability. To go ahead prematurely would surely risk dissipating the potential benefits of tax reduction amid the fears and actuality of releasing fresh inflationary forces.

I have spoken before with this Committee and others about the need for changes in other areas of economic policy to support our economic goals. Paramount is the need to reduce our dependence on foreign oil -- a matter not unrelated to tax policy. We need to attack those elements in the burgeoning regulatory structure that impede competition or add unnecessarily to costs. And I believe it would be a serious mistake to seek relief from our present problems by retreat to protectionism, at the plain risk of weakening the forces of competition, the pressures on American industry to innovate, and undermining the attack on inflation.

We are now at the critical point in our efforts to reduce inflation while putting the economy back on the path to sustainable growth in the 1980's.

I sense the essential objectives are widely understood and agreed -- the need to wind down inflation even as recovery proceeds; the importance of restoring productivity and increasing incentives for production and investment; the maintenance of open, competitive markets; a substantial reduction in our dependence on foreign energy.

You know as well as I how much remains to be done to convert glittering generalities into practical action: to achieve and maintain the necessary fiscal discipline, to make responsible tax reduction and reform a reality, to conserve energy and increase domestic sources, to tackle the regulatory maze. But I also know there is no escape from facing up to the many difficulties. Our policies must be coherently directed toward the longer-range needs. In that connection, I believe that economic policies, public and private, should recognize that the need for discipline and moderation in the growth of money and credit provides the framework for decision-making in the Federal Reserve.

* * * * * *

For use at 10 a.m.,
July 22, 1980

Board of Governors of the Federal Reserve System

Midyear Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978

July 22, 1980

65-969 O - 80 pt.2 - 18

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., July 22, 1980

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES.

The Board of Governors is pleased to submit its Midyear Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978.

Sincerely,
Paul A. Volcker, Chairman

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CHAPTER 1

THE OUTLOOK FOR THE ECONOMY AND MONETARY POLICY OBJECTIVES

SECTION 1. THE OUTLOOK FOR THE ECONOMY

The economy moved into recession in the first half of this year. A cyclical downturn had been widely anticipated for some time, but the decline in spending, output, and employment, once under way, has been steeper than most analysts had foreseen. The second quarter decrease in real gross national product, at an annual rate of about 9 percent according to the Commerce Department's preliminary estimate, was considerably sharper than in the initial quarters of other postwar recessions.

The slump in activity has been most pronounced in the housing and auto industries—the latter sector being adversely affected by structural problems as well as by general cyclical pressures. But the decline has not been limited to these sectors. Retail sales excluding autos have dropped considerably since January, and business outlays for equipment and new construction also have fallen.

The very sharp curtailment of spending on houses and consumer goods and services in the current downturn probably is attributable in large part to the cumulative effect of inflation on consumers' financial well-being. Real disposable personal income was virtually flat in 1979 and has declined appreciably this year. Earlier, consumers had reduced their rate of saving in the face of shortfalls in real income in an effort to maintain consumption standards and in anticipation of inflation. This was accomplished by further rapid growth in installment and mortgage credit in the late stages of the recent expansion, but with the result that debt service burdens--which already were at high levels historically--continued to climb. Sharply higher interest rates and generally more stringent credit terms in late 1979 and early 1980 acted as additional deterrents to spending, encouraging households in their efforts to reduce debt and to rebuild savings.

The falloff in final sales has caused businessmen to spend more cautiously. This tendency has been reinforced by financial factors as well. The liquidity position of businesses had deteriorated appreciably during the expansion, particularly in the latter stages when there was a surge in short-term borrowing; many firms now are making strong efforts to restructure balance sheets.

The unexpected rapidity of the current downturn thus far has led analysts to reassess their view of the prospects for economic activity in the period ahead. Significant disagreement has arisen with regard to whether recovery will be prompt and strong, with the recent relaxation of credit market conditions encouraging a resumption of normal spending patterns, or whether the cyclical adjustment will be prolonged and the subsequent upturn possibly sluggish. The experience of the past year or so has demonstrated the hazards of forecasting, and the uncertainties at the present time clearly are substantial. Much will depend, for example, on the perceptions of businessmen about the longer-range prospects for demand and the attractiveness of investment, the response of consumers to the 1981 model-year automobiles, and the strength of the rebound in housing that may develop in the wake of the recent easing in mortgage market conditions.

There are signs that the contraction in some sectors may be nearing an end, but these are far from conclusive. Retail sales in June turned up slightly after four months of sharp decline; in the first ten days of July auto sales were at the strongest pace in three months. Housing starts and sales of new homes strengthened in the most recent months for which data are available.

In reflection of the prevailing uncertainties, there is a considerable range of views among the members of the Federal Open Market Committee regarding the movement of major economic variables over the remainder of the year. Most of the members believe that the recession probably will persist into the fourth quarter, with a cumulative net drop in real GNP less than that in the downslide of 1973-75. Although the decline should slow in the months ahead, employment may be cut back further, and the unemployment rate could rise beyond 8-1/2 percent by year-end. The increasing slack in labor markets and in industrial capacity utilization should at the same time help to moderate inflationary pressures.

The table below presents ranges for key economic variables that generally encompass the judgments of the individual FOMC members about the probable performance of the economy this year and in 1981.

	Actual	Projected	
	1979	1980	1981
Change from fourth quarter to fourth quarter, percent			
Nominal GNP	9.9	5 to 7-1/2	8-1/2 to 11-1/2
Real GNP	1.0	-5 to -2-1/2	1/2 to 3
Implicit GNP deflator	8.9	9 to 10	7-3/4 to 9-1/2
Average level in fourth quarter			
Unemployment Rate (percent)	5.9	8-1/2 to 9-1/4	8 to 9-1/4

The outlook for 1981 is especially uncertain at the current time. Economic and financial developments over the next six months should lay the groundwork for the recovery anticipated in 1981. But, in addition, any

actions taken in the fiscal arena would have an impact on the path of recovery. The projections presented in the table, which do not assume a tax cut in the next year, indicate a turnaround in economic activity--although there is a considerable range of views concerning the potential strength of the recovery. On balance, the forecast is for a moderate rebound in real GNP, accompanied by some further slackening in the pace of inflation. Unemployment, however, is likely to remain high throughout the year.

Should there be a tax cut in 1981, the impact on economic performance will, of course, depend on its timing and composition. There is the distinct--and very troubling--possibility that a poorly designed tax reduction, or one not coupled with adequate restraint on the expenditure side, might give rise to added inflationary and financial pressures that would in time dissipate the beneficial short-term effects of the fiscal stimulus. Any indication that the Congress and the Administration were moving away from a commitment to rigorous fiscal discipline would run the risk of reinvigorating the inflationary expectations that have played such a major role in the economy's difficulties. The Committee thus feels it important that the question of a tax cut be approached cautiously; if a tax cut ultimately is enacted, it should be carefully structured to enhance the productive potential of our economy and to yield the greatest relief from cost and price pressures over the longer run.

SECTION 2. MONETARY POLICY OBJECTIVES

The task for monetary policy—and for stabilization policy generally—in the current circumstances obviously is a difficult one. Recession naturally summons forth calls for stimulus to aggregate demand. The prevailing high level of unemployment, and the exceptional weakness apparent in particular industries and sectors of our economy, certainly must be given careful consideration in the formulation of public policy. But caution must be exercised in the application of any broad countercyclical stimulus, especially in the present environment of persistent inflationary pressures. Indeed, there is no clearer lesson from the experience of the past decade and a half than that excessive stimulus is detrimental to the objective of achieving and sustaining noninflationary, balanced growth.

A primary and continuing goal of monetary policy must be to curb the accelerating inflationary cycle. It now appears that some progress is beginning to be made in that direction. Price increases have slowed considerably from the pace of early in the year, in part reflecting some relief in the food and energy sectors, but also as a result of the drop in demand pressures. In addition, recent attitudinal surveys point to a reduction in inflationary expectations. The continuation of this trend in expectations will result in a greatly improved economic and financial environment, one more conducive to long-term growth. We already have witnessed one benefit of an easing of inflationary fears: a substantial decline in long-term interest rates from their highs earlier this year and a revitalization of the bond markets. The Federal Reserve's pursuit of a policy of monetary restraint--evidenced this year by a moderation of money growth--has been an important factor in this

turn in expectations; a sustained commitment to the attainment of noninflationary rates of money and credit growth is essential if this progress is to be extended.

Despite the improvement that has occurred, however, inflationary forces are far from subdued. The past years have left a legacy of adverse cost trends that will not be reversed quickly. Moreover, more extreme inflationary expectations easily could be reignited. In establishing its plans for growth in the monetary aggregates, the Federal Reserve will continue to place high priority on reducing inflation, believing that this is essential to fostering a sound and sustained recovery. Over the long term, a reduction in the underlying rate of inflation is essential for a strong U.S. economy, for encouraging the saving we will need to finance adequate capital investment, and for maintaining the position of the dollar in international markets.

But it is clear also that if inflation is to be restrained without undue disruption of economic activity we cannot rely solely on monetary policies. For example, fiscal discipline is essential to ensure that excessive pressure is not placed on the financial and real resources of the economy. The structure of our tax system should be examined with an eye to the incentives it provides for productivity-expanding research and capital formation. And the full range of governmental policies should be reviewed to ensure that they do not add needlessly to costs and do not stunt innovation and competition.

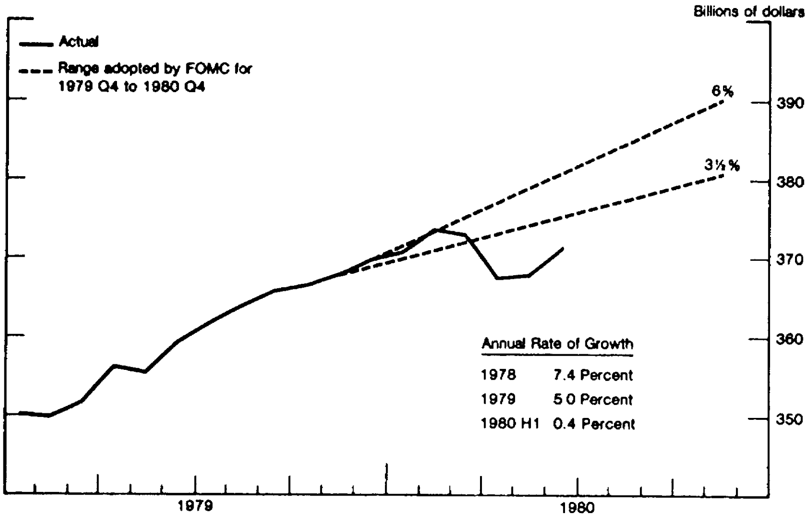
SECTION 3. MONEY AND CREDIT GROWTH IN 1980 AND 1981

In February the Federal Reserve reported to the Congress ranges of growth for the monetary aggregates in 1980 that it believed to be consistent with the continuing objective of reducing inflationary pressures over time while providing for sustainable growth in the nation's production of goods and services. These ranges anticipated a substantial deceleration in monetary growth in 1980 from the pace of the preceding year. Measured from the fourth quarter of 1979 to the fourth quarter of 1980, the ranges adopted were: for M-1A, 3-1/2 to 6 percent; for M-1B, 4 to 6-1/2 percent; for M-2, 6 to 9 percent; and for M-3, 6-1/2 to 9-1/2 percent. The associated range for bank credit expansion was 6 to 9 percent.

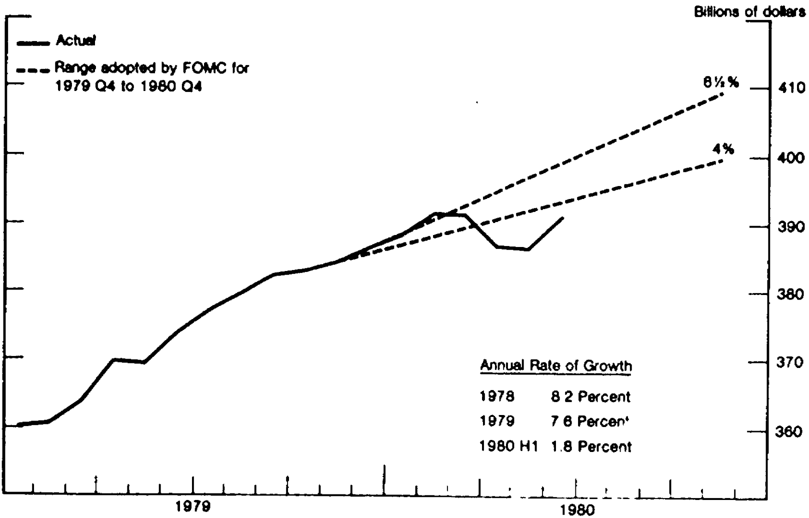
During the first half of 1980, growth of the monetary aggregates slowed considerably from the 1979 pace. The deceleration was particularly marked for the narrower aggregates, M-1A and M-1B, which grew at rates below the lower limits of their longer-run ranges--at annual r tes of about 1/2 and and 1-3/4 percent, respectively, from the fourth quarter of 1979 to the second quarter of 1980. (M-1A is currency and demand deposits held by the public, while M-1B includes checkable interest-bearing deposits as well.) At the same time, the broader aggregates, M-2 and M-3, grew at annual rates of 6-1/2 and 6-3/4 percent, respectively, which is somewhat above the lower limits of their ranges. In fact, by June, as the accompanying charts show, M-2--which includes money market fund shares and all deposits except large CDs at banks and thrift institutions--was around the midpoint of its longer-run range, and M-3 slightly below, while the narrower aggregates were moving back toward their ranges, following an unusually sharp drop in early spring.

Growth Ranges and Actual Monetary Growth

M-1A

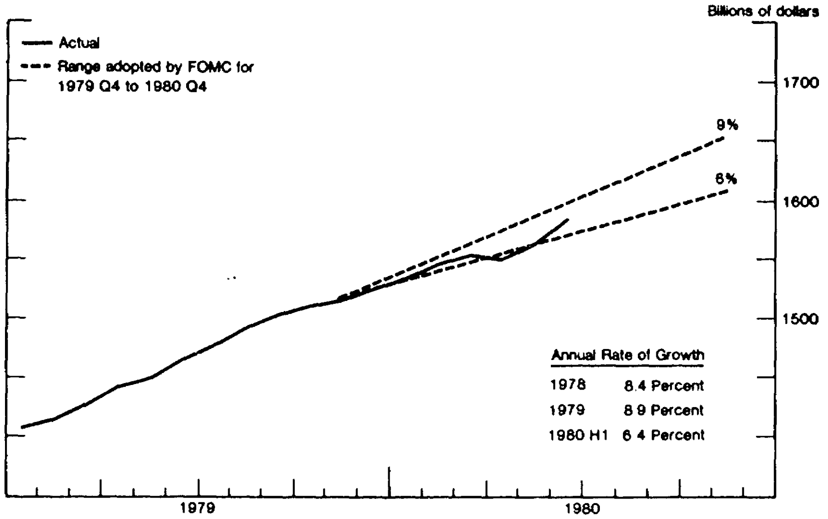


M-1B

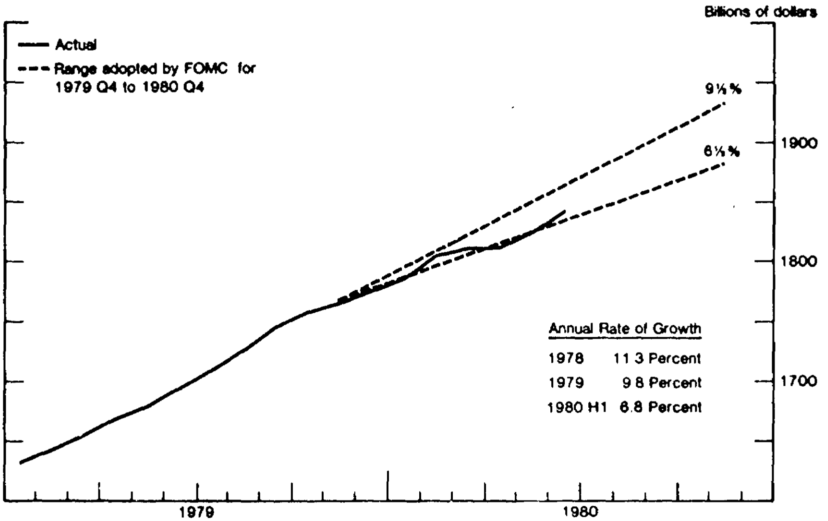


Growth Ranges and Actual Monetary Growth

M-2



M-3



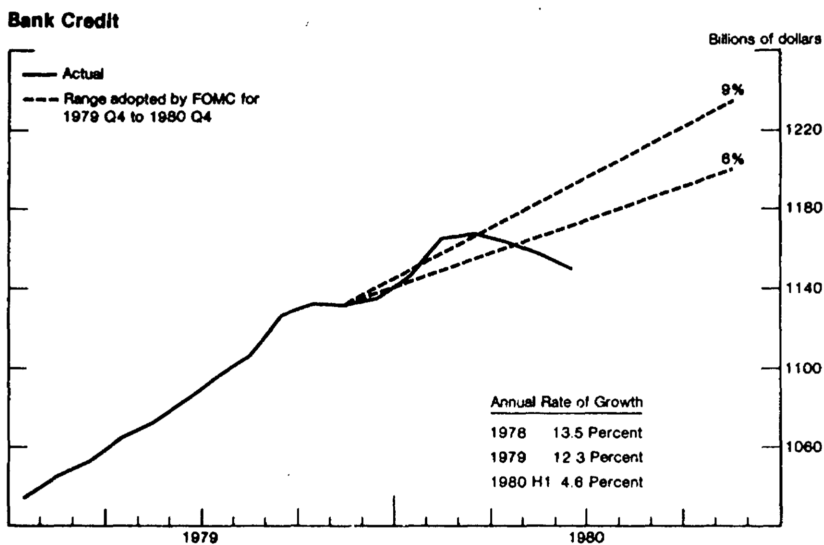
The contraction in the narrower aggregates during the second quarter was much greater than would be expected on the basis of the historical relationships among money, income, and interest rates. This unusual weakness may have reflected exceptional efforts by the public to pare cash balances, such as have characterized some other periods following a sharp upward adjustment in market interest rates to new record levels. There may also have been an impact from the surge in debt repayments, especially at banks, after the imposition of the credit control program in mid-March, with some of the funds apparently coming out of cash balances. In light of these special circumstances affecting the public's demand for transactions balances, and given the relative strength of the broader aggregates and the usual lags between changes in credit conditions and growth in the narrow aggregates, the FOMC believed it appropriate to foster a more gradual return of M-1 growth to the ranges established earlier.

In connection with reserve targeting procedures, System open market operations supplied a large volume of nonborrowed reserves over the course of the second quarter. Given the weak demand for money and bank credit, most of the added nonborrowed reserves were used by banks to repay borrowings from the Federal Reserve discount window. Borrowings fell from a high of $2.8 billion on average in March to minimal levels recently, and the easing of bank reserve positions was reflected in a sharp decline in the federal funds rate. From their peaks of late March or early April, short-term interest rates have declined 7 to 9 percentage points and long-term rates by roughly 2 to 3 percentage points.

Expansion in the broader aggregates over the first half of the year reflected the very rapid growth for much of the time in money market mutual fund shares, 6 month money market certificates, and 2-1/2 year small saver certificates, instruments that pay market rates of interest. Late in the period, as short-term market interest rates declined sharply, the contraction in savings deposits at banks and other depository institutions halted, and the outstanding amount of those deposits began to rise. For part of the period, growth in M-3 was sustained also by continued issuance of large time deposits by commercial banks and thrift institutions, which are included in M-3 but not in M-2; however, large time deposits began to contract in late spring as credit demands weakened substantially.

Bank credit growth greatly exceeded the FOMC's range in the first quarter of the year. The second quarter, however, saw a sharp contraction in this measure, and credit growth was well below the FOMC-specified range as of midyear. Demands for bank loans by households and businesses dropped abruptly in the second quarter, while the banks--concerned about the possible erosion of profit margins by high cost funds obtained earlier and seeking to conform to the guidelines of the March 14 special credit restraint program--pursued relatively tight lending policies. Businesses, meanwhile, have met a substantial portion of their credit needs through issuance of commercial paper (which serves as a close substitute for bank credit for many large firms), by borrowing in bond markets, and by reducing holdings of liquid assets. Over the half year, the total of credit advanced by banks and in the private short-term money markets rose at an annual rate of around 7-1/2 percent.

Growth Ranges and Actual Bank Credit Growth



At its meeting in July, the Federal Open Market Committee reassessed the ranges it had adopted for monetary growth in 1980 and formulated preliminary goals for 1981. The Committee elected to retain the previously established ranges for the aggregates over the remainder of 1980. This decision by the Committee took into consideration the recent behavior of the money stock measures as well as emerging economic conditions. In this regard it was recognized that, if the public continues to economize on cash balances to an unusual degree in the second half of the year, growth in the narrower aggregates would likely fall toward the lower end of the established ranges.

With respect to the broader aggregates, growth in the second half is likely to place them nearer the midpoints of their respective ranges, and in the case of M-2 quite possibly in the upper half of its range. Recent trends suggest that a continued substantial expansion in the interest-bearing nontransactions component of M-2 is likely. In the current cyclical environment, consumers have begun to reevaluate their financial positions and have reduced their borrowing and adjusted upward their rate of saving. Thus, if the recent lower level of interest rates persists, the outlook is for an augmented flow of funds to depository institutions along with continued, though slower, growth in money market mutual funds.

The Committee also noted that the recent sharp contraction in bank credit makes it quite likely that this measure will fall below the 6 to 9 percent growth range specified in February. A resumption of bank credit expansion during the second half is anticipated, but the strength of that move will depend to a considerable extent on patterns of corporate finance. The desire for balance sheet restructuring may well continue to mute business

loan demands, although weaker corporate cash flows and a narrowing of the spread of the prime rate over commercial paper rates likely will prompt some borrowing at banks. Mortgage loan demands also should begin to recover as the year progresses, and the runoff in consumer loans is expected to abate.

One factor that contributed to the recent weakness in bank lending was the Board's special credit restraint program. As announced earlier, the program is being phased out this month because there is now no evident need for extraordinary measures to hold bank lending within reasonable bounds. In removing the special controls, the Board has emphasized its intention to continue to maintain aggregate growth in money and credit at rates consistent with a reduction in inflationary pressures.

With regard to monetary policy over the longer run, the FOMC reiterates its intent to seek reduced rates of monetary expansion over coming years, consistent with a return to price stability. While there is broad agreement in the Committee that it is appropriate to plan for some further progress in 1981 toward reduction of the targeted ranges, most members believe it would be premature at this time to set forth precise ranges for each monetary aggregate for next year, given the uncertainty of the economic outlook and institutional changes affecting the relationships among the aggregates. The extent and timing of adjustments in the targets will depend upon an appraisal of the outlook at the end of the year. The appropriate money growth in 1981 relative to 1980 of course will depend to some extent on the outcome in this year--that is, on exactly where in the present ranges the various aggregates fall at year-end.

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In addition, the various measures of money will be affected in 1981 by shifts in the demand for different types of financial assets. The introduction of NOW accounts on a nationwide basis in January will accelerate the shift from regular demand deposits into interest-earning transactions balances, thereby depressing M-1A growth next year. On the other hand, M-1B probably will be boosted somewhat next year by shifts from savings deposits and other interest-bearing assets into NOW accounts. The range for M-1B thus may have to accommodate a period of abnormal growth as the public adjusts to the availability of a new instrument. The experience of the past year and a half with ATS accounts has indicated the difficulty of estimating in advance the public's demand for such balances. Although growth in M-2 and M-3 will not be affected by NOW account movements, these broader aggregates include other relatively new financial instruments, the demand for which is still subject to uncertainty. The behavior of these instruments in coming months will aid the FOMC in determining appropriate growth ranges for the broader aggregates in the 1981 period.

SECTION 4. THE ADMINISTRATION'S SHORT-TERM ECONOMIC GOALS AND THE RELATIONSHIP OF FEDERAL RESERVE OBJECTIVES TO THESE GOALS

The Administration, in association with its midyear budget review has updated its forecast of the behavior of major economic variables for 1980 and 1981. The revised figures are shown below.

The Administration's Forecast

	1980	1981
Change from fourth quarter to fourth quarter, percent		
Nominal GNP	6-3/4	12-1/2
Real GNP	-3	2-1/2
Implicit price deflator	10	9-3/4
Average level in fourth quarter		
Unemployment rate (percent)	8-1/2	8-1/2

These estimates, which the Administration has indicated should be viewed as forecasts rather than as goals, show a considerably greater decline in real activity in 1980 than had been anticipated in the January Economic Report of the President. The outlook for nominal GNP growth through year-end has been lowered by a smaller amount, owing to a somewhat higher anticipated rate of inflation for the four quarters of 1980. The Administration's projections for this year fall within the ranges expected by the members of the FOMC.

The Administration has projected a resumption of output growth next year that places real GNP near the upper end of the range encompassed by the forecasts of the members of the FOMC. At the same time, the Administration's estimates place the rate of inflation somewhat above the range of the FOMC members' expectations. (Like the FOMC members' projections, the Administration's forecast does not include a tax cut provision for 1981.)

As indicated in the preceding section, the Federal Reserve intends to set monetary growth ranges for 1981 that will help to restrain inflationary pressures in the recovery period. As experience this year illustrates, considerable uncertainty attaches to any analysis of the relationships over relatively short periods among money, interest rates, and nominal GNP. However, a substantial expansion in demands for goods and services, accompanied by a lack of progress on the inflation front--or worse, an actual increase in inflation or inflationary expectations--would raise the possibility of a considerable firming of conditions in financial markets. Large and prolonged federal deficits would increase that risk. This highlights the urgency of concerted effort by the public and private sectors to reduce the rate of advance in costs and prices and the need to focus any discussions of fiscal action on approaches that would serve to alleviate cost pressures and bolster productivity.

CHAPTER 2

A REVIEW OF RECENT ECONOMIC AND FINANCIAL DEVELOPMENTS

SECTION 1. ECONOMIC ACTIVITY DURING THE FIRST HALF OF 1980

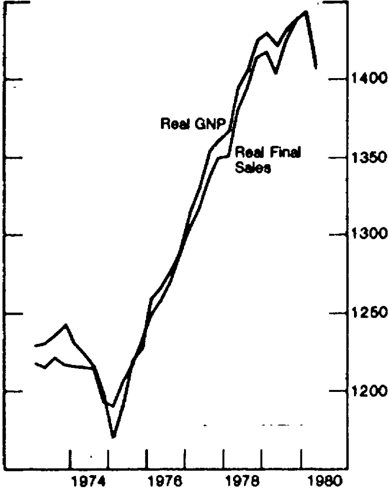
Economic activity turned down early this year following almost five years of expansion. Between January and June, industrial production fell 7-1/2 percent, employment declined by about 1-1/4 million, and the unemployment rate jumped 1-1/2 percentage points. Real gross national product is estimated to have fallen at an annual rate of 9.1 percent in the second quarter, with the decline in activity widespread among major sectors of the economy. Retail sales have decreased substantially since January, housing starts have dropped to near-record postwar lows, and business outlays for equipment and new construction have declined. Although businesses were cautious in building inventories during the expansion, the severity of the recent decline in final sales has led to some involuntary stock accumulation; as in past cycles, the resulting efforts to curb inventory growth have played a significant role in the weakening of orders and production.

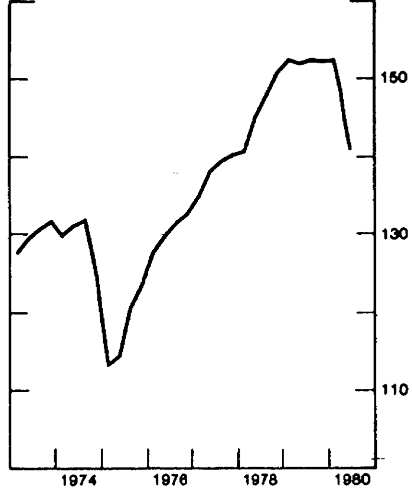
Recent reductions in aggregate demand, coupled with a slower rise of energy prices, meanwhile have brought some moderation in the overall pace of inflation. The producer and consumer price indexes have risen at much less rapid rates in the past few months than they did earlier in the year. Moreover, there are indications from consumer surveys that inflationary expectations have been lowered. Nevertheless, inflation still possesses a strong momentum, with unit labor costs continuing on a steep upward trend.

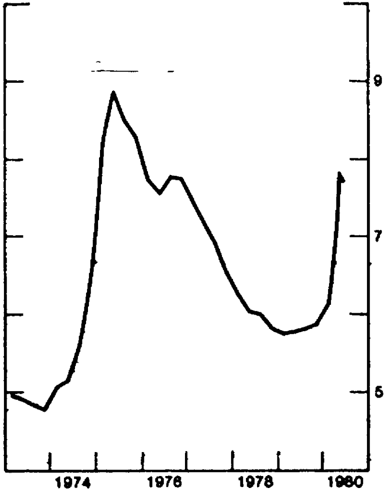
Personal Consumption Expenditures

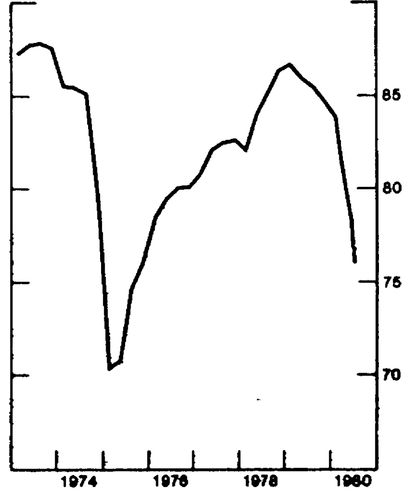
Personal consumption expenditures fell sharply in real terms during the first half. A number of adverse trends had characterized household finances for some time prior to the beginning of 1980. Real disposable income had stagnated after 1978, household liquidity positions had weakened as liabilities

Current Indicators of Economic Activity







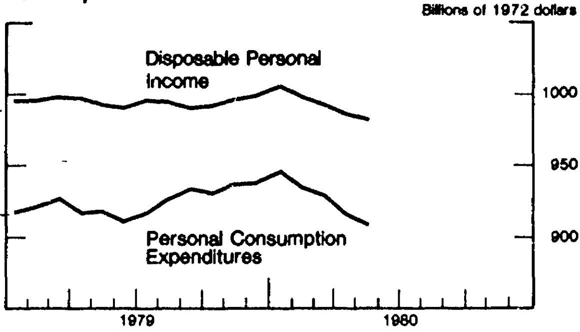


increased faster than financial assets after late 1976, and a near-record proportion of disposable income had been committed to the servicing of debt. Moreover, consumer confidence, as measured by opinion surveys, had deteriorated to levels last seen in the 1973-75 recession. In the light of these trends, a downward adjustment of consumer outlays might have been expected last year; the fact that it did not occur appears attributable in part to growing expectations of inflation that fostered a buy-in-advance psychology.

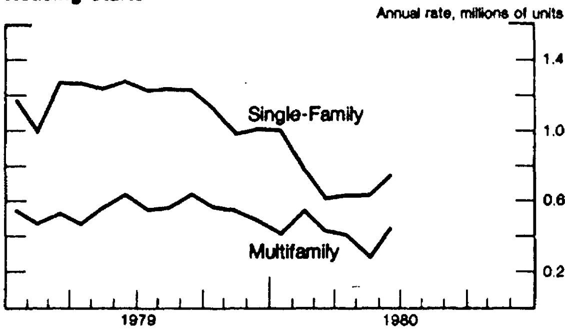
Between January and May, retail sales fell 6-1/2 percent in nominal terms and more than 9-1/2 percent in real terms--the sharpest four-month drop in the postwar period. Preliminary estimates for June, however, indicate that sales moved up somewhat. As in past recessions, large decreases in sales this year have occurred for the relatively discretionary items of consumer expenditure. Automobile sales in June averaged only 7.6 million units at an annual rate, close to the May pace, which was the slowest since late 1974. Furniture and appliance sales also are down sharply this year, in part because of the fall in housing sales. But weakness in consumer outlays has not been confined to the durable goods sector. Purchases of nondurables in real terms also have been falling since late last year, with sizable declines recorded for clothing and general merchandise.

Since January, real disposable income has decreased substantially as employment and hours worked have fallen and prices have continued upward at a rapid pace; nonetheless, the retrenchment by consumers has lifted the saving rate somewhat above the extraordinarily low level of the fourth quarter of last year. It still remains low by historical standards, however, and uncertainty

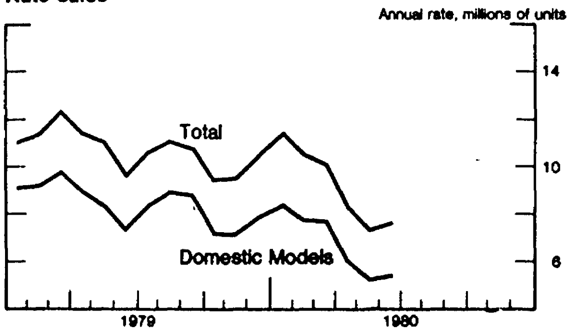
Real Personal Consumption Expenditures and Real Disposable Personal Income



Housing Starts



Auto Sales



about job and income prospects may well prompt households to enlarge precautionary savings, thereby contributing further to the weakness in personal consumption expenditures.

Residential Construction

Homebuilding activity has experienced a severe decline. Housing starts, which averaged nearly 1-3/4 million units at an annual rate during the first nine months of 1979, began to fall sharply last autumn. By December, starts were at a 1-1/2 million unit pace, and by May they had declined almost to a 900,000 rate. June saw a pickup in starts to a 1-1/4 million annual rate.

In the single-family sector, starts dropped 45 percent between the third quarter of 1979 and the second quarter of this year. Although demographic factors remained quite favorable during this period, the demand for such dwellings was curtailed by the increased cost of homeownership associated with higher house prices and the rapid rise in mortgage interest rates. The monthly cost of interest and principal on an average-priced new home financed with a conventional mortgage rose to $700 in May--a third higher than six months earlier and 50 percent above the same month of 1979. Households probably were increasingly reluctant to undertake such heavy financial obligations, especially as income and employment conditions weakened this year.

Home sales have dropped almost 40 percent from the pace of last summer. Although production adjustments have reduced the number of unsold new single-family dwellings on the market, these unsold units bulk larger relative to the recent slower rate of sales. At the May sales pace, which was up sharply from April, there was almost a nine-month supply of unsold new single-family units on the market. The pickup in sales in May is perhaps a sign of

some increased interest on the part of homebuyers, prompted by the recent easing in financial markets; however, the still large overhang of unsold homes is likely to discourage a quick resumption of building in many localities.

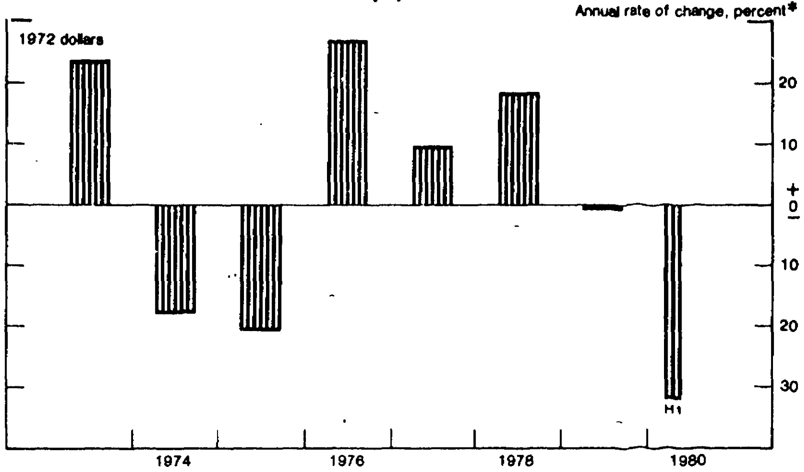
Multifamily housing starts began declining sharply late last year and in the second quarter were off about 35 percent from the already-reduced pace of the third quarter of 1979. The decline in this sector has been less severe than in the 1973-75 period, as low vacancy rates in many areas and an acceleration in rent increases beginning in late 1979 have given builders an incentive to sustain a significant level of apartment construction in the face of high construction costs and tight financial conditions. In addition, demands for condominiums--a lower-cost alternative to single-family homeownership--have provided support to multiunit activity.

Business Spending

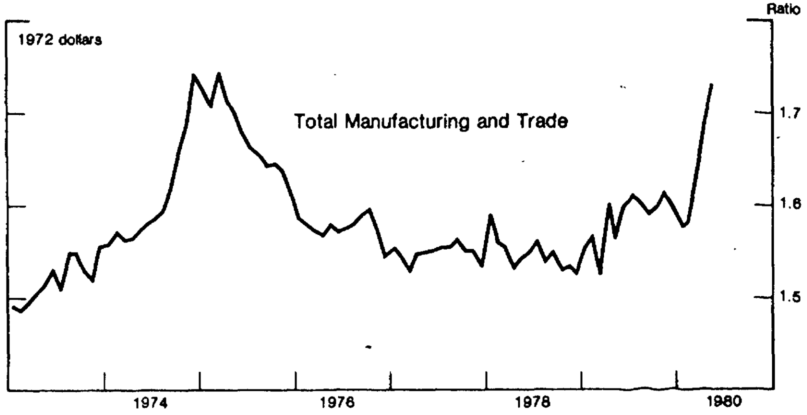
Business spending on plant and equipment has slowed in recent months as firms have sought to avoid expanding capacity at the onset of a recession. Spending on nonresidential structures, which accounted for much of the gain in investment during 1979, peaked in January and declined substantially in the following months. Business purchases of trucks and automobiles also have been falling since early this year, as have outlays for other capital equipment.

Weakness in capital spending in the first half of the year--as well as in forward-looking indicators of investment activity such as surveys, construction contracts, and equipment orders--probably reflected businessmen's anticipations that sales may remain sluggish for a while. In addition, corporate cash flows are diminishing, and with liquidity positions already

Contracts and Orders for Plant and Equipment



Inventories Relative to Sales



*Annual changes are from Q4 to Q4, semi-annual change is from Q4 to the April-May average.

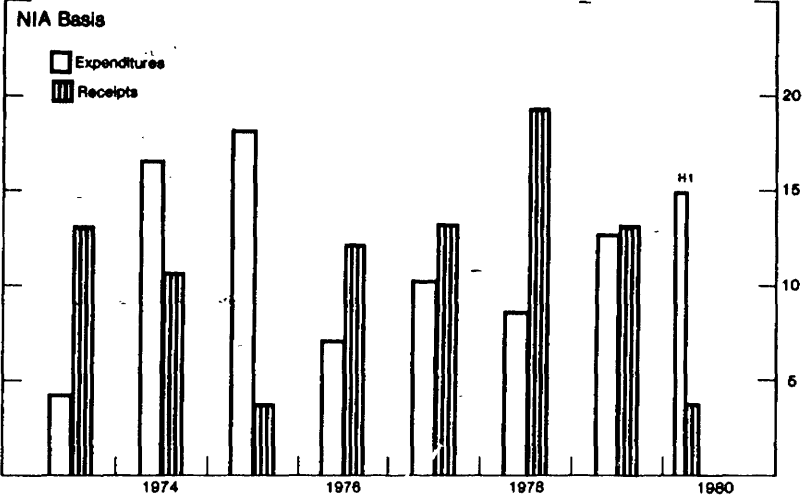
strained in many instances, there may be a reluctance to undertake additional projects requiring external financing. Although interest rates have fallen dramatically from the high levels reached earlier this year, growing excess plant capacity suggests the likelihood of further decreases in real outlays, while firms take advantage of lower long-term rates to restructure their balance sheets.

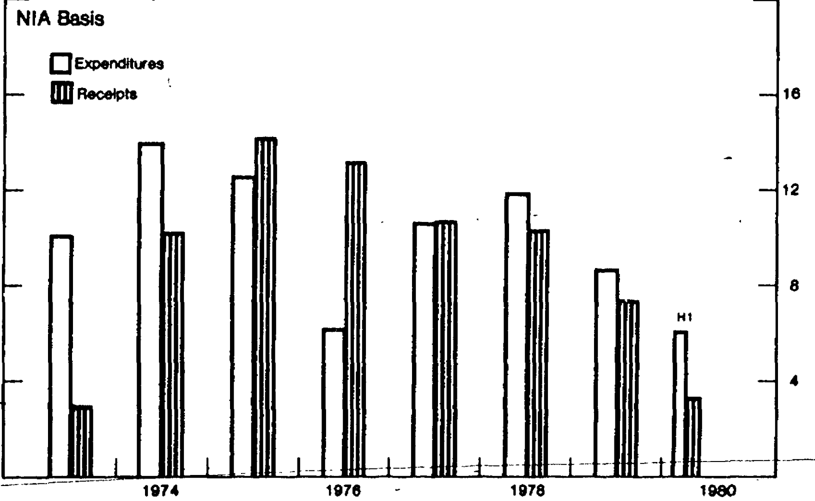
Despite sizable cutbacks in production, some involuntary inventory accumulation appears to have occurred this spring as a consequence of the steep fall in sales. The stock-sales ratio for all manufacturing and trade in real terms rose only moderately during the first quarter, but climbed appreciably in April and May to near the level of late 1974. Since the start of the year, substantial increases in the ratio have been registered in most major industries with especially large rises for primary metals manufacturers, furniture and appliance retailers, and the motor vehicle industry. Auto sales incentive programs and production adjustments in the first quarter of 1980 largely eliminated excessive stocks that had resulted from last summer's gasoline shortages. However, beginning in mid-April, automobile sales plummeted and, despite further curtailments of production, some overhang of stocks at dealers reappeared.

Government

Spending at all levels of government has been restrained in recent months. Total federal expenditures, which grew rapidly in the early months of the year, moderated in the second quarter largely as a result of the March budget cuts. Growth in receipts fell off much more, however, as weakness in

Public Sector Expenditures and Receipts





*Annual changes are from Q4 to Q4; semi-annual changes are from Q4 to Q2.

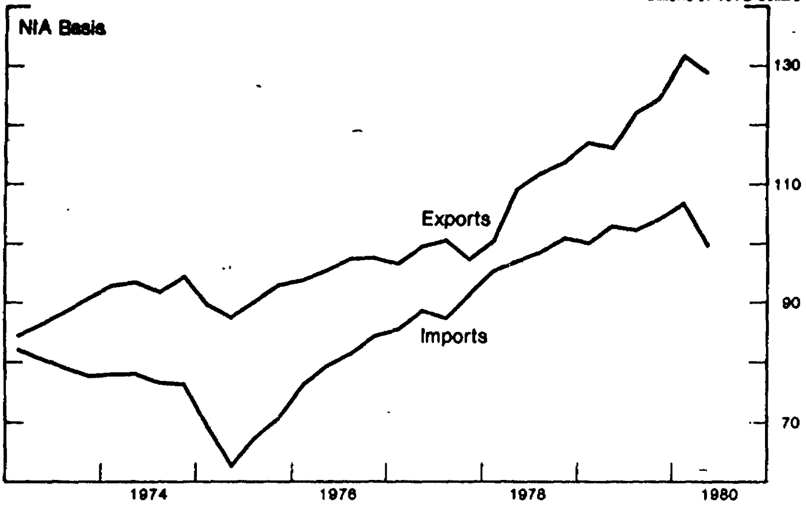
Data for 1980 H1 are partially estimated by the Federal Reserve.

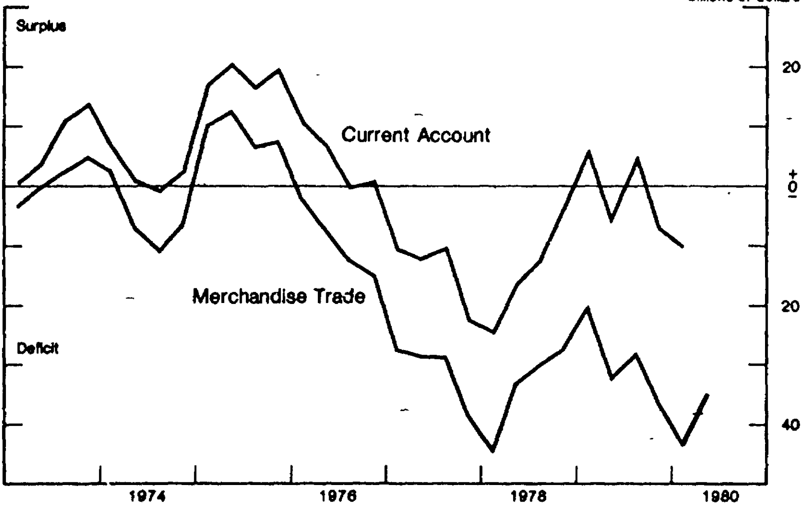
personal income and profits offset the impact of additional revenue from the windfall profits tax on oil producers. As a result, the federal deficit on a national income accounts basis probably deepened by about $30 billion, at an annual rate, between the fourth quarter of 1979 and the second quarter of 1980. However, the high-employment budget, a better indicator of the thrust of discretionary fiscal policy, showed a movement toward restraint during this period.

State and local government spending fell in real terms during the first half of 1980, as governmental units curtailed outlays in response to the slower growth of revenues caused by tax cuts enacted in 1979, the weakening economy, and the March reductions of federal grants-in-aid. The reduced pace of spending was most pronounced for construction activity because federal funding was cut back and municipal bond issuance was constrained in the first quarter by high interest rates. Despite the downward adjustments of outlays, the aggregate operating deficit of the state and local government sector apparently widened considerably in the spring.

International Trade and Payments

Real exports of goods and services continued to grow rapidly in the first quarter of 1980, but the rise appears to have slowed somewhat in the second quarter. The deceleration largely reflected the slowing of economic expansion abroad and the fading of the impact of the 1977-78 real depreciation of the dollar. All of the growth in the first half was concentrated in nonagricultural exports; agricultural shipments were reduced, partly because of the





Data for 1980 Q2 Merchandise Trade Balance are partially estimated.

embargo on additional grain sales to the Soviet Union imposed by the President in January.

The volume of imports, meanwhile, began to fall off as U.S. economic activity slackened and as higher prices and greater fuel efficiency acted to restrain oil imports. The volume of non-oil imports rose slightly on balance in the first half of 1980, but all of the increase was in the first quarter. The quantity of oil imports fell, apparently reaching its lowest rate in four years in the second quarter. Despite a declining volume of oil imports in the first quarter, higher OPEC prices resulted in a continuation of the rapid growth in the dollar value of oil imports. The oil import bill nearly doubled between the fourth quarter of 1978 and the first quarter of 1980; in the second quarter the value of oil imports changed little as lower volume offset a further rise in import prices.

The U.S. merchandise trade deficit increased about $6-1/2 billion, at an annual rate, in the first quarter of this year from the rate in the last quarter of 1979. The current account moved from a deficit of about $7 billion at an annual rate in the fourth quarter, and near balance for the year 1979, to a deficit of about $10 billion in the first quarter of 1980. Higher foreign earnings of U.S. oil companies offset part of the rise in the merchandise trade deficit. Partial data indicate that the trade and current-account deficits narrowed in the second quarter.

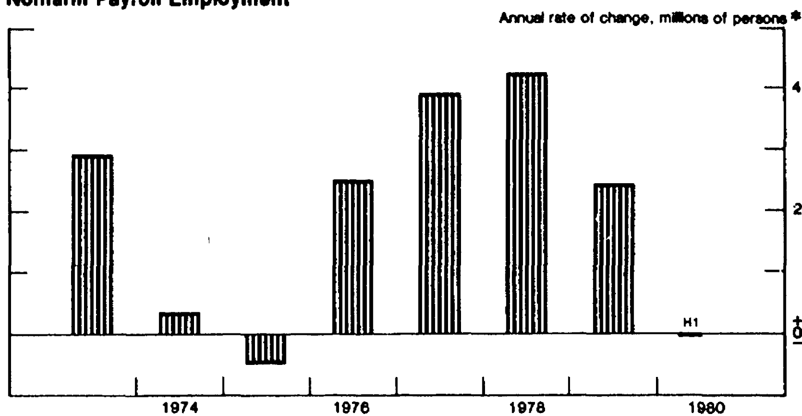
SECTION 2. LABOR MARKETS AND CAPACITY UTILIZATION

Labor demand was relatively well-maintained early in the year, but it fell off steeply in the spring as firms responded to the sharp declines in sales by cutting their work forces and shortening workweeks. Between January and June, the number of workers on the payrolls of nonfarm establishments fell almost 950,000; total employment, as measured by the household survey, fell more than 1-1/4 million. With layoffs rising, the nation's jobless rate jumped from 6-1/4 percent in January to 7-3/4 percent in May and June.

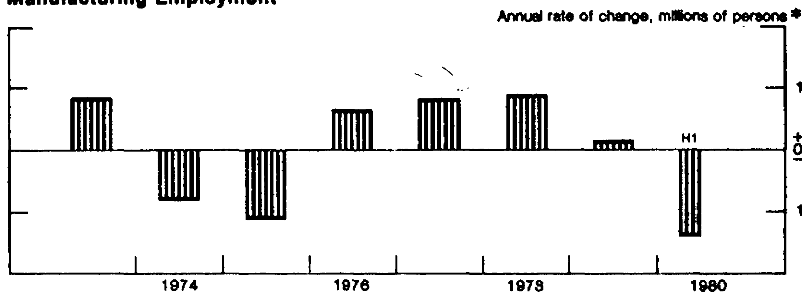
Much of the cutback in employment occurred in the construction sector and in durable goods manufacturing, especially motor vehicle and related industries. By June, the number of auto workers on indefinite layoff was nearly 250,000 (about 30 percent of total hourly workers in the industry), and substantial layoffs had occurred in the steel and tire industries as well. Construction employment began to drop early in the year, and subsequently suppliers of building materials also reduced their payrolls. During the spring, however, weakness in labor demand began to spread throughout the economy; employment at trade establishments dropped 190,000 over the second quarter, and in June payrolls in the service-producing sector registered the first monthly decline since 1975.

In addition to trimming payrolls, employers have curtailed work schedules in light of the weakening of sales. Since January, the average workweek at manufacturing establishments has been shortened almost 1-1/4 hours. More generally, the number of workers on part-time schedules for

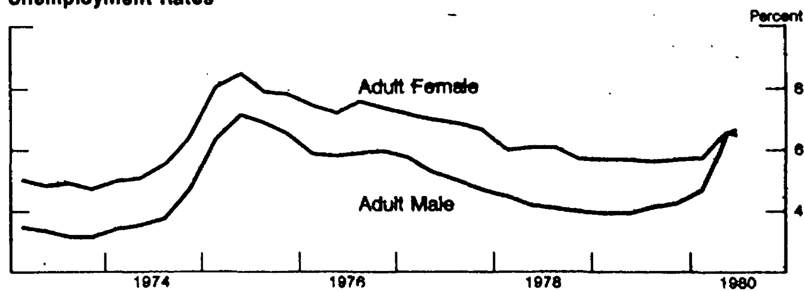
Nonfarm Payroll Employment



Manufacturing Employment



Unemployment Rates



*Annual changes are from Q4 to Q4; semi-annual changes are from Q4 to Q2.

economic reasons rose sharply in the second quarter, with former full-time jobholders accounting for most of the increase.

The rise in joblessness has been widespread among demographic and occupational groups, with especially large increases reported among adult males. Since December, the jobless rate among men has climbed almost 2-1/2 percentage points, compared with an increase of 3/4 percentage point for adult women, and June marked the first time in two decades that the rate for men was higher than that for women. Unemployment among blue-collar workers rose sharply to an 11-1/2 percent rate in June, the highest since September 1975. In contrast, unemployment rates among white-collar workers have increased only marginally since the end of 1979.

The adjustments in output by firms, especially in the second quarter, were reflected in a sharp decline in the index of industrial production. Between January and June, industrial production fell nearly 7-1/2 percent. Production declines in auto-related industries and in industries supplying construction materials began early in the year, but by late spring cutbacks were occurring in most other industries as well. Among manufacturing firms, capacity ut ization in June dropped to 76 percent, almost 11 percentage points below its 1979 peak.

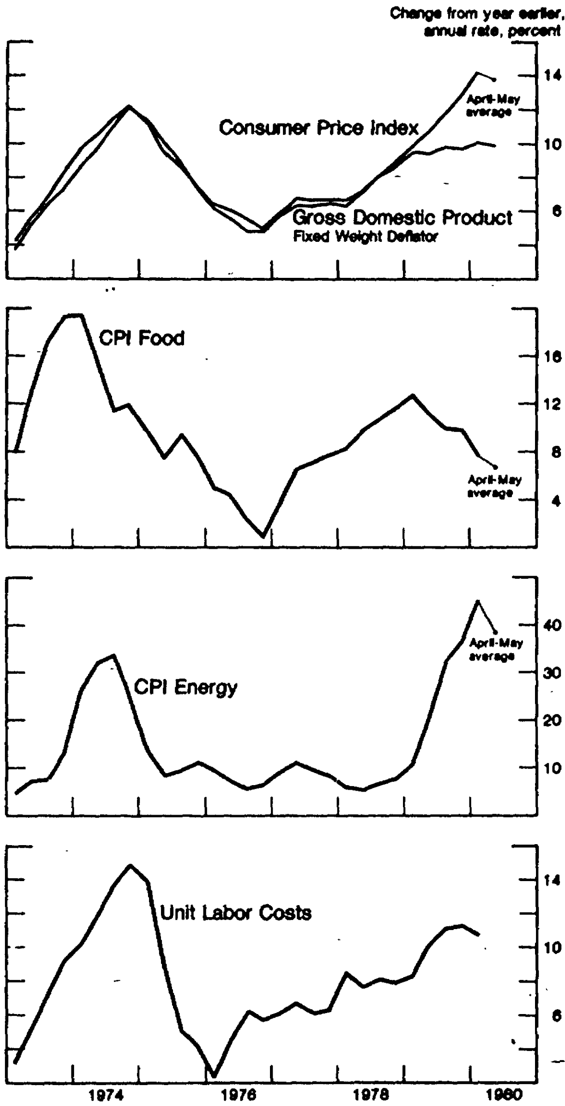
SECTION 3. PRICES, WAGES AND PRODUCTIVITY

After exploding upward in the early months of the year, rates of price increase moderated significantly in the second quarter. The improvement resulted primarily from a stabilizing of energy prices and from declines in the prices of nonferrous metals, after a flurry of speculative activity earlier in the year. Increases in the prices of construction materials and components also slowed noticeably in the second quarter with the decline in activity in the housing sector.

In the energy area, retail prices surged in January and February, in large part the result of the hike in OPEC prices that occurred in late 1979, but the pace of increase then slowed noticeably in the spring, as inventories reached near-record levels and demand continued to drop. The increase in energy prices also moderated at the producer level. Nonetheless, indirect effects of earlier increases in the prices of fuels and petroleum feedstocks were still evident through the end of June in items such as plastics and rubber products, industrial chemicals, and household supplies. Moreover, a number of factors--including the latest increases in OPEC prices, the curtailment of gasoline production, and the progressive decontrol of crude oil prices--suggest that further relief in the energy area is not to be expected.

Food prices generally have exerted a moderating influence on aggregate price measures since the beginning of the year. At the producer level, finished food prices fell at about a 4-1/2 percent annual rate between December and June. Steep drops in wholesale prices through May--particularly for livestock--alleviated cost pressures at the retail level, contributing to relatively

Prices and Labor Costs



stable retail food prices since the end of last year. However, recent developments in the markets for livestock and fresh produce indicate that food prices also are likely to rise more rapidly in the second half of the year.

Inflationary pressures have persisted in sectors outside food and energy since the beginning of the year. In the consumer price index, increases in the homeownership component have been particularly large, as the measures of mortgage rates and home purchase prices both advanced rapidly in the first half of this year; the recent easing of mortgage rates will likely hold down increases in the CPI during the next few months. In the producer price index, prices of capital equipment accelerated in the first half of 1980 from the already rapid pace of 1979.

Labor cost pressures remained intense in the first half of 1980, as compensation increases were substantial while productivity declined further. Output per hour in the private nonfarm business sector dropped at about a 1-1/2 percent annual rate in the first quarter, after falling 2 percent over the preceding year. At the same time, hourly compensation accelerated to a 10-1/4 percent annual rate, so that the unit labor costs of nonfarm businesses rose at about an 11-3/4 percent rate in the first quarter. Preliminary data for the second quarter suggest that unit labor costs continued to rise rapidly, as productivity contracted further. Although cyclical reductions in overtime and the changing employment mix may restrain the growth in total compensation somewhat in coming months, wage demands are likely to remain strong, especially in light of past increases in consumer prices. Thus, upward pressures on unit labor costs will probably remain substantial over the near term.

SECTION 4. FINANCIAL DEVELOPMENTS DURING THE FIRST HALF OF 1980

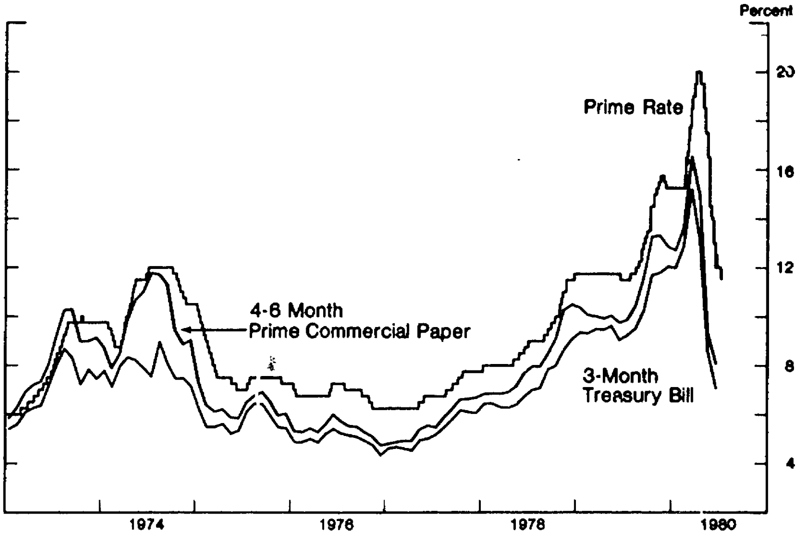
Interest Rates

Market rates of interest moved sharply higher in the early months of 1980, exceeding previous record levels and peaking around the end of the first quarter. These increases were largely reversed in the second quarter amid a substantial downslide in economic activity and contracting demands for money and credit. The upward pressure on yields at the turn of the year resulted from a combination of factors, including a deterioration in inflationary expectations as actual price increases accelerated in January and February, the failure of incoming data to confirm the long-anticipated downturn in activity, and international political developments that raised the likelihood of an increase in federal deficit spending. In February, moreover, growth in money and credit surged, creating demands for bank reserves well in excess of the provision of nonborrowed reserves consistent with the Federal Reserve's target ranges for growth in the monetary aggregates. In the Treasury bill market, in particular, the resulting rise in short-term interest rates was reinforced by large sales of securities by foreign institutions to finance intervention in foreign exchange markets.

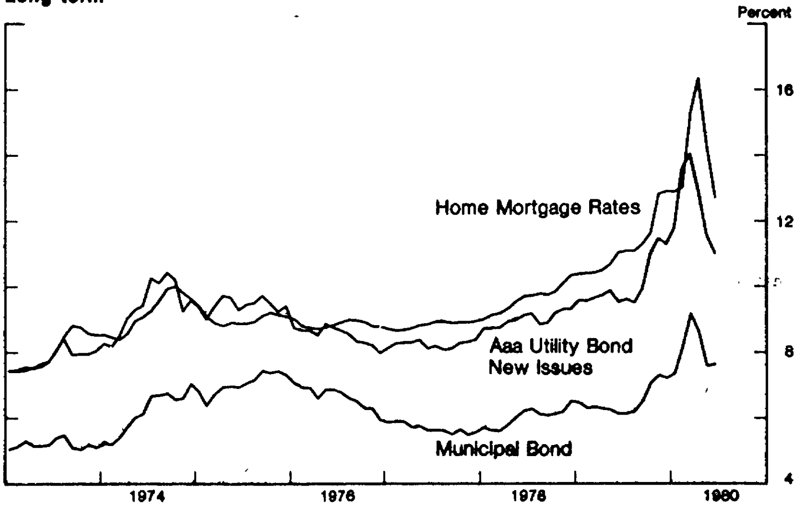
On March 14, the Board of Governors took actions of a temporary nature designed to reinforce the effectiveness of the measures announced in October 1979 and thus to provide greater assurance that the monetary goals reported to the Congress in February would be met. These actions, some of which were taken under the authority of the Credit Control Act as part of a broad government effort aimed at reducing inflationary pressures, included:

Interest Rates

Short-term



Long-term



(1) a special credit restraint program directed toward limiting the growth in loans to U.S. customers by commercial banks and finance companies to ranges consistent with the monetary and credit objectives of the Federal Reserve; (2) a special deposit requirement for all types of lenders on increases in certain categories of consumer credit; (3) an increase in the marginal reserve requirement on managed liabilities of large member banks and U.S. branches and agencies of large foreign banks; (4) a special deposit requirement on increases in managed liabilities of large nonmember banks; (5) a special deposit requirement on increases in total assets of money market mutual funds; (6) a surcharge of 3 percentage points on frequent borrowing by large member banks from Federal Reserve Banks.

These measures hastened the movement toward reduced credit availability already in train at many lenders, and apparently increased the resolve of consumers to curtail their use of credit. In subsequent weeks, incoming data revealed a substantial slackening in money and credit growth to well within the Federal Reserve's objectives. In light of these developments, the Board amended the special credit program: on May 6 the 3 percentage point surcharge on discount borrowing by large banks was eliminated, and on May 22 special deposit requirements were reduced by half and the special credit restraint guidelines were modified. On July 3 the final phase-out of the program was announced.

The rise in most interest rates came to a halt in late March and early April, and yields began to move down as demands for money and credit dropped abruptly in response to developing slack in the economy. Most private short-term rates fell 7 to 9 percentage points, to their lowest levels since

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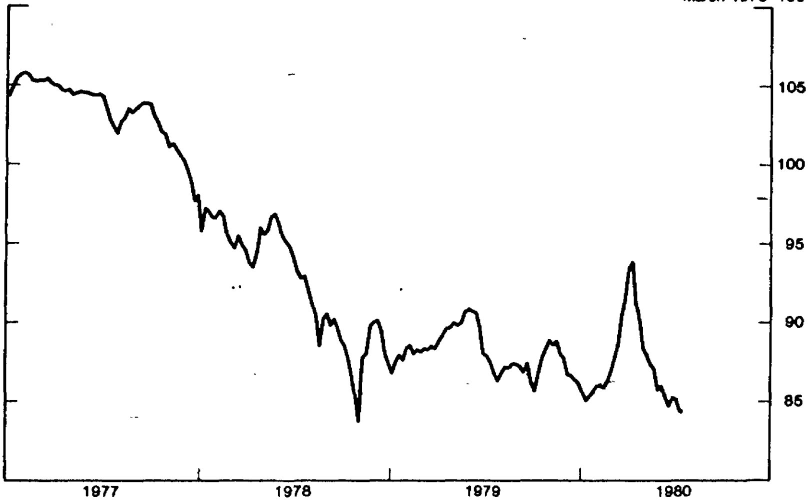
the spring of 1978. In long-term securities markets, bond yields retraced most or all of the increases recorded earlier in the year, as market participants appear to have lowered their expectations of inflation. The restraining posture of monetary and fiscal policy, as well as moderating rates of price increase in the cyclical downturn, has contributed to this improved outlook for price changes.

Foreign Exchange Markets and the Dollar

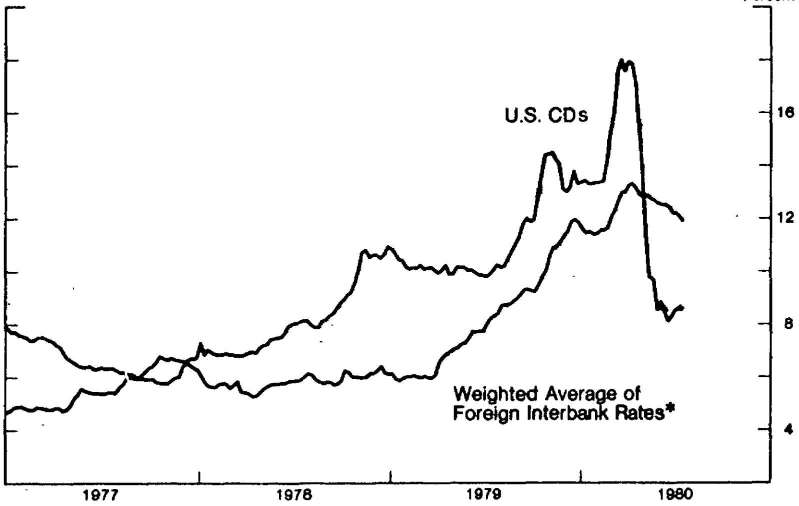
Movements in U.S. interest rates greatly influenced fluctuations in the foreign exchange value of the dollar over the first half of 1980. The dollar was in strong demand early in the year when U.S. interest rates rose sharply. The growing perception by market participants of accelerating inflation and worsening payments deficits abroad gave added impetus to the dollar's rise over this period, as did the announcement of credit control measures on March 14. Authorities in a number of foreign countries also moved to tighten monetary conditions, but the resulting increase in foreign interest rates lagged well behind that of U.S. rates. The strengthening in the foreign exchange value of the dollar in February and March was moderated somewhat by substantial intervention activities by U.S. and foreign monetary authorities.

The peaking and subsequent steep decline in U.S. interest rates in early April triggered heavy selling pressure on the dollar in international markets, and its foreign exchange value fell in the April to June period. Foreign and U.S. monetary authorities intervened to moderate this decline by making net purchases of dollars. Even so, by the end of June earlier gains were entirely erased, and the weighted-average exchange value of the dollar at midyear was little changed from its value at the beginning of the year.

Weighted Average Exchange Value of U.S. Dollar*



3-Month Interest Rates



* Weighted average against or of G-10 countries plus Switzerland using total 1972-76 average trade of these countries

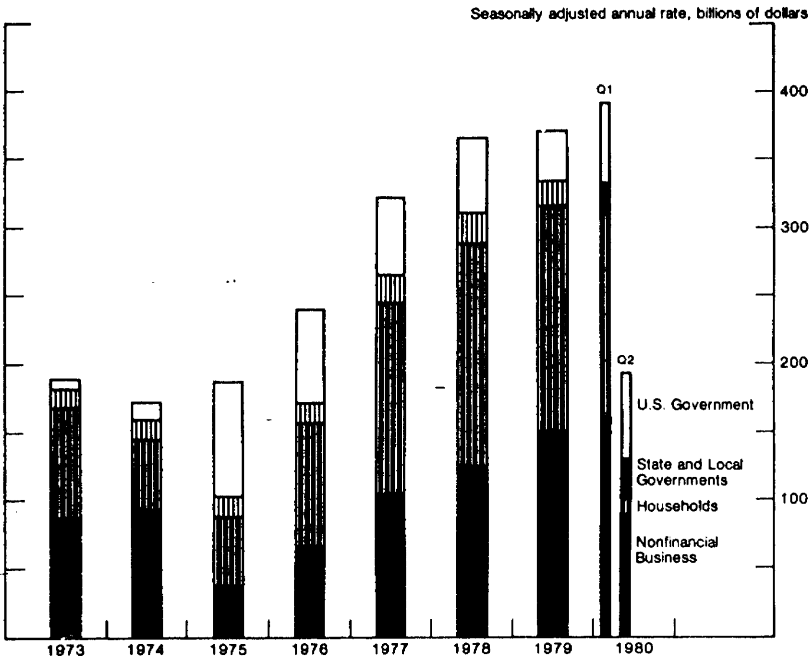
Domestic Credit Flows

Net funds raised in credit markets by domestic nonfinancial sectors of the U.S. economy totaled a sizable $391 billion at an annual rate in the first quarter of 1980, but contracted sharply to an estimated $193 billion in the second period. This exceptionally large decline in borrowing reflected in large part the recent sudden weakening in production and sales activity; in addition, monetary restraint, supplemented by the special policy actions of mid-March, contributed to tauter credit terms and reduced availability of funds at many lenders.

In the private sector, the volume of funds raised in the first quarter was greatly enlarged by a surge in borrowing on the part of nonfinancial business firms. Some of this increased borrowing reflected needs to finance growth in inventories and fixed capital outlays, as the gap between such expenditures and internally generated funds of nonfinancial corporations widened. But fears that unchecked inflation would lead to the imposition of credit controls and a consequent reduction in credit availability apparently led to a burst of anticipatory borrowing by firms as well. As a result, corporations added substantially to their holdings of liquid assets in the first quarter and appear to have drawn down these holdings in subsequent months.

As interest rates moved up rapidly early in the year, businesses concentrated their credit demands in short- and intermediate-term markets, with borrowing at banks and in the commercial paper markets especially heavy. Corporate bond financing remained relatively low as businesses, especially industrial firms, were reluctant to issue long-term debt at historically high

Net Funds Raised in Credit Markets By Domestic Nonfinancial Sectors



Source: Federal Reserve Board *Flow of Funds Accounts*. Data for 1980 Q2 are partially estimated.

yields. This pattern of corporate financing shifted dramatically, however, when interest rates dropped rapidly in the spring. Public offerings of longer-term corporate bonds accelerated to unprecedented levels, with the proceeds from many of these issues being used to pay down bank debt.

After March, commercial banks--concerned both about pressures on their earnings margins as interest rates dropped and about meeting the loan growth guidelines of the voluntary special-credit restraint program--tended to discourage business borrowers. In particular, adjustments in the bank prime lending rate lagged substantially behind downward movements in other market rates, greatly increasing the relative cost of this source of financing. As a result of the relatively high cost of bank credit, coupled with a desire of businesses to adjust their balance sheets following the heavy reliance on short-term debt in previous months, business loans at banks contracted markedly in the second quarter. Although commercial paper issuance by firms remained very large, total short- and intermediate-term business credit demands in the second quarter moderated appreciably from the first-quarter pace. Late in the second quarter, the prime rate began to move down, narrowing the gap with market rates somewhat; survey data, furthermore, suggest that banks in May were making a large share of short-term business loans at below-prime interest rates.

In the household sector, consumers greatly reduced their use of installment credit during the first half. The large growth of consumer installment and mortgage debt in 1979--both in absolute terms and in relation to disposable income--had produced a marked deterioration in household liquidity. The combination of resulting heavy debt burdens, high interest rates, and, in some states, restrictive usury ceilings acted to slow growth of installment

credit in late 1979 and the first quarter of 1980. The volume of outstanding installment credit contracted in the second quarter as consumers curtailed expenditures and repaid debt against a backdrop of rapidly declining real incomes and rising unemployment. Credit-tightening measures by lenders after the announcement of the credit-control package on March 14 and uncertainty on the part of consumers about the effects of those controls contributed further to the reduction in credit use.

Household borrowing in mortgage markets also slowed considerably in the first half. Reduced deposit flows and pressures on earnings margins from rising costs of funds constrained the lending activity of thrift institutions and pushed mortgage rates to record levels in March. Many would-be homebuyers were deterred by the high cost of mortgage credit. More recently, lower market interest rates have helped to reduce cost pressures for thrift institutions and have contributed to a pickup in deposit flows. Sharp drops in mortgage rates since early April and reports of some easing in nonrate terms suggest that lending institutions have become more active in seeking mortgage loans since early June. But mortgage rates remain high by historical standards, while demands for housing and housing credit continue to be damped by a weak economy and by the liquidity concerns of households; consequently, mortgage commitment activity apparently has remained relatively sluggish.

The Treasury borrowed heavily in credit markets in the first half to finance the combined deficits of the federal government and off-budget agencies. Normal seasonal patterns in federal cash flows associated with the timing of tax receipts led to a concentration of the Treasury's borrowing in the first three months of the year. Although the first-quarter deficit was

further deepened this year by unusually large tax refunds associated with over-withholding in 1979, the Treasury was able to even out its borrowing pattern somewhat by permitting its cash balance to drop over the first quarter and then rebuilding it in the second.

In contrast to the federal sector, net borrowing by state and local governments dropped off in the first quarter but accelerated appreciably in the second. Many municipal governments postponed or canceled scheduled bond issues early in the year because of high interest rates; for some governmental units, these actions were necessitated by the rise of interest rates above statutory limitations. But the volume of tax-exempt financing picked up considerably in the second quarter when interest rates fell and many previously postponed bond issues were brought to market. The financing needs of state and local units generally increased over the first half in response to slower growth of revenues and a consequent widening of their operating deficits. In addition, the volume of tax-exempt securities issued continued to be boosted by offerings of mortgage revenue bonds, designed to finance single-family housing.

The CHAIRMAN. Next we are going to hear from Mr. Lawrence Klein of the Wharton School of Economics.

Mr. Klein, we are very pleased to have you back before our committee, and we will await with interest your advice.

STATEMENT OF LAWRENCE KLEIN, WHARTON ECONOMETRICS

Mr. KLEIN. Thank you, Mr. Chairman.

I have submitted a brief statement. I might summarize it briefly, and particularly refer to some tables at the back of it that deal with these tax issues.

Generally speaking, the setting in which this statement is made is one in which we are in the midst of a recession, and under ordinary circumstances there will be a recovery, but not a very strong recovery. What I have done is to consider various fiscal measures, particularly on the tax side, that could aid the recovery and make it look better.

In order to lay out these difference alternatives, I have considered as a base case on in which we leave present tax policies unchanged, excepting any kind of statutory provisions that are already on the books, in particular the social security increase for next January.

Then I consider one in which there is approximately a 50-50 division between business and personal tax cuts. The business tax cut is accelerated depreciation, shortening guideline lives by 20 percent, and increasing investment tax-credit from 10 to 15 percent. Both those are effective January 1, 1981, by an assumption.

And that is, roughly, a $20 billion tax cut package looked at from the point of view of next year.

I considered also one that is 50 percent bigger than that in all dimensions, a $30 billion cut.

The fourth one is one that stylized a little bit more. It is a $20 billion cut, hypothetically, but at the personal level there is a roll back of social security to give about the same tax yield as the personal income tax cut that I considered in the second one, and then a cut in the guideline lives.

The fifth one is a tax cut that is an across-the-board cut. It is a $20 billion calculation, half personal and half corporate rate.

Finally, I introduced indexation, indexing the personal rates to the CPI, and indexing corporate rates to the deflator for plant and equipment. That is a much bigger cut if you make the full indexation. It is a $40 billion cut.

On the second table I have given some estimates of budget deficits on a unified basis, and that is on a fiscal year calculus, that would be associated with these different tax programs.

In any event, of course, we are in for a significant deficit this year on the order of magnitude of $60 billion, and for next year, even doing nothing, just letting the recession take its course and incurring all the recessionary expenditures, especially in unemployment benefits and similar welfare payments, there is an estimate of much more than $50 billion deficit. With some recovery in 1982, that deficit would get lower, but there would still be a very noticeable deficit.

None of these are budget balancing in the near term. You can see at the other extreme, to go to full indexation would have a very serious impact on budget deficit. In between we have the various kinds of compromises.

I have not really searched comprehensively for what would be called the ideal kind of tax cut, but I rather prefer the policy No. 4 in which there is a joint rollback of social security, and cut in the guideline lives, and also raising the personal exemption. This gives something, in my view, on productivity, on inflation, and on general equity grounds keeping with the rising living costs, having in a partial sense some indexation.

These are the alternatives. If I were to try to answer the question, how soon should it be, and what size should it be, I would say, the discussions and debates are to be in place for having something by January, and the order of magnitude should be around $20 billion.

That summarizes what I have got in this statement.

The CHAIRMAN. Thank you very much.

I will defer to the other Senators while I read the remainder of your statement. I started reading it in detail before you started testifying. I am going to call Senator Packwood first.

Senator PACKWOOD. Your preference is No. 4?

Mr. KLEIN. Yes.

Senator PACKWOOD. You have got a $20 billion social security rollback, guideline lives cut, personal exemption increased. Does that come out to about a 60-percent business, and 40-percent individual cut?

Mr. KLEIN. Of course, the first year is a little misleading because the 20-percent guideline lives cut does not amount to much in the first year, and it builds up, in effect, quite a bit as things go.

Rolling back social security is a 50-50 proposition in itself. That comes to about $19.5 billion. Then the guideline lives in the first year is about $1 billion. The personal exemption decrease was just a small amount here. It is an increase in the exemption, and a decrease in the taxes for about $1 billion.

But after this program were operating for 1 year, or a couple of years, the cut in guideline lives would get much more than 50 percent toward the business side.

Senator PACKWOOD. The one you like least is No. 5.

Mr. KLEIN. That is the across-the-board cut.

Senator PACKWOOD. Yes.

Mr. KLEIN. Yes.

Senator PACKWOOD. As I look at your chart, it is an across-the-board cut, and a corporate rate cut.

Mr. KLEIN. That is right. That is a cut in personal rates, and a cut in the general corporate rate.

Senator PACKWOOD. But what you get in terms of the total part of the package is heavily skewed toward personal cuts.

Mr. KLEIN. In this calculation, I assumed that we would cut the corporate rate to yield as much as the cut in the personal rate. It would be unrealistic, but this was just to see what a 50-50 cutback would be.

Senator PACKWOOD. I see, you are assuming a 50-50 cut in terms of the loss at $10 billion apiece.

Mr. KLEIN. Yes.

Senator PACKWOOD. Looking at your chart, in 1982, Even with 50 percent of it for corporate rate cuts, for the real gross national product, it is the second worst of all the ones there. From the gross national product deflator it is the worst. From the Consumer Price Index it is the worst. From productivity it is the worst. From unemployment it is the second worst of all the models.

Mr. KLEIN. You see, my opinion is that targeted tax cuts do much more for the economy than across-the-board cuts. Across-the-board cuts have a very significant impact on distribution of income, and who gets what.

For getting a decision to invest in productive capital formation, it is much more effective to leverage. If you make the tax relief dependent on making the investment, I think you get much more for your cut, and that contributes directly into productivity.

Senator PACKWOOD. I have no other questions, Mr. Chairman.

The CHAIRMAN. Senator Danforth.

Senator DANFORTH. Mr. Klein, assuming a $20 billion tax cut and assuming a 50–50 split between business and corporations, with respect to the business portion of it there are various alternatives. One would be a corporate rate cut, and one would be depreciation, and one would be investment credit.

Of those three, I take it that the rate cut, you feel, would be the least desirable for reasons previously given?

Mr. KLEIN. There is a fourth one, which is the social security rollback, and half of that is an employer payroll tax.

Senator DANFORTH. OK.

Mr. KLEIN. I think that that is really good. I think that that has really good aspects because the cost base for pricing would be reduced, and one would assume that a good deal of that would be passed through. So it would have a direct impact on inflation. It would not be lasting as far as the inflation rate is concerned, but in the initial year there should be a significant impact.

Senator DANFORTH. So if you had $20 billion, and that was the figure you were working with, the social security rollback how much would that be?

Mr. KLEIN. About $19.5 billion.

Senator DANFORTH. Roughly all of it?

Mr. KLEIN. Yes.

Senator DANFORTH. So that would be your preference, just the simple social security rollback?

Mr. KLEIN. Yes, that is the preference.

I think we ought to look at two things in tax legislation. First, the contribution to productivity; and, second, the contribution to inflation. Of course, the contribution to productivity, the first mentioned item will eventually work through to the inflation. But the direct impact on inflation would come either through cutting indirect taxes, or cutting the payroll tax.

Senator DANFORTH. So that with respect to the business portion of a tax cut, you would favor the Social Security rollback more than the investment credit, or depreciation?

Mr. KLEIN. That is a little deceptive, because I said in the first year, I had a 20-percent guideline life cut in that package, and in the first year that does not yield very much. But it builds up rather quickly.

So after this kind of program was running for 2 or 3 years, there would be a very significant contribution from the guideline life cut. What you would get out of this would be an initial impact against inflation from the social security rollback in the first year, and then cumulative impacts as we got more investment, more productivity.

Senator DANFORTH. Your social security rollback would be a 1-year proposition only?

Mr. KLEIN. Yes.

If you had an indefinite rollback, its impact on inflation would be only in the first year. Not on the price level, but on the rate of increment of the price level, you would get the big impact in the first year. There is a difference between the level of a price and its rate of change. We measure inflation by the rate of change. The rate of change would be impacted mainly in the first year.

Senator DANFORTH. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Thank you, Mr. Chairman.

Mr. Klein, you suggest a rollback of social security, and you said that the impact on inflation would be in the first year. What is your view of an investment income tax credit to offset the increase in social security? Why did you recommend a rollback instead of the income tax-credit?

Mr. KLEIN. I think they could be made equivalent. It is a question of what is the net saving to the taxpayer for a given item.

Though, I would like to see it impact on business decisions. That is, if the income tax credit were given only to persons, then—

Senator BRADLEY. No, 50–50.

Mr. KLEIN. Then it probably would have the same effect. The payroll costs per unit of output would drop, and some of these price savings should be passed through to the final consumer.

Senator BRADLEY. So from your standpoint, you would recommend the income tax credit as just as good as a rollback from the macroeconomic standpoint?

Mr. KLEIN. That is right.

Senator BRADLEY. One of the things that I am curious about, and you stated that it was one of your criteria, is the effect any tax cut would have on inflation and productivity.

Mr. KLEIN. Yes.

Senator BRADLEY. Have you worked through in your model, in the various options for business tax cuts, what an elimination of the corporate income tax with full integration would mean in the way of productivity increase, and inflation?

Mr. KLEIN. I have not done that one in particular. I have considered corporate rate cuts, the subsidization of R. & D., or the investment tax credit, or the liberalized depreciation rules, or extension of the investment tax credit to cover structures, many of these options.

But the particular one you mention, I have not considered, and I would put that more under the heading of tax reform. I think one ought to distinguish at the present time between tax reform and countercyclical tax reductions.

What I am really advocating, or arguing for here, a countercyclical tax reduction, but as long as we are going to do it, we might as well make it a good package, and get the best productivity out of it.

Senator BRADLEY. Yes.

Mr. KLEIN. I think that if we want to take the longer view, and go through all the legislative work of revamping the tax system, as it obviously needs some revamping, then one would look into this whole question of integration.

Senator BRADLEY. You have not run that through your model?

Mr. KLEIN. No.

Senator BRADLEY. Could you tell me, in the out years, what is the 20-percent guideline reduction; what does that yield in the way of revenue loss?

Mr. KLEIN. I am just guessing. I think that it would probably be between $5 and $10 billion. It starts out at $1 billion the first year, and by 1983 or 1984 it would probably be between $5 and $10 billion.

Senator BRADLEY. Are you familiar with the depreciation recommendation of Professor Jorgensen?

Mr. KLEIN. All in one year, yes.

Senator BRADLEY. What is your view of that?

Mr. KLEIN. Well, that has a lot of merit. I think the greatest merit——

Senator PACKWOOD. Let me interrupt just a moment, Bill.

You did not mean expensing it all in one year in your answer, did you, because I don't think it is what Professor Jorgensen recommended.

Senator BRADLEY. I was not completely sure what Professor Jorgensen said, so I was going to try and have Mr. Klein give us his interpretation.

Senator PACKWOOD. It is not an expensing in one year, although it is front loaded.

Senator BRADLEY. Most of it would occur in 1 year.

The CHAIRMAN. Let me see if I understand his proposal, it because it is not all that easy to understand. Insofar as you get a write off, or you get an advantage for depreciation, you would get it all in the first year. Is that right?

Mr. KLEIN. That is right.

Senator DANFORTH. It is the immediate deduction of the discounted amount.

The CHAIRMAN. Whatever you are going to get, you are going to get it in the first year. You could have a carryforward, or a carryback, but assuming that you have the taxes against which to take the benefit, you would get the whole benefit of it during the first year.

Senator BRADLEY. That is my understanding.

Mr. KLEIN. Yes.

The advantage of that is that it guards against the adverse effect of rising prices of replacement. You can then invest the funds that you get in the early year, and have them appreciate as inflation goes, presumably, and that would give a hedge against having to replace equipment at higher prices.

That is very similar to indexation on the business side.

Senator BRADLEY. What is your view of it?

Mr. KLEIN. I think that has some merits. I find it quite an acceptable view. I would argue against a complete indexation of our whole tax system, and even of our asset liability system because I think the more we index, the more we destabilize the economy. The more sensitive the economy becomes to external disturbances, the more it is indexed.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Dr. Klein, I am curious how you drew up this model. Do you just take, for example, an alternate number for the $20 billion cut, and just crank it through, and see what effect it has on CPI, GNP deflator, and so forth?

Mr. KLEIN. Yes. It is run through the Wharton Econometric model, and each tax policy has different effects on the tax structure.

Senator BAUCUS. I understand that.

Do you try to anticipate from other sources or other information of what you expect other pressures will be on the CPI, or the GNP deflator, or anything else, for that year?

Mr. KLEIN. Yes.

Senator BAUCUS. Or, do you take this $20 billion?

Mr. KLEIN. The model tries to anticipate some of these, and we keep some in mind.

Senator BAUCUS. What about external forces on those factors, independent of the $20 billion cut?

Mr. KLEIN. Yes.

Senator BAUCUS. What is your percentage rate of error?

Mr. KLEIN. You can't ask me about the percentage rate of error on hypothetical calculations like this because most of them never transpire. But if you ask me about our forecasting error, just on our best judgment, which we have been keeping records of for almost 20 years, every quarter for 20 years, I would say that our projections of GNP are plus or minus a percent. Our projections of inflation rates are probably plus or minus two or three percent. Our projections of unemployment rates are about plus or minus a half a percent for period of up to 1 year. Our interest rates about plus or minus 20 or 30 basis points, depending upon whether or not it is a short or a long range. These are representative rates.

There have been many such tabulations. The most comprehensive and reliable are those published by the Federal Reserve Bank of Boston.

Senator BAUCUS. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. Dr. Klein, your statement reflects the same philosophy that we had from those who served as Chairmen of the Council of Economic Advisers and who testified here. Basically, implicit in their statement was the fact that the purchasing power of the dollar is not the only thing to be considered.

For example, Mr. Keyserling, who would be the most liberal in those respects, was of the view that what you had better be looking at is what you are producing in terms of goods and services. I think his view is that if you have a growing economy, the purchasing power of the dollar tends to stay better than it does if you do not have an expanding economy. I think you are familiar with his thought on that matter.

Do I take it from your presentation here today that you think that the extent to which you emphasize the stability of the dollar, or the extent to which you put emphasis on trying to maintain stability of your money, is a matter of degree, and it should be weighed in connection with the various other objectives you are seeking to achieve?

Mr. KLEIN. Yes, I would agree.

One thing I would say is that looking at this range of alternatives, they don't have enormous impact on inflation rate, or the stability of the dollar from a domestic point of view. I think that it is very important for us to take whatever gains we can get here and there, but there don't seem to be any magic policies that are suddenly going to get us down to the 3-and-4 percent inflation rates, and have a good economy at the same time. That isn't there.

The other aspect is that one must continually look at the international value of the dollar, and adopt a set of policies that will look favorable in the eyes of participants in the world money markets.

The CHAIRMAN. This is interesting. You start out with these various assumptions, and one of them is present policy unchanged—you don't have a tax cut, you just continue the way you are going. Looking at the Consumer Price Index for fiscal year 1980 to 1982, that policy would be more inflationary than any of them, except for No. 5, the one where you would have a tax cut of $20 billion, apparently equally cut between personal rate cuts and corporate rate cuts.

Mr. KLEIN. Yes.

The CHAIRMAN. Looking at some of the other suggestions, taking No. 4, which you think might be the best one in terms of inflation, your studies indicate that you would more effectively fight inflation for 1981 and 1982 if you had the tax cut in the form of a social security tax rollback, depreciation guidelines cut, and exemptions increased.

Mr. KLEIN. Yes.

The CHAIRMAN. I would think that most of the business witnesses we had here would tend to take a different view. They would want to have more emphasis on the things that would be useful to business in buying new plants and equipment.

What does "guideline lives cuts" refer to?

Mr. KLEIN. That would be 20-percent reduction in guideline lives, and that is sort of a watered down version of the 10-5-3. The 10-5-3 is much more expensive.

The CHAIRMAN. In relative terms, how much of the $20 billion would go into the guideline lives changes?

Mr. KLEIN. A 20-percent would cost the Treasury only $1 billion in the first year.

The CHAIRMAN. Only $1 billion in the first year.

Mr. KLEIN. But by 3 or 4 years, it would be between $5 and $10 billion.

The CHAIRMAN. I see.

It is interesting that in terms of inflation, the second most inflationary policy of the whole group would be to do nothing, just to let things go the way they are going.

Mr. KLEIN. Let me explain why.

There are two effects on productivity. A cyclical effect, and a trend effect, a long-term effect. We are getting adverse cyclical effects. Productivity is falling. When productivity falls, the economy operates inefficiently, and prices go up on wages and other costs, and with no productivity offset.

The other policies that I am suggesting are all policies that would give some fiscal stimulus to the economy, some cyclical stimulus. The cylical stimulus would have a favorable impact on productivity in the short run.

The investment stimulus in the longer run would help productivity, but you have to look at both the cyclical and the trend aspects together.

The CHAIRMAN. Thank you very much, sir.

Senator Roth.

Senator ROTH. Thank you, Mr. Chairman.

Next year, as you know, Dr. Klein, social security rates will go up.

Mr. KLEIN. Yes.

Senator ROTH. What impact will that increase have on the economy?

Mr. KLEIN. As far as individuals are concerned, it will be less take-home pay. As far as employers are concerned, it will be added wage costs. So I would say that it would have a negative impact on household spending, and will have an inflationary impact on business pricing.

There has been a fairly regular jump in prices every January 1 when the social security rates go up. It is included in the cost base.

Senator ROTH. So when we talk about a social security rollback, we are just talking about not permitting those increases to go into effect.

Mr. KLEIN. That is right.

You see, in the projections here, the base projection has them in, and that gives an inflationary kicker, and also takes away from disposable income.

Senator ROTH. I think it is a fair statement to say that that is not any kind of a cut as far as working people are concerned. All we are doing is preventing something from taking place.

Mr. KLEIN. That is a good thing to do.

Senator ROTH. That is already in place.

Mr. KLEIN. I agree.

Senator ROTH. As you say, it only has a 1-year impact on the inflation rate. So that long term it does not do much about our economy.

Mr. KLEIN. No; I think that it is no way of dealing with the basic problem by itself. All of these are packages in which one looks for a balanced policy.

Senator ROTH. May I ask, how do we deal with the basic problem of our economy and productivity?

If I may ask my question a little more pointedly. Revenue is scheduled to go up in 1980 from roughly $560 to $1 trillion in 1985. Do you feel that it is important that any or a large part of that be returned to the private sector to have a beneficial impact on productivity?

Mr. KLEIN. Yes, indeed, if one has a tax incentive, or an investment incentive in the tax system, it is returned. The investment tax credit is a way of returning some, or even getting it out of the stream before it gets there, or the liberalized depreciation rules are a way of doing it, or subsidization of R. & D. would be another way of returning it. Those would be all ways that should increase capital formation. The increases in capital formation should all help productivity.

Senator ROTH. Do you think that all capital formation, then, should come through tax changes for business?

Mr. KLEIN. No; there is a basic capital formation going on all the time. This is a way of enhancing it and accelerating it. There is a general feeling that we never really recovered from the last recession in the area of capital formation. That was a weak recovery.

Senator ROTH. But if you talk about accelerated depreciation, or whatever, that basically applies to existing business.

Mr. KLEIN. It is on the top of what already exists.

Senator ROTH. The question I am really asking you is: In 1965 only 7 percent of all taxpayers faced marginal rates higher than 25 percent. By 1976, 35 percent of taxpayers faced these higher rates.

Do you think that it is important to promote savings on the part of the individuals?

Mr. KLEIN. Certainly. I think the real problem for America is to shift over to a higher investment-higher saving economy. It means that instead of 10 percent of the GNP going into investment,

maybe we ought to have 12 percent. Then we ought to match that by a corresponding rise in savings.

Senator ROTH. Without going into detail, would you agree with me that, No. 1, if we are going to have higher savings, that we have to let the working people retain more of their earnings and, perhaps, build some incentives to save?

Mr. KLEIN. Definitely, there should be saving incentives. I have not thought through the best way of stimulating those incentives, but we ought to have saving incentives. We ought to make people want to put aside another couple percents of their income.

Senator ROTH. Don't you think that the higher marginal tax rates that the American people are having to pay have an impact on savings, on investment, and on work?

Mr. KLEIN. It probably does. I don't think we know the precise nature of that, but intuitively I would say it does.

Senator ROTH. Savings are substantially lower here than in Japan, and in Western Europe.

Mr. KLEIN. That is true.

Senator ROTH. Thank you, Mr. Chairman.

The Chairman. Thank you very much, Dr. Klein, for your statement here today.

[The prepared statement of Mr. Klein follows:]

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Statement of Lawrence R. Klein
University of Pennsylvania
and Wharton Econometric Forecasting Associates
before the Senate Finance Committee Hearings

July 28, 1980

The present debate about national economic policy centers on the following basic issues:

1. Should there be a general tax cut?
2. If taxes are reduced, when should the cut begin?
3. If taxes are reduced, what kind of tax cut should be implemented?
4. If taxes are reduced, how large should the tax cut be?

There are obviously many dimensions of economic policy that are always relevant, but the problem to be considered in my statement is focussed on near term tax reductions.

For some time, the central projection by Wharton Econometric Forecasting Associates has contained an implicit policy assumption that there would be a tax cut of $20 billion or more, beginning in 1981. But to assess the full effect of a tax cut on the economy, it is more convenient and instructive to use, as a baseline projection, one that is based on an assumption that no tax policy changes are introduced; i.e., that the present tax structure remains intact, with statutory changes that are already scheduled

to take place during 1981 and 1982. In particular, present tax policy allows for the statutory increases in social security payments that are scheduled to begin on January 1, 1981. Some main indicators of aggregative economic performance under these baseline assumptions can be seen in rows I under different headings in both tables 1 and 2.

Broadly speaking, if nothing is done to stimulate the economy, there will be a significant yearly decline for 1980, as a whole. It is already too late, however, to do anything about this year. In addition, 1981 will also be a year of negative, or nearly zero, growth. Recovery will set in, but it will be slow and moderate, even in 1982. Inflation is expected to worsen, and continue to be serious in 1981 before there is slight improvement in 1982. Unemployment should grow, peaking during 1981, and falling gradually during 1982; nevertheless, the average rate of unemployment for the whole of 1982 is as bad as the yearly figure for 1980.

The American trade accounts have improved in recent years in spite of rising costs of oil imports. The recession and high prices had restrained imports, including oil, and invisible exports have improved significantly. Moderate deficits are expected, on current account, this year and the next two.

The end result of keeping the present tax system intact is to incur large deficits during the present and next fiscal years.

Even without a tax cut during 1981, there should be a large deficit (more than $50 billion) because of the recession. Tax revenues should fall short of previous targets, and many income security payments will rise. A natural business cycle recovery that would be taking place during 1982 will lower the budget deficit but cannot be expected to bring it into balance.

The annual figures in Table 1 make the presentation very compact but obscure some extreme movements of the economy by averaging over 12 months or 4 quarters. At the extreme, unemployment reaches a projected value of 8.56% on a quarterly basis during 1981. The best short term price performance is 7.68% for the GNP deflator and 8.01% for the CPI during 1982.

If we drop to rows labeled II in tables 1 and 2, we see the effects of a moderate tax cut -- one of about $20 billion, started at the beginning of 1981. Guideline lives for business depreciation are reduced by 20%; the investment tax credit is increased to 15%; and the personal income tax exemption is raised to $1250. These are "scenario" changes, introduced into the Wharton Model for a projection under an assumed tax reduction policy. The numbers in lines II show how the Model interprets this policy change.

A principal result of tax cut policy II and, indeed, of all the tax policies considered in this presentation, is to turn an expected small decline for 1981, on a yearly basis, into a small

increase. This argues in support of a tax cut now in order to help the recovery along during 1981. It does not promise to be a strong recovery, at best, and needs fiscal support. Hesitation in introducing a tax cut as early as January 1, 1981, is undoubtedly associated with the fear of inflation. Most of the fiscal policies looked at in this investigation do not set off renewed bursts of inflation; on the contrary, they are likely to improve the situation by increasing the supply of goods available and by improving the growth rate of productivity. They all contribute to customary cyclical gains in productivity, to overcome the inflationary pressures of raising effective demand. It is only in Policy VI, implementing an across-the-board cut in rates that inflation worsens a bit. The other cuts do recognizable good for capital formation and hence productivity. They are more structured tax cuts.

A second reason for hesitating with regard to tax cuts at an early date are that they will widen the expected budget deficit. This is clearly visible in Table 2, but the direct association between federal budget deficits and inflation is very obscure, and my advice in the present circumstances is to suffer the immediate deficits for whatever harm they do to other aspects of our economy now, in the hopes of turning the recession around and embarking on a prudent course of recovery that should bring us to a better budget balance in the years to come.

Cogent reasons for tax cuts now are that the impending increases in social security contributions and the inflationary bracket slippage impose serious burdens on our population during 1981, and some tax relief is in order to counteract recessionary influences.

The different tax policies considered in this presentation vary in design. Policies II and III are split on approximately a 50-50 basis between personal and business cuts, but the latter are tied to investment incentives, affecting depreciation rules and investment credits. Policy IV goes another direction in design by providing for a roll back in social security taxes. It also cuts guideline lives for depreciation by about 20%. Policy IV contributes most towards reduction of inflation in 1981 and does very well in raising the productivity improvement factor. The only cases that seem to be as good or better in any of these respects are policies that provide a much larger tax reduction. The initial year reduction for policy IV is about $20 billion. The same is true of policy II. Policy III is a $30 billion cut, while policy VI is a $40 billion cut. The type of cut envisaged in policy IV could, of course, be enlarged.

The policy that does the least good for inflation and productivity is the across-the-board tax cut, policy V. It fails to achieve targeted gains in capital formation and does not get directly at price formation. A roll back of social security

rates under policy IV would reduce the cost base for business by lowering payroll taxes. This is why the Wharton Model estimates that it would have an immediate impact on inflation at the time of introduction of this tax change.

Policy VI is interesting. It resorts to indexation to relieve the taxpayer of the burden of inflation. There is much to be said for this kind of adjustment in the name of economic equity and justice, but its adoption as a fiscal rule would, in my opinion, tend to destabilize the economy. It would make our economy more sensitive to inflationary shocks when they occur, for whatever external reason. Also, they tend to validate and accommodate inflation rather than combat it.

Full indexation, as introduced in these econometric simulations, becomes very large. Policy VI leads to an outsize tax cut, reaching $40 billion in 1981. The figures for expected deficits show the full effect of such a large cut.

It is hard to be very definite between a cut of $20 billion and one of $30 billion, at the present time. Cuts that are structured like that in policy IV, however, do a great deal of good even if they are held to about $20 billion at inception; therefore, this appears to be the preferred policy among those that I have considered at this time. Admittedly, the menu should not be restricted, and there are surely other policy combinations that are equally good or better.

Table 1

Main Economic Indicators
Alternative Tax Policies
1980-1982

		1980	1981	1982
Real GNP (%)	I	-1.61	-0.10	3.80
	II	-1.61	0.34	4.53
	III	-1.61	0.57	4.95
	IV	-1.61	0.52	4.89
	V	-1.61	0.24	3.99
	VI	-1.61	0.92	5.28
GNP Deflator (%)	I	9.20	9.43	8.55
	II	9.20	9.26	8.14
	III	9.20	9.15	7.89
	IV	9.20	9.04	8.21
	V	9.20	9.42	8.62
	VI	9.20	9.37	8.52
CPI (%)	I	13.49	10.02	9.08
	II	13.49	9.87	8.59
	III	13.49	9.80	8.33
	IV	13.49	9.62	8.62
	V	13.49	10.03	9.14
	VI	13.49	9.99	8.96
Productivity (%)	I	-1.19	-0.61	1.67
	II	-1.19	-0.31	1.95
	III	-1.19	-0.14	2.12
	IV	-1.19	-0.18	2.12
	V	-1.19	-0.38	1.66
	VI	-1.19	0.09	2.24
Unemployment (%)	I	7.58	8.44	7.65
	II	7.58	8.30	6.24
	III	7.58	8.23	7.02
	IV	7.58	8.25	7.09
	V	7.58	8.32	7.40
	VI	7.58	8.10	6.69
Current Account ($billion)	I	-3.7	-2.8	-1.6
	II	-3.7	-4.4	-6.0
	III	-3.7	-5.4	-8.6
	VI	-3.7	-5.3	-8.2
	V	-3.7	-4.1	-3.8
	VI	-3.7	-6.8	-11.8

I Present tax policy unchanged.
II Tax cut, $20 billion, personal exemption increased, guideline lives cut, investment tax credit increased.
III Tax cut, $30 billion, same mix as in II.
IV Tax cut, $20 billion, social security roll back, guideline lives cut, personal exemption increased.
V Tax cut, $20 billion, personal rates cut, corporate rates cut.
VI Indexed tax cut, $40 billion, personal rates indexed to CPI, corporate rates indexed to investment deflator.

Table 2

Estimated Budget Deficit, Unified Basis, Fiscal Years

	1980	1981	1982
I	-61.1	-55.8	-25.6
II	-61.1	-70.7	-48.1
III	-61.1	-78.2	-59.8
IV	-61.1	-70.5	-52.8
V	-61.1	-73.9	-63.5
VI	-61.1	-85.0	-82.2

Next we will hear from Wendell Wilkie Gunn.

Mr. Gunn, we are pleased to have you here today, and to have your statement.

STATEMENT OF WENDELL WILKIE GUNN

Mr. GUNN. Thank you, Mr. Chairman.

I apologize for not having a prepared statement for you to look at, but I have been busy all week trying to raise some of that long-term debt that you talked about earlier.

I would like to thank the members of this distinguished committee for this opportunity to share with you my personal views on the vital important issue of taxation, specifically tax reduction.

I want to discuss tax reduction within the context of the new so-called supply side economics. As I understand it, only the name is news. The economics is really very old.

I was privileged to appear before this distinguished committee about 2 years ago to express my views on the Roth-Kemp tax cut proposals. I return today still determined that our economic problems do, indeed, have solutions.

The free enterprise system that brought this Nation in a short 200 with a small group of colonists to the most powerful Nation on Earth will not find its final resting place between a rock and a hard place, better known as inflation and unemployment.

People who are struggling to improve their lot, especially the poor and late entrants into the economy, will not continue to accept economic contraction as the way to balance the Federal budget. Even if you could balance the budget with 50 percent unemployment, who would want it?

The supply side proposals are proposals for growth. Specially, they call for one-third cut in individual tax rates over a 3-year period, coupled with restrained monetary growth, as a way to encourage growth in the private sector, hence reducing unemployment and inflation.

There are other important elements in the supply side package regarding Government regulation, price control, and international monetary policy, but I will limit this statement to a discussion of the Roth-Kemp proposal.

The debate thus far has focused on the expected effect of Roth-Kemp on Government tax revenues, the Federal deficit, and the price level, and very little direct emphasis on the human aspects of such a dramatic policy shift.

From my point of view, if the supply siders are correct, then the ancillary benefits of such an action are potentially enormous. This could, perhaps, be the single most unifying policy initiative in recent history. It would represent an opportunity, perhaps unique in our history, to promote with a single stroke the legitimate interests of a large number of diverse interest groups.

Hardly anyone here would disagree that a healthy private economy is an important part of the solution to most, if not all, of the important problems facing us. The solutions to social problems ultimately require the deployment of real economic resources.

A strong national defense can only be afforded by a strong underlying economy, and the vitality of any city depends upon the vitality of its industry. Even private charities finance their good deeds with capital invested in private enterprise, the value of which depends directly upon the health of the underlying businesses. Even Federal tax revenues have, as their ultimate source, private economic transactions.

Therefore, the only problem facing us is how to achieve economic growth. For the last 14 years, or so, the American economy has been in a near constant state of contraction in real terms. At the same time, the base rate of inflation has risen to an all-time-high level, and this has occurred in spite of a myriad of solutions enacted by Government, including wage and price controls, monetary growth, monetary contraction, new taxes, new regulations, and new Government spending programs.

The problem arises out of a widely held belief that economic growth causes inflation, or that unemployment and inflation must be used as weapons in fighting the other. Most of our economists and politicians will, of course, deny belief in this tradeoff, but it is clear from their policy proposals and initiatives that this is not the case.

This is illustrated, for example, by the administration's latest anti-inflationary program, which was clearly designed to force a recession in the hope of bringing down inflation.

Those who hold this belief seek to ring inflation out of the economy by taxing away private sector purchasing power, and are willing to accept the resulting level of unemployment as simply part of the price. What this means is breaking inflation over the backs of the poor and underprivileged.

Fortunately, it does not work anyway. The reason seems simple enough. The production of the laid off worker drops to zero, but his demand for goods and services drops only to the level of his unemployment compensation or welfare payment. Supply, therefore, falls relative to demand, and inflation continues. Our modern word for this situation is "stagflation."

Others, also believers in tradeoffs, seek to fight unemployment through increased Government spending funded by monetary expansion. But these are the tools of income redistribution, and not economic growth. They simply represent the shifting of resources from one sector of the economy, creating disincentives, to another sector, creating questionable benefits to the recipients.

The irony is that both groups have been fighting what they believe to be opposite causes, using essentially the same weapons—tax rate increases. Conservatives use direct taxes, and liberals use

the indirect, but nonetheless real tax of money creation. Therefore, no matter what the problem is, higher tax rates seem to be part of the solution. The effect of both kinds of taxation are exacerbated by the graduated personal income tax schedule which increases tax rates automatically year after year.

The theory underlying Roth-Kemp is that the supply of goods and services depends ultimately on the incentives that are offered to producers. That is, the after tax return to work and investment. Then, given the supply of goods and services, the amount of money in circulation will determine the price level.

It therefore follows that lower tax rates can restore growth, and inflation can be held in check by keeping money supply growth in line with real production. The former contributes to the achievability of the latter because as people move from the unemployment rolls into the work force, they stop receiving Government transfer payments, and begin paying taxes with obvious beneficial effects on the budget.

The social argument against Roth-Kemp is that most of the tax reduction will go to people who do not need tax relief, that is, highly paid individuals. This arises simply from the fact that people who earn more, pay more in taxes, even proportionately more, given the graduated-income-tax schedule. But even this is true only within limits.

As tax rates rise, a point is eventually reached where it becomes more profitable to invest in inefficient tax shelters, in overseas ventures, the shadow economy, or simply to choose more leisure over more productive enterprise. When this happens, other persons seeking to use their productive energies to earn their way to prosperity can find no opportunity to do so, and must depend on Government transfer payments for subsistence.

The Roth-Kemp objective is to restore opportunity for the latter by restoring the freedom of the former. The Roth-Kemp argument certainly seems more plausible than the rock and hard place implied by the inflation and unemployment tradeoff.

Margaret Bush Wilson of the NAACP once said that inflation is not caused by too many people working. Believe it or not, she is singing the supply siders' song. It is easy to understand, considering that she heads an organization whose raison d'etre is fighting for the very people who bear the real brunt of economic contraction and its attendant unemployment.

A few years ago a press release by the Teamsters Council of New York contained the following, and I quote:

> There is no question that government taxing policy can and does nullify private sector union power. The government taxes the employer, and he has less to offer the worker in wages. The government taxes the worker, and he has less food and shelter to share with his family. Having no other place to turn to, the worker increases his wage demands, knowing full well that it will result in fewer employment opportunities. The irony is that the tax collector, who pays no union dues, who walks no picket line, is the first beneficiary of any wage increase so extracted.

If the supply side arguments are not correct, then American free enterprise is clearly in serious jeopardy with the prospect of never receiving full social acceptability. Presently encumbered, the private economy cannot produce the social benefits which it is otherwise capable of producing.

Economic contraction always pits individuals and interest groups against each other as they vie for shares a shrinking pool of economic resources. This places serious strains on the social fabric of the Nation. Even racial discrimination rears its ugly head again, albeit in subtler and cleverer forms, as last end-first out employment clauses before operative.

Long years of hard fought social progress is negated in the process. We cannot afford to have the clock turned back by economic contraction. We fought for the freedom to participate, and now we need the freedom to grow unencumbered by tax barriers to opportunities.

Supply side economics, in the broader sense, is more than a matter of taxes, or monetary policy, or of international trade policy. It is a matter of individual freedom and its potential for accomplishing a broad range of social and economic goals for society as a whole. The freedom to pursue one's chosen endeavors. The freedom to trade one's product for the product of another with a minimum of Government interference. The freedom to enjoy a reasonable portion of the fruits of one's efforts and ingenuity.

The most precious aspect that America possesses is the freedom of its individual citizens to make certain choices, and the strength of our economy is built upon it. To take it away either abruptly or a little bit at a time would be to drain our unique society of its life's blood.

I can see only one problem with the Roth-Kemp proposal. In light of the fact that tax rates have been rising and the economy has been contracting for some time, and is expected to do so even into the foreseeable future, the proposed cut in tax rates may, indeed, not be large enough.

Thank you.

The CHAIRMAN. Thank you for your testimony, Mr. Gunn.

A lot of people think that a tax cut is likely to be inflationary. But what they are overlooking is that we are going to have about the same amount of inflation whether we do cut taxes or whether we don't cut taxes.

Furthermore, they are overlooking the fact that you might have less inflation if you cut taxes than if you do not cut taxes. If you cut them the right way, you may even have less inflation.

Mr. GUNN. That is the view that I support.

The CHAIRMAN. The average citizen is thinking about a tax cut in terms of saying that he does not want a tax cut if that is going to be inflationary, because he thinks that it is going to take more away from him than he is going to gain. But he is overlooking the fact that come January 1 he is going to be hit with a tax increase. He is going to have an $14 billion social security tax increase. Unless we do something to cut taxes between now and then, he is going to have a big increase in his taxes.

I have talked to people who are not concerned about the tax cut. I say to them, "Are you aware of the fact that you are going to pay more for your social security next year?" I discussed that with my wife just the other day. She was surprised to learn that the social security taxes are going up. She managed to get somebody to do some work for her, and she is very concerned when she sees how

much she has got to take out because she is paying for the employee as well as for herself.

People who are going to pay that social security tax increase, who will have it taken out of their paycheck, once they see this taxes have gone up, they are going to be very upset about it. But they are just sitting in a vacuum at the moment because they don't see it.

I think that their reaction to all this would be entirely different if they realized that come January 1 they are going to pay an increase in social security taxes. They are going to have to take something out of what they are spending now and what they are living on to pay that social security tax increase which is due come January.

Mr. GUNN. That is one of the reasons that I say that the tax cut proposal that is being put forward is probably not large enough. I think that that was perhaps large enough in 1978, when we first started talking about it because it would have brought us back to the tax rate levels of 1973.

Now, you are right, we are not talking about a tax cut. We are talking about limiting a tax increase.

The CHAIRMAN. As far as the average worker is concerned, unless he can firmly anticipate he is going to have an increase in his income, unless he can predict with confidence that his check is going to increase, he is going to have to get set for a further squeeze because his social security tax is going up, the taxflation of the bracket creep is going to move into his paycheck and is going to take more. In addition to that, the price of energy is going to go up.

Mr. GUNN. I agree.

The CHAIRMAN. So he is going to be squeezed three different ways. If we don't give something back to him, it is going to hurt. Isn't that about the size of it?

Mr. GUNN. I agree with that wholeheartedly.

The CHAIRMAN. In that respect you are in sympathy with what Mr. Roth is trying to do. I also say that we ought to do something about it.

Senator Roth.

Senator ROTH. Thank you, Mr. Chairman.

Mr. Gunn, I would like to once express my appreciation for your appearance here.

The CHAIRMAN. If you will excuse me, I have to go elsewhere, but I will leave you with Senator Roth. I don't think that he will abuse you. I think that he is going to be very sympathetic to what you are saying.

Senator ROTH. You may have heard the testimony of Professor Klein where he said that across-the-board tax cuts would be inflationary. You have been, since the beginning, involved in Roth-Kemp. I believe you are apprised of some of the recent economic studies made of Roth-Kemp. What is the impact of Roth-Kemp on inflation and unemployment?

Mr. GUNN. During this century, tax rates have been cut, I believe, four times. I specifically exclude any tax cuts in the form of tax credits, or rebates. But four times tax rates have been cut in this century, and shortly after taxes were cut, there was either no

rise in the rate of inflation, or actually a decrease in the rate of inflation. The most recent having been in 1962 to 1964 under the Kennedy administration.

The reason that happened, I believe, is because the supply of goods and services increased following those tax cuts as the prospects of higher returns on investments were then on the horizon.

So I do not believe that the tax cuts would be inflationary at all. In fact, I believe that tax policy determines simply the supply of goods. That is the tax incentives that are offered to producers. Given that supply of goods and services, it is monetary policy that determines the price level.

Senator ROTH. As far as I know, the Roth-Kemp tax proposal is the only legislation that I have seen where studies show that it will have a beneficial impact both on unemployment and on inflation. It attacks both problems at once.

As you point out, the minorities are the ones that suffer most through a recession because it is their jobs that go first.

One further question, going back to social security. Last year I proposed that we use the increased taxes paid by corporations because of the increased profits due to higher oil prices to delay the increase in social security taxes. I still support that. But that is not really attacking the basic problem of productivity, of getting lower rates, of providing more incentives to the individuals to save and invest in the same sense that Roth-Kemp does.

Mr. GUNN. I believe that taking one tax increase to fund another tax cut, is not really a tax cut at all. Ultimately, no matter what sector of the private economy is taxed, that tax is ultimately borne by every sector of it as they simply negotiate for the after-tax returns.

So I will not even get into an argument about whether it should be a gasoline tax, an income tax on individuals or on businesses, because ultimately people pay all taxes, whether it be on the business or on the individual.

Just as the management and labor sit at the negotiating table, they are really bargaining for what is left after the Government takes its bite. A tax on either one of those sectors will just simply make the wedge between them larger, and make it more difficult for them to reach agreement.

So I agree that what we have to do—If we talk about tax reform, there are only really two alternatives, that is tax-rate increases, or tax-rate decreases. Roth-Kemp is basic in that it goes right to the heart of the matter.

Senator ROTH. I want to thank you. My time is up for the hearing. We look forward to working with you on this in the future.

The committee is recessed until 10 o'clock tomorrow.

[Whereupon, at 1:05 p.m., the committee recessed, to reconvene at 10 a.m., Tuesday, July 29, 1980.]

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