TAX CUT PROPOSALS

HEARINGS

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COMMITTEE ON FINANCE

CONTENTS

ADMINISTRATION WITNESS

PUBLIC WITNESSES

COMMUNICATIONS

ADDITIONAL INFORMATION

TAX CUT PROPOSALS

TUESDAY, JULY 29, 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, Bentsen, Moynihan, Baucus, Bradley, Dole, Packwood, Roth, and Danforth.

The CHAIRMAN. Let me call this meeting to order.

We are pleased to have as our first witness this morning, the Honorable Jacob K. Javits, senior Senator from the State of New York.

Senator, we will be very pleased to hear from the senior representative of the financial capital of the United States.

STATEMENT OF HON. JACOB K. JAVITS, SENATOR, STATE OF NEW YORK

Senator JAVITS. Thank you, sir. It is very good advertising, and we appreciate it.

Mr. Chairman, this subject, of course, has been very properly discussed, and my testimony arises by virtue of the fact that my Republican colleagues did me the honor of making me chairman of their Subcommittee on Economic Policy. Recently, we kind of reviewed the bidding, and again I was asked to marshal the opinion of our colleagues through a task force that worked on the proposition.

We have been on record, for the last 3 years Mr. Chairman, which may not be as well known as it should, as favoring the enactment of a tax cut to business and to individuals. Our purpose is to spur increased savings and investment and, therefore, productivity, jobs and economic growth.

I have set forth in my statement, and I will not trouble the committee with reading it, our 1977 policy statement, which was headed, "Two Million Jobs at Last" where we emphasized that capital formation was vital if we were going to keep the United States ahead in economic terms, and provide the necessary employment opportunities.

In 1979, we again declared our conviction that the tax system not operate to reduce the real standard of living of the American people. Therefore, we supported phased across-the-board tax reductions to encourage incentives for economic growth, et cetera.

In our most recent declaration in March of this year, we declared that with all of the troubles, which this committee is so familiar with—unacceptably high inflation, stagnation or flat growth in respect of productivity, a historic decline in the gross national product, and the erosion of personal savings and personal disposable income in real terms—I quote, "Federal taxes must be reduced and the tax laws changed to encourage greater individual and business, savings, investment, output and productivity, and thus more jobs for Americans."

Now we have actually offered, inspired by Governor Reagan, our candidate's declaration, a tax cut plan which contains both business and individual tax cuts, and which we feel is entirely consistent with our policy declarations of the last 3 years.

I think we face here, Mr. Chairman, a fundamental philosophic difference. I speak only of the apparent views of the administration because that is all that we can go by. Even with the present state and direction of the economy, the administration asks us to wait until 1981 for a tax cut decision.

We differ. We feel that a tax cut decision should come now, and we are confirmed, we believe, by the fact that in the past week alone we have been hit with two very grim forecasts on the state of the economy. One from the Office of Management and Budget, and the other from the Congressional Budget Office. They confirm what we have, in terms of our policy declarations, been saying for 3 years. Our country is in perilous shape economically. There is as yet no bottom to the erosion of confidence in the future of our country.

I might interject here, Mr. Chairman. The Chair has served so long, and I have, in all of my lifetime in politics I have not seen a time when there was such an erosion of confidence in the future of this country.

No matter how dark the days, including the days of the Great Depression of the 1930, there was always a looking outward, and upbeat that the United States would make it. You can't get us down, etc. To me one of the most horrendous developments is that so many millions now don't see a bright future for our country, or foresee it only dimly.

I resume my statement.

The data, it seems to me, requires action and for this reason, Mr. Chairman, to put it colloquially instead of in the formal way that it is put in this statement, we are going to come out of this recession, I believe, and we are going to come out of it on a high plateau of both unemployment and inflation.

If I were guessing, I would say that that plateau for inflation would be between 9 and 10 percent. Naturally, every effort will be made to avoid that double-digit level. In unemployment, probably in the area of 6 percent, maybe 6.5.

The danger, Mr. Chairman, is that not having made the structural changes in this economy which are demanded, and made ourselves more competitive as a result, we will then be on a plateau from which we will get into another recession in 2 or 3 years, except that the next one may turn into depression because we are starting from a higher level.

That is why it is unwise to assume that the world is going to stand still between today, July 29, and whenever we can act on a tax cut in 1981. I am confident that you will give us a tax cut in

1981. The question is, so what? Will our situation just hold, or will it deteriorate?

People like myself, and those of my colleagues who work with me in this effort, believe that we can't stand still; that we will deteriorate further unless we have a really targeted incentive to move up America's competitive position, and to modernize its industrial plant. Otherwise, we will be in much worse trouble than we are today.

This news that we have today, by historic standards, is really catastrophic, telling us that we are in very grave trouble.

The other thing, Mr. Chairman, is that there is no positive program around. We are simply asked to wait. You can't, as they say in our business, beat something with nothing. The tax cut which has been proposed on the Republican side, we believe is the way to go and I will explain why. But we are not doctrinaire about it.

We have had to pull ourselves together. The Chair knows, and my colleagues know, the grave differences that there were between Senator Roth, and Kemp-Roth, and myself. The way we have bridged that gap, from the point of view of getting ourselves together in a unified position, is what I consider a very gifted suggestion, which we have discussed, but which did not come out as authoritatively as it now has, to break up the Roth-Kemp package, give it the 1 year, and then see how we look. I think it makes a lot of sense.

Incidentally, and very interestingly, it has gotten high marks from all the economic commentators who were scared to death of Kemp-Roth on the ground that it would send us into very high inflation. Whether those descriptions may be warranted or not, the fact is that you have an important body of opinion in the Senate which is now together.

In addition, Mr. Chairman, the people of this country take very badly to a program of starving ourselves out of a recession. That is wishing ourselves out; or determining that we are going to go into a serious unemployment situation so that we can deal with the problem of inflation, and get ourselves out of the jam that we are in.

We are also told that there is not enough time, Mr. Chairman, to develop a positive program to pull ourselves out of this economic crisis. But, Mr. Chairman, any general who has ever fought a war, or a staff officer who has helped him, like me and a few others here, will always tell you that there is never enough time. We never have enough stuff, and we never know enough. When you have to act, you have to act.

We feel that the time is now. Even the administration does not quarrel with the need to offset tax increases like the social security increase which is coming upon us very fast, through some form of tax reduction. We are still asked to wait even though the necessity is recognized, and this I cannot see us doing.

The other thing, which I would like to explain to the Chair, as to how this package is designed, is based upon the following. We realize that if you were dealing idealistically only with what you absolutely need, a rifle shot, you would target that rifle shot to the increase of capital, to the increase of savings, and to the modernization of the American industrial machine, the incentive to increase research and development, in which we are lamentably falling behind, and other measures which will put us in a more competitive position.

We realize, however, that that cannot be done. There are individuals out there who are going to get whopping tax increases next year, variously estimated even for individuals at $40 billion total, including business it is some $80 billion. Therefore, they have to have something. The 10 percent idea, we feel, or at least I feel, and Governor Reagan and many of my colleagues feel, is the right course.

So, Mr. Chairman, for all of those reasons, we feel that we have presented a reasonable tax cut proposal in response to a record high peacetime tax burden of 21.7 percent of he GNP by 1981; an almost double digit unemployment rate; zero or declinining productivity; and a very serious erosion of savings, down now even from the 6 percent base which we thought was an absolute rock-bottom minimum.

Finally, Mr. Chairman, as to the 10-5-3, the capital cost recovery plan, I am the first to agree that it is a rough measure. But we are in public life, and we have to find something which the public can understand. Simply to target a tax cut for business to enable it to accumulate capital, which many of our experts in our own task force, the one I presided over, recommended, by reducing the corporate tax brackets—which might be the best way in terms of producing that capital out of earnings—just will not fly.

People will get an idea that with all these earnings, for example of oil companies—you see whopping increases of 40 percent, 50, 60, 70, and 80 percent—all we are going to do is pyramid that. We are not. The way we design it, therefore, is that if you make capital investment, then you get the benefit of capital cost recovery. As I say, the measure may be crude, but we believe that it is acceptable, and it is effective and it is targeted.

Last, Mr. Chairman, we do not believe that the 10 percent cut in personal income tax rates will be stimulative in terms of personal consumption, but rather consider it compensatory in nature due to the fact that income tax burdens will rise by $24 billion in fiscal 1981, starting with $15 because of the "bracket creep" of people getting into the higher brackets because of getting more dollars in wages and salary, and also because of the fact that this rise is so imminent that what we will be giving back in terms of a 10-percent cut will soon have to be paid out in terms of these other taxes.

So we present these ideas to the committee with the main point, Mr. Chairman, being that we strongly favor action now. This is the time when it will count the most. I believe our country would look to the Republicans as the opposition, to perform the role of the opposition, which is to call the term on the obsolescence of the U.S. industrial machine, the root cause of our stagnant productivity, persistent inflation, and widespread unemployment, and in a pragmatic way to help the individual with the heavy tax increase he is due to get, and to enable business to do the job for which the American people look to it, which will require a targeted tax cut. While 10-5-3 is a crude way to do it, it is effective, and it can pass, and pass in time. Hence, we urge it upon the Senate and the country.

Thank you.

Senator DOLE. Chairman Long has stepped out to take a telephone call. We follow the "early bird" rule, and Bob Packwood was the first one here.

Senator PACKWOOD. I agree with almost everything Senator Javits has said. I have no questions. Thank you very much.

Senator DOLE. Senator Roth.

Senator ROTH. Senator Javits, I, too, will not ask you any questions because of the many witnesses before us. I would like to thank you for your very illuminating statement, and particularly the fact that you have underscored the need for taking some long-term steps to do something about productivity.

What concerns me is that this Congress, and most committee concern themselves with the short-range. I think that that is the reason that we find ourselves in the situation we are. I am not only concerned about working our way out of this immediate recession, but what bothers me, are we really going to take some steps to begin to become competitive again. So far I have not seen this Congress do much.

I just wanted to thank you for your excellent statement.

Senator JAVITS. Mr. Chairman, may I make an observation on that particular matter, just to show you what I mean by structural changes.

We have got a tremendous problem of youth unemployment. Youth unemployment, taking whites, blacks, and others together, is running at 16 to 17 percent. Among minorities it is from 30 to 40, and even 60 percent, an absolutely horrendous figure.

There are about 4 million individuals that are concerned. If you could call the turn on 1 million of those individuals, you would break the back of this problem as a social problem. It is inconceivable to me that with an industrial machine which is employing in the area of 90 million people that we cannot, with suitable incentives, design a way in which business would take the responsibility for that 1 million. It is just inconceivable. I cannot see it at all.

The other point on structural development. We are trying an export drive, but everything we do—I am not talking for Reg Jones who is Chairman of the President's Export Council, and I am a member—everything you do is like an echo on a wall. It just comes back to you, and nothing happens. We are being skinned alive all over the world under antitrust laws, under what we conceive as the need for superethical practices, under the fact that we are not getting out there and allowing our people to take the jobs because they get murdered in taxes under the so-called section 911 problem.

It is just inconceivable that we can be so paralyzed that we cannot help ourselves.

The CHAIRMAN. Senator Dole.

Senator DOLE. Mr. Chairman, I want to thank Senator Javits, not only for his statement, but for his leadership particularly on the Republican side, but which I think is appreciated on both sides. Senator Javits has assumed the duty of serving as chairman of our economic committee in an effort to bring together, as he has indicated, the different views that many of us had, particularly on the tax package that nearly every Republican supports.

We agree with the chairman that it is unlikely that any bill will pass that has my name, or Bill Roth's first, but maybe our names will be somewhere in the title or at least in the footnotes. Maybe Senator Javits's name will be first.

In any event, it seems to me that the productivity figures released yesterday by the Labor Department dramatically emphasize the need for a tax cut, a productivity tax cut. The nonfarm business section productivity fell during the last quarter at the alarming rate of 4.1 percent, the biggest drop since 1974.

We have had 4 days of hearings. We have had 15 outstanding witnesses. I know that the chairman indicated in a speech last Friday that there seems to be a consensus for a tax cut developing in the committee and in the Congress. I believe that if we look at the tax increase that the American people face next year because of inflation, and the other things that Senator Javits mentioned, that we can and will, after the Democratic convention, come back to this committee and mark up a tax proposal that is going to be hard to resist by the administration and by the House of Representatives.

We look forward to working with Senator Javits in that effort.

Senator JAVITS. Thank you very much.

The CHAIRMAN. Senator, you have made a very fine statement. You are the first of a list of very prestigious witnesses to be appearing here today. I may submit some questions to you for answer in writing, but I will not question you now because I want to allow the other witnesses to have their say. I thank you for what you had to say. It is very helpful to us in working on this bill.

Senator JAVITS. Thank you so much, Mr. Chairman.

[The prepared statement of Senator Javits follows:]

SENATOR JAVITS TESTIMONY BEFORE SENATE FINANCE COMMITTEE

Mr. Chairman, I am testifying today in my capacity as Chairman of the Economic Policy Subcommittee of the Republican Policy Committee and as Chairman of an Ad-hoc Committee that the Minority Leader caused to be formed in March of this year to develop a program we could put forward to deal with our faltering economy. I am pleased to give my views on the question of a tax cut in 1980.

Senate Republicans are on record for three years as favoring the enactment of a tax cut for business and individuals to spur increased saving, investment, productivity, jobs and economic growth. In our 1977 Policy Statement, "Two Million Jobs That Last," we stated: "There is a longer term need for capital formation in order to provide expanding employment opportunities at rising real wages. Unless that problem is addressed at this time, inflationary pressures caused by shortages, decreased output per worker and lack of additional employment opportunities appear likely in the future. To avoid these future problems, it is recommended that the Federal Government formally declare a national policy in support of adequate capital investment in the private sector. . . . In attacking unemployment caused by lack of demand, it must be recognized that temporary solutions have had very limited success in the past; thus, permanent, confidence-building solutions must be used now and this means a permanent tax cut, not some form of temporary gimmick."

In 1979, we declared: "It is vitally important that the tax system not operate to reduce the real standard of living of the American people. Therefore, we support substantial phased across-the-board reductions in federal income taxes to encourage incentives for economic growth and job opportunities without inflation and to limit the growth rate of federal spending."

In our most recent Declaration of Economic Principles, issued on March 12th of this year, Senate Republicans declared that our numerous and complex economic problems—including unacceptably high inflation; stagnation of productivity; and historic decline in real GNP; and most tragically, the erosion of personal savings and personal disposable income—are not insolvable or insuperable. On the contrary, because our problems are the product of specific economic policies, they can be dealt with by the adoption of a creative program, which will take advantage of the build upon the fundamental resiliency and vitality of our economic and political system and by a compact among government, business and labor. So we proposed that: "Federal taxes must be reduced and tax laws changed to encourage greater individual and business savings, investment output and productivity and thus more jobs for Americans."

And now Senate Republications have introduced a tax cut plan, inspired by Governor Reagan, continuing both business and individual tax cuts, that is consistent with our policy declarations of the past 3 years.

Mr. Chairman, contrary to the apparent views of the Administration, the present state and direction of the economy does not allow us to wait until 1981 for a tax cut decision. We have been hit with two very grim forecasts in the past week on the state of the economy, one from the Office of Management and Budget, and the other from the Congressional Budget Office. They confirm what I have been saying for three years: that our country is in perilous shape economically and that there is as yet no bottom to confidence in its future.

The data should move us to action. We are confronted with the prospect of 9.4 percent inflation by the end of the year, remaining at intolerable levels throughout 1981. Last month's figures indicated an annual rate of 12.4 percent. We are confronted with a fall in GNP from 2.3 to 4.3 percent through the course of 1980. In the second quarter the decline was at an annual rate of 9.1 percent. We are also confronted by a core rate of inflation that by historic standards is not only catastrophic, but is guaranteed to establish firmly for the future in sight the inflationary expectations that plague our economic policy making. Let's face it, Mr. Chairman, the U.S. economy is in very grave trouble and there is no telling what could happen in the next twelve months.

Ironically, the economic crisis of simultaneous recession and inflation into which we have now entered was not inevitable; it is the direct result of deliberate and misguided policies. It will cause the loss of billions of dollars in personal incomes and of human and other productive resources; and it is exposing our already weakened economy to the perils of a major recession.

Incredibly, in the face of what is clearly an economic catastrophe of major proportions, the Administration gives us no positive program. On the contrary, what we are getting is negative—induced unemployment and continued unacceptable inflation via a managed recession, and the negative program is working, much to the detriment of the country! We are told that the political climate is not propitious to judicious tax policy decisions and that recent economic events have caught the U.S. by surprise. And we are told that in the time left to us we simply cannot develop a positive program to pull us out of this economic crisis. The Administration itself does not quarrel with the need to offset the tax increases borne by the American people as a result of inflation-induced bracket creep and Social Security tax increases. Secretary Miller said as much in his testimony before this Committee.

This must be the most widely advertised—if not contrived—recession in history. We have been receiving warnings of impending crisis for a year and a half. We have also faced the facts on the need for greater capital formation, higher productivity and enhanced competitiveness for at least three years. Certainly, many among us have been sounding the alarm on these issues, warning of just the situation at which we have arrived.

And the outlook for the foreseeable future is very grim. CBO forecasts a very slow recovery beginning around the New Year, but unemployment will remain in the 8.5 percent range. Indeed, private forecasters are projecting such slow growth that absent recovery policies, unemployment may not go below 6 percent until after 1985.

What then is the basis for the Administration's claim that further time is needed to assess the facts? At a time when positive action is required, all we hear are timid words of caution and delay. At a time when the destructive effects of inflation and unemployment are impoverishing the American people and they are hoping for answers, they are being given rationalizations for inaction.

Congressional Republicans have again presented a creative proposal that is tailored specifically to restoring personal incomes and providing business incentives for economic growth without rekindling inflation. The Republican tax cut proposal is a response to a record-high peacetime tax burden (21.7 percent of GNP by 1981); an almost double digit unemployment rate; and, perhaps most critically, it is a response to our long-standing problems of declining productivity, savings and investment.

This Republican Program calls for a permanent 10 percent across-the-board rate reduction for individuals and phased-in accelerated and simplified depreciation tax treatment to encourage new capital investment—the so-called 10-5-3 capital cost recovery plan. This proposal represents a call for a fundamental shift in tax policy in the direction of restoring incentives and encouraging production. It is targeted toward productivity and investment, the key of any industrial revitalization program—not to consumption. It may be a crude approach but it is understandable to the people and gives a workable basis for tax reduction targeted to raise capital for modernization to increase productivity. In my judgment, the obsolescence of the U.S. economic machine is one of our most dangerous problems—a root cause of stagnant productivity; persistent inflation and widespread unemployment.

One point should be perfectly clear: The 10 percent cut in personal income tax rates will not be stimulative of personal consumption; it is compensatory in nature. Personal income tax burdens will rise by at least $24 billion in fiscal year 1981, because of the "bracket creep" of inflation ($15 b). In other words, we will have major effective tax increases during the 1980-81 recession if we do not adopt a tax cut bill this year. Our tax cut, therefore, is compensatory, not additive.

Senate Republicans present this Republican Economic Policy Statement as a pledge of their intention to introduce, work for and implement economic policies which are truly designed for the decade to come—and, I urge the committee to give it every consideration.

[From the Office of Senator Jacob K Javits, New York]

JAVITS CALLS FOR PERSONAL AND BUSINESS TAX CUTS

WASHINGTON.—Declaring that "our numerous and complex economic problems can be solved with creative programs," U.S. Senator Jacob K. Javits (R-N.Y.) today urged the Senate Finance Committee to adopt a 10 percent across-the-board cut in personal income taxes and phased-in accelerated and simplified depreciation schedules—the 10-5-3 captial-cost recovery plan—to encourage investment by business and industry.

"The economic crisis in which we find ourselves was not inevitable," Javits told the Committee. "It is the direct result of deliberate and misguided policies" by the Carter Administration.

Javits, who appeared as the lead-off witness at the Finance Committee's hearings on tax cuts in his capacity as Chairman of the Senate Republican Economic Task-Force, said the proposals he and his colleagues were advancing were "tailored specifically to restoring personal incomes and providing business incentives for economic growth with rekindling inflation."

"This is not a quick-fix remedy," he stated. "It represents a call for a fundamental shift in tax policy in the direction of restoring incentives and encouraging production."

"It is targeted toward productivity and investment—the key to any industrial revitalization program—not consumption," Javits explained.

The 10 percent personal income tax cut would be "compensatory in nature, not stimulative of consumption," he said, because personal income tax burdens will rise by at least $24 billion in 1981 as a result of Social Security tax increases and inflationary, tax "bracket creep."

The "10-5-3' depreciation proposal would lower by about one-third the time in which businesses could write-off investments on plants and equipment. The Internal Revenue Service currently determines the allowances based on its evaluation of "useful lifetime." The Republican plan would codify the schedules to allow a 10-year write-off on structures, 5 years on equipment and 3 years on vehicles.

The proposal will make depreciation allowances more realistic, "thereby providing a powerful incentive to plant modernization," according to the Senator. "The obsolescence of the U.S. economic machine is one of our most dangerous problems—a root cause of stagnant productivity, persistent inflation and widespread unemployment," he asserted.

"We cannot wait until 1981 for decisive economic leadership," Javits declared. "In the face of an economic catastrophe of major proportions, the Administration has given us platitudes and excuses—but no positive program."

"What we are getting is negative," he continued. "We are told what we cannot do. At a time when hold leadership is required, all we hear are timid words of caution and delay. The American people are hoping for answers and they are getting rationalizations for inaction."

The Republican program, on the other hand, is "innovative" and "designed for the decade to come," Javits continued. "It will take advantage of and build upon the fundamental resiliency and vitality of our economic and political system."

The CHAIRMAN. Next we will call the Honorable Jack F. Kemp, Congressman from the State of New York. Is Mr. Kemp here?

Senator ROTH. Not yet.

The CHAIRMAN. We will offer him the opportunity to testify later on when he arrives.

I will now call a panel consisting of Edward I. O'Brien, president of the Securities Industry Association; Mr. Arthur Levitt, Jr., chairman of the American Stock Exchange; and Mr. David Silver, president of the Investment Company Institute.

In this case, each witness is authorized 5 minutes to summarize his statement. I will ask each member to please read these statements so that he can ask the questions he wants to, and then we will allow each Senator 5 minutes to ask the questions he would like to ask.

First, let me call on Mr. Edward O'Brien, president of the Securities Industry Association.

STATEMENT OF EDWARD I. O'BRIEN, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

Mr. O'BRIEN. Good morning, gentlemen.

My name is Edward I. O'Brien, and I am president of the Securities Industry Association. Our 500-member firms serve 25 million investors and thousands of all companies of all sizes across the country. We very much appreciate this opportunity to participate in these hearings as we have in the past.

Throughout the last decade the Nation's economy has sagged, and the U.S. international competitive position has deteriorated. Our standard of living now ranks fifth in the world, and just 8 years ago it was first.

The decline in the U.S. share of world markets has cost billions of dollars in lost production and millions of jobs. Our productivity and economic growth lag badly behind other nations.

A major cause of the U.S. decline is the fact that capital investment and personal savings rates in this country are the lowest in the industrialized world.

These disturbing trends are compounded by the severity of the current recession, which is the second worst in three decades.

We urge Congress to adopt long-term tax provisions designed to increase savings and investment by individuals and business. Short-term solutions alone will only provide temporary relief from the inflation, and other economic ills which plague our Nation.

Individual reductions to offset increased taxes and the inflation, and accelerated depreciation to stimulate business investment are essential elements of a balanced tax policy. We endorse initiative in these directions.

But accelerated depreciation will assist only some sectors of the economy. The most effective means of improving the flow of capital to other sectors, particularly small business, would be to improve the return on investment in those businesses.

Two years ago, Congress enacted the first reduction in capital gains taxes in over 40 years. Since that action, equity values have rebounded, with the most dramatic increase experienced by smaller capitalized companies which historically have accounted for the sharpest gains in employment.

But U.S. taxation of stock investments remains the highest in the industrialized world, as the study prepared by Arthur Andersen & Co. and attached to our testimony demonstrates.

Investors are responsive to changes in tax policy. After Congress cut capital gains taxes in 1978, individual investment, initial public offerings and venture capital issues increased. Following capital gains tax increases in 1969, the number of individual investors declined 18 percent.

A survey by Opinion Research Corp. also demonstrates investors' favorable response to the 1978 capital gains tax reductions, and indicates they will increase their investments with an improved tax climate.

As explained in our written statement, increased realizations of capital gains have been offset by a large portion of the inflated revenue loss projections forecast by the Treasury Department in opposing the reductions.

Building upon the actions of 1978, either through lowering the maximum tax on investment income or through increasing the capital gains exclusion, would have positive effect for the economy.

Econometric simulations performed for SIA by Data Resources indicate that such changes would increase economic growth, investment and disposable income without increasing inflation.

For example, reducing the capital gains tax from 28 percent to 21 percent would boost real GNP $10 billion over 3 years. Real investment would rise nearly $5 billion and disposable income would increase by almost $6 billion.

Mr. Chairman, we urge Congress to prevent tax increases next year which would compound the recession, but we also urge long-term solutions. Combining reduced capital gains taxes with accelerated depreciation and individual tax relief will increase savings and investment and strengthen our economy.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Arthur Levitt, chairman of the American Stock Exchange.

STATEMENT OF ARTHUR LEVITT, CHAIRMAN, AMERICAN STOCK EXCHANGE

Mr. LEVITT. Mr. Chairman, as chairman of the American Stock Exchange, I am here representing its listed companies, its member firms and individual investors. I am also here on behalf of the American Business Conference, a newly organized coalition representing the interests of midsize growth companies.

Mr. Chairman, the time for enacting tax legislation is now, and not next year. There is no reason to keep workers, investors, and business in the dark about a cut for many more months, which might well stretch deep into 1981 in view of the time involved in organizing the new Congress, holding new hearings, and finally winning passage of a bill.

A tax cut enacted in 1980, and effective January 1, 1981, would be a downpayment on what is needed. It would be a step toward a longer term restructuring needed to reduce the Federal tax system's drag on economic growth.

Without these fundamental changes in our tax system, our economy will be ill-equipped to provide the jobs, price stability, and real income growth, required for the decade ahead. Of course, to be anti-inflationary, such a carefully fashioned responsible tax reduction bill should be targeted at three specific economic problems.

First, modernization of our outmoded depreciation laws. This goal, recommended by the administration, a majority of the Congress, leading economists, and business groups representing all sectors of the U.S. economy, has also been endorsed by the White House Conference on Small Business. I would urge the committee to act on this consensus, and include some form of faster and simpler depreciation in the tax bill you report to the Senate.

Second, this committee should act to encourage individuals to save and invest, particularly in those smaller companies and emerging industries where there is the greatest potential for growth and job creation.

Third, the committee should act to abate the impact that high inflation rates are having on our progressive of income tax. I urge the committee to enact tax cuts that reduce the increased tax burden on our productive middle-class.

Perhaps what I can do of most value today is to present the special perspective of the American Stock Exchange, special because we are a securities market for approximately 900 small and medium companies, and because more than half of our trading is done by individual rather than by institutional investors.

Our companies are not household words. Among them are the Xeroxes and Polaroids of tomorrow. They represent every American industry in every region. The smaller and midrange companies, creative, innovative, risk-taking, are our best source of economic growth. The financing of these smaller companies is substantially drawn from individual investors. Therefore, these enterprises are dependent on an economic climate that encourages individuals by offering a favorable risk reward ratio.

The exchange's experience with the 1978 capital gains tax reduction has led us to believe that the simplest, most effective step this Congress can take to encourage the kind of investment these companies need is enactment of the capital gains tax cut.

There has been much debate about the effect of the 1978 cut on the stock market. Of course, it is impossible to say that the tax cut alone is responsible for what we have seen. However, we have observed several indicators of market strength which reflect that it has had a very positive effect, one far more marked and dramatic in its effect on the market as a whole.

In the first 6 months of 1978, 438.8 million shares changed hands on the Amex. In the first 6 months of this year trading volume was 730.7 million, an increase of 67 percent. Since 1978, when the capital gains cut took effect, the Amex market value index has jumped more than 120 percent.

In the first 6 months of 1978, Amex listed companies brought only two equity offerings to the market, raising $36 million. By contrast, in the first 6 months of this year, 21 companies had raised nearly $300 million.

But the evidence is not alone in terms of statistics. We have talked to top executives of growth companies, investment bankers, and stockbrokers to get their opinions. All of them have attested to the importance of the tax cut in terms of their own financing plans, in terms of the various kinds of capital structures that are imposed upon their companies.

Therefore, Mr. Chairman, I urge this committee to further reduce the capital gains tax from 28 to 21 percent for individuals and corporations. The maximum effective rate for individuals should be cut to 21 percent by increasing the income exclusion from 60 to 70 percent. The corporate capital gains tax should be reduced by changing the statutory corporate capital gains rate from 28 to 21 percent.

In short, I urge this committee to enact this kind of capital gains tax proposal because it is simple, and it works.

Thank you.

The CHAIRMAN. Next we will hear from Mr. David Silver, president of the Investment Company Institute.

STATEMENT OF DAVID SILVER, PRESIDENT, INVESTMENT COMPANY INSTITUTE

Mr. SILVER. Thank you, Mr. Chairman.

My name is David Silver, and I am president of the Investment Company Institute. I am accompanied this morning by Matthew Fink, general counsel of the institute. We appreciate your kind invitation to appear here this morning.

The ICI is the national association of the mutual fund industry. Our 544 member mutual funds have assets of some $110 billion, and approximately 8.5 million shareholders.

The institute strongly supports changes in the Federal income tax laws to promote capital formation through increases in savings and investment. Preliminary estimates for 1979 indicate that personal savings by U.S. citizens as a percentage of disposable income have fallen to a level of about 4.5 percent, the lowest in some 30 years, with no present likelihood of increase in 1980 and 1981. Our savings rate is lower than that in any other major country, including Canada, West Germany, France, and Japan.

We believe that the Federal tax laws should be modified to provide further encouragement for individual savings, and we are here this morning to make a specific proposal on how this may be achieved. It can be accomplished, we believe in a way that would serve socially desirable and anti-inflationary purposes, such as providing for retirement, housing, and education.

To attain these objectives readily and simply, it is desirable to build on existing programs, rather than to create new tax structure that would require a new set of rules and regulations.

We recommend that the existing Individual Retirement Account system, known as IRA's, be simplified and universalized, and that it be expanded by making the following changes.

First, remove the present prohibition against use of IRA's by persons who are participants in a qualified employer plan.

Second, increase the limit on deductible contributions to IRA's from $1,500 to $2,000.

Third, permit nondeductible contributions to IRA's of up to $10,000 a year, with a lifetime ceiling of $100,000.

Fourth, permit withdrawals from IRA's without the present 10-percent penalty tax: (*a*) For purchase of a first home; and (*b*) to pay for higher education or vocational training of a taxpayer's children.

We believe that for a number of reasons these recommended changes in IRA's would permit these plans to play a major and efficient role in capital formation by stimulating individual savings and investment. To mention only a few:

The proposal would utilize the existing IRA structure without requiring a new type of account with new rules and regulations. In fact, the changes we recommend would eliminate and simplify existing IRA provisions which have caused administrative complexities, and which have also significantly reduced the number of eligible users. These limitations have also discouraged savings and investment media from promoting IRA's because promotional expenses have been too high in relation to the permitted size of these plans.

The proposal also has the virtue of neutrality in at least two respects. First, as to the allocation of IRA contributions by taxpayers, all savings and investment media can be utilized. Thus, stocks, bonds, government obligations, bank deposits, and insured annuities will all be eligible funding media.

Second, the proposal is neutral in that the taxpayer could take advantage of its benefits by either choosing to make additional contributions to an existing employer plan, or to his own IRA.

Most importantly, the expanded IRA will permit some withdrawals without tax penalty to meet the basic family needs of purchasing a home or for education.

Finally, as in the case of present IRA's, the new plan will permit accumulation of investment income, including rollover of capital gains, on funds in the account. However, only cash could be contributed to the account, and there will be reasonable ceilings on the amount of these contributions.

In summary, we believe that this program combines in a single package the benefit of many proposals that have been advanced, and have achieved broad support, including, if I may say, one of Senator Dole's. We think that it could be a major contribution to the economy of the Nation. It would not be inflationary because the funds in the IRA's would be saved and invested to help fill the Nation's needs for capital formation and improved productivity.

I will be happy to answer any questions, or submit any further information that the committee may desire.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Dole.

Senator DOLE. I understand, and I appreciate, Mr. Silver, your reference to the provision that we have been working on with reference to education and housing.

Do I understand that everyone on this panel agrees that there should be a tax cut, I know that some of you have different provisions in mind, but a productivity tax cut effective next year. Is that a fair statement?

Mr. SILVER. Yes.

Mr. LEVITT. Yes.

Mr. O'BRIEN. Yes, it is.

Senator DOLE. There might be some differences in what the mix might be.

Mr. O'BRIEN. Right.

Senator DOLE. I know the witnesses have great expertise, and there are some who suggest that it would be inflationary, and that we should wait until sometime next year.

It seems to some of us on this committee that we could well wait until next year, or later next year by the time we reorganize, and the Congress gets underway. That has been one of the reasons some of us believe that we ought to mark it up, pass it either in a postelection session, if we are concerned about the politics of it, or a preelection session would be all right to some of us.

I want to make sure that I understand the panel's affirmative response.

Mr. O'BRIEN. It seems to me that it would be desirable to do something about it in 1980 in anticipation of 1981, so that people will have an understanding of what is intended by the tax provision, and be able to build their plans accordingly, rather than to wait until 1981. I think the very anticipation can be an incentive for people to do something about these things.

Mr. SILVER. I wholly agree with Ed O'Brien on that, and I would add, Senator, I think there is nothing lost by going to work now. If the politics preclude a consensus, so be it. But I think that it is important for the Congress to go to work on a tax cut now.

Mr. LEVITT. I think with the newer entrepreneurial companies that we are so greatly concerned with, so much of this is a question of momentum. The momentum that started in 1978 with that reduction can well be stimulated, and continued at this point when these kinds of companies are being far more impacted by the pressures of inflation than the larger companies in the Nation.

For them, the companies that are producing the jobs, and are taking the risks because they have to take the risks, a tax cut is a matter of compelling necessity and should not be delayed.

Senator DOLE. I understand that the first target must be inflation. In fact, in the survey just concluded in my State, we asked the people in my State of Kansas what their priorities are, and 47 percent said the first priority was the ending of inflation. Only about 9 percent referred to a tax cut. So I think everybody understands what our prime responsibility is.

At the same time, I think that once there is agreement on the need for a tax cut, then we can work out the specifics and make certain that it is not an inflationary tax cut.

I don't have any other question. I know that everyone has their specific recommendations. I think our first decision must be, whether there will be a tax cut. I agree with the chairman. I think that there will at least be one on this side.

The CHAIRMAN. Let me just make this point.

In a statement given yesterday by one of the most respected economists in America, Mr. Lawrence R. Klein, who is head of the Wharton School of Business at the University of Pennsylvania and in charge of the Wharton Economic Forecasting Associates, said that if we don't have a tax cut, we are going to have worsening inflation next year. We will have slow but gradual recovery.

He says that if we have a tax cut to increase productivity, we will have less inflation than we will if we don't have a tax cut. If that is true, it completely destroys the case against the tax cut because so far the administration and those who are opposing a tax cut take the view that the tax cut will be inflationary. What if just the opposite it true? Then I would think that they would favor the tax cut.

Most people are not aware of the fact that they are in for a big tax increase otherwise. Right now they are only thinking about a tax cut as reducing their taxes. They are not aware of the fact that they are going to get a social security tax increase in January which will increase the withholding from their checks.

They are going to be paying relatively higher taxes because of bracket creep. There will be a further reduction of their income because of energy prices going up. If you put all of those elements in there, then they are going to pay tax and other increases estimated to be around $80 billion.

I would like to ask you, gentlemen, do you think that a tax cut geared to productivity would be inflationary, or anti-inflationary? I would like each one of you to give me his thoughts.

Mr. O'BRIEN. I think that we should promote investment, and that it would not per se be inflationary. In fact, I would agree, therefore, with Professor Klein of the University of Pennsylvania. I think that he is right.

Mr. SILVER. As you have indicated, Mr. Chairman, it is solely a question of how you structure it. We have made, for example, one proposal here this morning which would fill that bill. There would be a revenue cost, we estimate, of about $3 billion, but which in the first year would lead to an increase in savings of $15 billion, clearly a net gain, and clearly not inflationary.

Mr. LEVITT. I think that a tax cut to stimulate the fight against the lag in productivity is the most critical factor in terms of the fight against inflation at this point. I think a cut would definitely not be inflationary, particularly at this time, rather than deferring it until such time as we may be already on our way out of the recession.

Mr. O'BRIEN. There is one other thing that I would like to add to it, Mr. Chairman. As you know, from our written and oral statement, as in the past we have worked with Data Resources, and they have made various projections. It is their position as well that a reduction in the capital gains, building something in the area of incentives for investment would also not be inflationary.

We would be glad to furnish additional information on that, if it would help.

The CHAIRMAN. We would like to have that, if it is possible for you to provide it.

[The following was subsequently supplied for the record:]

Econometric simulations performed by Data Resources, Incorporated on the effect of four proposed methods for reducing capital gains taxes showed a positive impact on real economic growth and investment. Those simulations also projected the effect upon inflation as measured by the Consumer Price Index. The results, illustrated in the table below, indicate that baseline projections of CPI increases for the years 1981-83 are unchanged by any of the four proposals. Thus, the simulations project the implementation of any of the proposals would not be inflationary.

[In percent]

	1981	1982	1983
Baseline forecast	8.9	9.3	8.0
Forecast under tax proposals:			
1. Increasing the capital gains exclusion from 60 to 70 percent	8.9	9.3	8.0
2. Lowering the maximum tax on investment income from 70 to 60 percent	8.9	9.3	8.0
3. Lowering the maximum tax on investment income from 70 to 50 percent	8.9	9.3	8.0
4. Increasing the capital exclusion from 60 to 70 percent and lowering the maximum tax on investment income from 70 to 60 percent	8.9	9.3	8.0

The CHAIRMAN. Mr. Baucus.

Senator BAUCUS. I have no questions, Mr. Chairman.

The CHAIRMAN. Senator Dole?

Senator DOLE. I just want to point out that we keep talking about a tax cut, but in view of the tax increases that will occur next year, I think that the proper terminology would be a tax abatement. There is not going to be a tax cut for anyone in 1981.

The CHAIRMAN. A tax increase moderation. [Laughter.]

Senator DOLE. I would not want anybody to have the wrong impression. We are for a tax cut, but we will be happy to have a tax abatement next year.

The CHAIRMAN. Thank you very much, gentlemen.

[The prepared statements of the preceding panel follow:]

OUTLINE OF TESTIMONY OF THE SECURITIES INDUSTRY ASSOCIATION

I. The combination of the recession and increased taxes have damaged the economy and the U.S. competitive position internationally. As inflation, taxes and unemployment have increased, economic growth, productivity, the standard of living, the individual savings rate and business investment have plummeted.

II. Tax policies to compensate for the short-term effect of inflation must be supplemented with long-term incentives to business investment and personal savings. Combining accelerated depreciation with further reductions in capital gains taxes will achieve this goal.

III. Econometric simulations performed by Data Resources, Inc. of alternative methods of reducing capital gains taxes show beneficial impact.

IV. Capital gains reductions enacted in 1978 have stimulated productive investment, particularly in small businesses. A survey conducted by Opinion Research Corp. indicates that investors are responsive to changes in tax policy. At the same time, increased realizations of capital gains have substantially reduced the cost of the tax reductions projected by the Treasury Department.

V. Nonetheless, a study prepared by Arthur Andersen & Co. indicates that U.S. taxation of investment in stocks is higher than in othr industrialized nations.

VI. SIA favors enactment of individual tax reductions, acceleration of depreciation and further reduction of capital gains taxes.

Attachments—Opinion Research Corp. Survey; Arthur Anderson & Co. study.

STATEMENT OF THE SECURITIES INDUSTRY ASSOCIATION

Mr. Chairman and members of the committee, I am Edward I. O'Brien, and I am appearing today as President of the Securities Industry Association. I appreciate the opportunity to participate in the committee's hearings on the need for tax reductions for 1981.

SIA represents nearly 500 leading investment banking and brokerage firms headquartered throughout the United States which collectively account for approximately 90 percent of the securities transactions conducted in this country. The activities of SIA members include retail brokerage conducted on behalf of 25 million individual shareholders, institutional brokerage, over-the-counter market making, various exchange floor functions and underwriting and other investment banking activities conducted on behalf of corporations and governmental units at all levels. Because of their role in the capital markets, SIA members are in a position to recognize the impact of tax policy on investment decisions by corporations and investors.

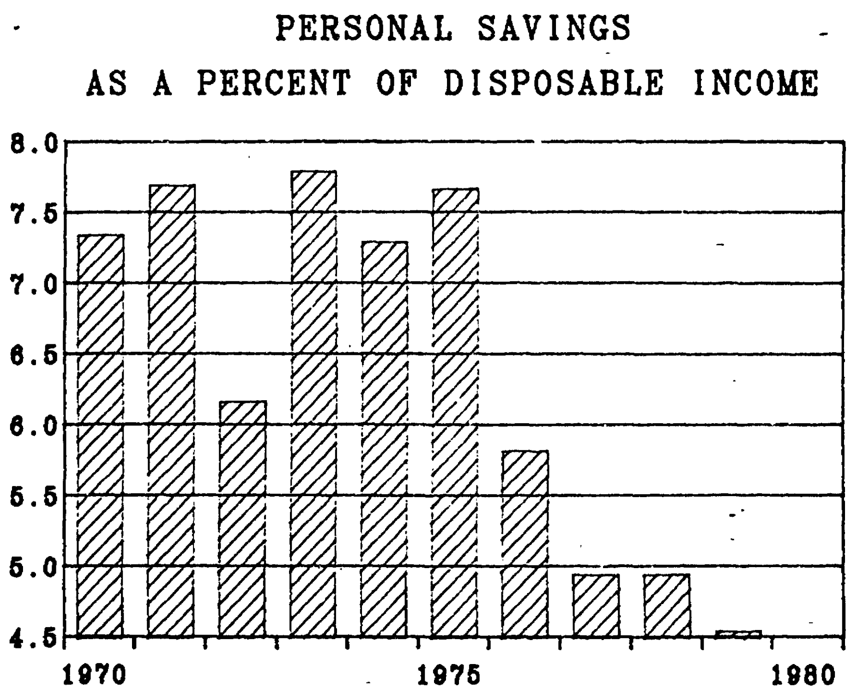
INTRODUCTION

The current recession calls for the establishment of a positive framework for the U.S. economy in the 1980's. During the second quarter of this year, the U.S. economy experienced a more severe downturn—9 1 percent—than it did over the entire course of the recessions in 1949, 1960, and 1970. Only the 1973-75 recession is likely to be more severe on an annual basis than the downturn which started in January of this year. The recession's severity combined with 1981 tax increases of approximately $40 billion resulting from "bracket creep," increased social security taxes and the oil windfall profits tax exacerbates the nation's economic problems.

U.S. economic growth fell to less than 3 percent annually in the 1970's compared to slightly more than 4 percent per annum in the 1960's. The U.S. standard of living currently ranks only fifth in the world; it ranked the highest eight years ago. Moreover, the U.S. inflation rate was higher than the average of all industrial countries in 1979 for the first time in history.

From 1948 through 1968, output per hour worked increased 3.2 percent annually; from 1968 through 1973, the rate of productivity increase fell to 1.9 percent; and from 1974 through 1979, to only 0.7 percent. Personal saving as a percentage of disposable income has declined precipitously in recent years. (See Chart I.) During the inflation-fueled buying spree of late 1979, this figure plunged to 3.5 percent.

Chart I



INTERNATIONAL COMPARISONS

The U.S. international competitive position has deteriorated sharply. The loss of competitiveness over the past two decades has been nothing short of a disaster. The decline of the U.S. share of world markets has cost $125 billion in lost production and at least 2 million industrial jobs despite a 40 percent depreciation of the dollar, which lowered the cost of our exports and increased the cost of imports to this country.

Below are some tables demonstrating how far our international competitiveness has deteriorated. First, the productivity gain of the U.S. has been below that of five other major industrial countries.

TABLE 1

	1979 manufacturing productivity gain, percent increase	Percent change in annual GNP growth per employee 1973-79
Italy	8.7	1.6
Japan	8.3	3.4
France	5.4	2.7
West Germany	5.2	3.2
United Kingdom	2.2	0.3
United States	1.5	0.1

Source: U.S Labor Department, Bureau of Labor Statistics and OECD.

Reduced savings and capital investment in the past several decades have been a major factor in the decline in productivity in the United States. The U.S. now ranks last among seven major industrialized countries in capital investment as a percentage of Gross National Product. The U.S. ratio is less than two-thirds the average for the six other nations and is less than half that of Japan.

TABLE 2.—*Nonresidential fixed investment as percent of real national output*[1]

Japan	23.8
Canada	17.4
France	16.2
United Kingdom	15.4
West Germany	15.2
Italy	14.9
Six Country Average	17.2
United States	10.6

[1] Period covered varies by country according to availability of data. Period is 1974-78 for Italy, U.S., West Germany, United Kingdom; 1974-77 for Canada, France, and Japan.

Source: Organization for Economic Cooperation and Development, Financial Statistics.

The U.S. has a comparatively low savings rate which limits the ability to finance increased investment and improved productivity. Our savings rate is now by far the lowest among the leading industrialized nations. The savings rate dropped by almost 40 percent between 1974 and 1979, from 7.3 percent to 4.5 percent—more than twice the decline experienced by West Germany, which suffered the second sharpest decrease. Table 3 compares the saving rate in the U.S. relative to that of other major countries.

TABLE 3.—*Savings as a percent of after-tax personal income*

Japan	25.0
France	17.2
Britain	17.0
West Germany	13.7
Canada	8.9
United States	4.5

Source: U.S. Department of Commerce. Data for U.S., 1979: France and Japan, 1978: others, third quarter 1979 at seasonally adjusted annual rates.

Two of the dominant factors in the U.S. rise as a nation have been the ready availability of large amounts of capital and the willingness to invest that capital. But, diminished capital investment and capital availability raise serious questions about this nation's continued ability to maintain efficient production facilities, compete effectively in world markets and sustain high employment levels.

INFLATION'S IMPACT ON PERSONAL SAVINGS AND INVESTMENT

Inflation is a major cause and effect of the nation's economic ills. Because wages simply do not decline, a drop in productivity places upward pressure on costs, with the paradoxical result of rising prices in the face of declining demand. Price increases have been least pronounced in those sectors that generate profits sufficient to finance the upgrading of physical plant and equipment. Inflation has also impaired corporations' ability to finance themselves through either retained earnings or through external financing from investors.

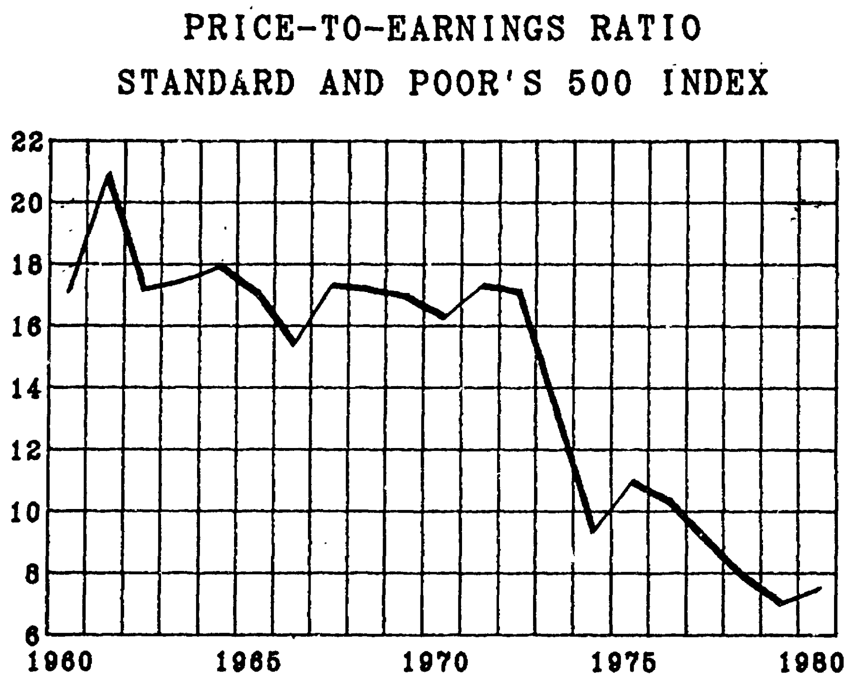
For individuals, savings tend to be a residual rather than a budgeted amount. The unwillingness to reduce living standards makes savings the first casualty of price rises. Individuals' ability to save is further hampered by the collision of cost-of-living pay raises with the graduated tax schedule.

INFLATION'S IMPACT ON BUSINESS INVESTMENT

Business has suffered from a tax system based on historical cost during an inflationary period. Companies report profits which may only reflect price rises in inventories. Since inventory must be replaced at higher costs, these gains are illusory. Companies also suffer because their annual depreciation charges frequently reflect less than half of the replacement cost of productive capacity consumed during the year. Use of historical cost figures to determine taxable income results in overstatement of tax liabilities and an erosion of capital. The Department of Commerce estimated that the effective corporate tax rate on real profits in the 1970–78 period averaged 68.7 percent, having been as high as 96 percent in 1974, far exceeding the 48 percent statutory rate then prevailing.

One result of this overtaxation has been a more than doubling of the corporate debt/equity ratio since 1965 as internal cash flow no longer suffices to renew and expand physical plant. Another result has been the decline in real profitability over the same period. The inflated earnings figures corporations report using historical cost conceal this decline, but the price/earnings multiple of the S. & P. 500 Index, which declined from 16.8 during 1965 to 7.3 at year-end 1979, articulates it well. (See Chart II.)

Chart II



This low level of profitability has resulted in a low investment rate, since the returns are not sufficient to justify the risk. The failure to modernize makes cost control more difficult and is detrimental to our international competitive position. The present straits of certain industries result from an inability to modernize at the rate foreign competition has done so. Protectionist measures, much like demand manipulation, can supply only a short-term remedy.

TAX MEASURES AIMED AT STIMULATING INVESTMENT

The traditional approach of countering recession with across-the-board tax reductions and increased government spending provides short-term relief but causes repetition of the same ills. We firmly believe that long-term economic growth requires a fundamental change in U.S. tax policy. A carefully constructed and honed tax structure can reduce inflation, which should remain the number one priority, and assist in restoring our former international competitiveness.

Accelerated depreciation would help corporations recover the cost of productive capacity in an inflationary environment, and lower corporations' reported pre-tax net income figures and, hence, corporate tax liabilities. Modification of present depreciation practices is an essential component of stimulating investment, but it would remove only one of several major impediments to capital formation.

For example, there would remain the problem of businesses for which tax liabilities are swollen by inventory profits. Small companies would not derive significant benefits from an easing of depreciation standards. The most effective means of improving the flow of capital to small business would be to improve the return available on such investments. Traditionally, individual investors have purchased the shares of start-up companies. Reduction of personal tax rates to increase the return on investments would benefit small business more directly than would a change in corporate taxation. Two methods of increasing the after-tax return on investments for individuals are especially desirable in our view.

Increasing the capital gains exclusion from 60 percent to 70 percent would reduce taxation of nominal gains and increase the after-tax return on long-term investments. Present inflationary conditions buttress the case for increased exclusions.

Reducing the maximum tax on investment income to 50 percent would give individuals an added incentive to invest rather than consume their incomes or seek out various "tax shelters."

ECONOMETRIC SIMULATIONS

Using the econometric model of Data Resources, Inc., four different proposals for increasing the after-tax return on investments for individuals were analyzed. These proposals were:

1. Increasing the capital gains exclusion from 60 percent to 70 percent.
2. Lowering the maximum tax on investment income from 70 percent to 60 percent.
3. Lowering the maximum tax on investment income from 70 percent to 50 percent.
4. Increasing the capital gains exclusion from 60 percent to 70 percent and lowering the maximum tax on investment income from 70 percent to 60 percent.

For each of these four proposals, we analyzed their impact on five key macroeconomic variables over the 1981-83 period. Table 4 below summarizes the results. Basically, these are comparatively small tax changes which have a disproportionately favorable impact on investment, savings and productivity.

The results reported below were derived assuming accommodating monetary policy. Under this policy, the money supply is adjusted so that interest rates remain close to the levels projected in the DRI baseline forecast. If monetary policy were assumed to be non-accommodating and interest rates allowed to deviate from the baseline forecast under the four tax proposals, the estimates would have been lower.

TABLE 4.—RESULTS OF ECONOMETRIC SIMULATIONS

[Dollars in billions]

Tax proposal	1981-83 changes[1]				
	Real GNP	Real investment	Disposable income	Retained earnings	Deficit
1. Increasing the capital gains exclusion from 60 percent to 70 percent	$6 0	$2.7	$4.1	$5.2	$2.2
2. Lowering the maximum tax on investment income from 70 percent to 60 percent	4.8	1 6	3 5	1.2	(0.3)
3. Lowering the maximum tax on investment income from 70 percent to 50 percent	7.7	2.3	6 5	2.0	1.8
4. Increasing the capital gains exclusion from 60 percent to 70 percent and lowering the maximum tax on investment income from 70 percent to 60 percent	10 2	4 7	5 8	9.6	2.4

[1] Increases over DRI baseline forecasts

Increasing the capital gains exclusion to 70 percent

This proposal increases the attractiveness of capital gains as the maximum tax on capital gains is reduced from 28 percent to 21 percent. It was assumed that the S. & P. index would increase 3 percent, over the level that would otherwise have existed, while the dividend-payout ratio would fall 1.5 percent.

Under this proposal, real GNP increases $6 billion over DRI's baseline forecast for 1981-83. Real investment jumps $2.7 billion, while the disposable income of individuals and corporate retained earnings rise $4.1 billion and $5.2 billion, respectively. At the same time, the deficit increases $2.2 billion during the 1981-83 period.

Lowering the maximum tax on investment income to 60 percent

This proposal increases the attractiveness of both capital gains and dividends. With the maximum tax on capital gains and dividend falling, it was assumed that the S. & P. index would rise 4 percent with no change in the dividend-payout ratio.

Real GNP and investment increase $4.8 billion and $1.6 billion, respectively, under this proposal. At the same time, disposable income rises $3.5 billion. Retained earnings for business increases $1.2 billion and the budget deficit actually drops $.3 billion over the 1981-83 period.

Lowering the maximum tax on investment income to 50 percent

The maximum tax on both dividends and capital gains drops under this proposal with the maximum effective rate on capital gains falling from 28 percent to 20 percent. We assumed a 5 percent increase in the S&P index and no change in the dividend-payout ratio.

Under this proposal, real GNP and investment jump $7.7 billion and $2.3 billion, respectively. Disposable income rises $6.5 billion, compared to an increase in retained earnings of $2 billion. The deficit increases by $1.8 billion over the three-year period.

Increasing the capital gains exclusion to 70 percent and lowering the maximum tax on investment income to 60 percent

This proposal increases the after-tax return on both capital gains and dividends for some taxpayers. The maximum effective tax rate on capital gains drops from 28 percent to 18 percent. It was assumed that the S&P index increases 6 percent while the dividend-payout ratio falls 3 percent.

From 1981-83, real GNP and real investment jump $10.2 billion and $4.7 billion, respectively. Disposable income rises $5.8 billion, and funds available to corporations through retained earnings increase an even more impressive $9.6 billion. At the same time, the deficit increases about $2.4 billion over the same time period.

Any of these proposals would do a great deal to reinvigorate our economy, stimulate new business growth, and provide additional jobs.

EXPERIENCE WITH THE CAPITAL GAINS TAX CUT IN 1978

The Revenue Act of 1978 contained the first reduction in capital gains taxes in over 40 years. The net effect of the 1978 changes was a reduction in the maximum effective tax rate on long-term capital gains from almost 50 percent to 28 percent. There is strong evidence that the capital gains tax cut was an effective and efficient means of stimulating investment despite a steadily deteriorating economic environment.

Between 1970 and 1975, the New York Stock Exchange reports an 18 percent decline in the number of individual shareholders. While several factors contributed to the flight of the individual from stock ownership, that decline paralleled increased taxes and reduced returns to investors resulting from the 1969 and 1976 changes in tax policy. Moreover, total equity values dropped from $914.6 billion in 1969 to $907 billion in 1970 and from $1,106.6 billion in 1976 to $1,039.4 billion in 1977. By contrast, after the 1978 capital gains tax cuts, total equity values rose from $1,086.1 billion 1978 to $1,244.6 billion in 1979.

Effect on capital raising process

The various stock market indices show impressive gains in light of the uncertain economic atmosphere which marked the period since the 1978 tax cuts. While the S&P 500 Index and the NYSE Common Stock Index made respectable gains, the AMEX Market Value Index and the NASDAQ Index have risen dramatically. (See Table 5) From December 1978 to December 1979, the AMEX index appreciated a sharp 64 percent and NASDAQ stocks fully 28 percent. From December 1979 to June 1980, the AMEX Index increased a further 19 percent and the NASDAQ 4 percent.

These two indices represent smaller capitalized companies that depend primarily upon the individual investor. The individual investor clearly valued the stocks of smaller capitalized companies substantially more highly after the capital gains tax cut.

TABLE 5.—PERCENTAGE GAINS IN STOCK MARKET INDICES

Period	S & P 500 index	NYSE common stock index	AMEX market value index	NASDAQ index
December 1978 to December 1979	12.3	15.5	64.1	28.1
December 1979 to June 1980	5.8	5.5	18.6	4.4

The languishing state of small business has recently attracted a great deal of attention from both ~~the political~~ and financial sectors. The high cost and/or unavailability of equity capital has been an integral part of small business'—and of the U.S. economy's—problems. Many financing sources are either meaningless for most fledging operations, as in the case of depreciation, or unavailable, in the case of long-term debt capital.

The increase value placed on the stocks of smaller companies enabled many of the lesser known companies to raise equity capital. Initial public offerings in the first half of 1978 amounted to only $54 million. Had this trend continued, initial public offerings in 1978 would have fallen to the second lowest level in eleven years. However, in the second half of 1978, the passage of the Revenue Act of 1978 was imminent and initial public offerings jumped to $194 million. Morever, the $592 million of initial public offerings in 1979 was double that of any year since 1973. First quarter 1980 figures indicated that initial public offerings this year could match or exceed the 1979 figure.

Capital raised by companies having a net worth of under $5 million, similar to the overall trends, ebbed in the first half of 1978 to only $1.2 million raised by a single issuer. In the second half of 1978, initial offerings by small companies rebounded, and 20 companies raised $128 million in the market. Offerings in 1979 by these smaller companies totaled $182.7 million, the highest amount since 1972. This is the grist from which jobs, new technologies, and new opportunities are made.

New capital raised by venture capital firms also rose dramatically in late 1978 and 1979. Capital raised by venture capital firms during the 1969-77 period averaged about $71 million, with a high of $171 million raised in 1969 and a low of $10 million raised in 1975. In sharp contrast, $570 million was raised in 1978 and $319 million in 1979. Disbursements by these firms in 1979 represented an almost 2½ time increase from the pre-1978 level to $1 billion.

Effect on investor behavior

Increased individual investment in stocks followed reductions in capital gains taxes, just as the departure of individual investors followed increases in capital gains taxes. In a survey conducted by Opinion Research Corporation for SIA in November 1979, investors were asked if they made new investments or increased existing investments as a result of the 1978 change in the capital gains tax law (this survey is attached). One-fourth of those surveyed reported new or increased investment because of the lowered capital gains tax rate. The investors were also asked if they realized capital gains through selling investments of any kind as a result of the change in the capital gains tax. About one in ten reported realizations, a very large number taking action in one year. Hence the lowered capital gains tax rate both enhanced investment and increased the mobility of capital. The study also revealed that investors would respond dramatically to further reductions in taxes on investment and that present taxes continue to inhibit investment.

Revenue effect

Increased realizations of gains have offset a good part of the cost of the 1978 tax reductions. The Department of the Treasury originally estimated that those cuts would reduce Federal revenues by $2.2 billion in 1979. Subsequently, the Treasury Department acknowledged the effect of increased capital gains realizations of about $8 billion, and reduced its origianl estimate of revenue loss for 1979 by $0.9 billion to $1.3 billion.

The current Treasury forecast for 1980 also assumes another $8 billion increase in capital gains realizations, yielding nearly $0.9 billion in additional income taxes. Economic stimulus due to the tax reductions will further mitigate the revenue impact. At the very least, the Treasury Department in opposing the 1979 tax cuts overestimated their cost to the government 100 percent. Even the the revised figures underestimate the impact on tax revenues of higher realizations because of the Treasury's assumptions that effective capital gains tax rates for 1979 and 1980 are 10.8 percent and 11 percent, respectively. In fact, the average effective tax rate in 1967 through 1969, when capital gains taxes were slightly lower than they are now, was 14.2 percent.

International comparison

Recently, SIA commissioned Arthur Andersen & Co. to do a comparative study of the taxation of gains realized on the sale of portfolio stock investments by individuals in ten countries (See the attached study). The study shows that among the ten countries reviewed only Canada includes a greater percentage of the long-term gain in taxable income than the United States. In Canada, however, there is no holding period required for long-term capital gains treatment and the maximum tax rate on income is 43 percent as compared to 70 percent in the United States. Only the U.K. had a higher maximum tax on capital gains than the U.S., while six of the ten nations exempted capital gains from taxation entirely (See Table 6).

TABLE 6.—SUMMARY OF INDIVIDUAL TAXATION OF CAPITAL GAINS ON PORTFOLIO STOCK INVESTMENTS IN 10 INDUSTRIALIZED COUNTRIES

Country	Maximum short-term capital gains tax rate [1]	Maximum long-term capital gains tax rate [1]	Minimum holding period to qualify for long-term gain treatment	Maximum annual net worth tax rate
United States	70 percent	28 percent	1 yr	None.
Australia	60 percent	Exempt	1 yr	None.
Belgium	Exempt	do	None	None.
Canada	22 percent	22 percent	None	None.
Germany	56 percent	Exempt	6 mo	0.7 percent.
Italy	Exempt	do	None	None.
Japan	do	do	None	None.
Netherlands	do	do	None	0.8 percent.
Sweden	58 percent	23 percent	2 yr	2.5 percent.
United Kingdom	30 percent	30 percent	None	None.

[1] State, provincial, and local taxes not included.

CONCLUSION

The severity of the recession and increased taxes scheduled for next year have altered the debate over tax cuts. The question is now not whether but when. Congress faces the dilemma of enacting individual tax cuts as a palliative for past and current inflation or rejecting such cuts as a potential catalyst for future inflation. Regardless of how the current dilemma is resolved, long-term economic problems will remain. Unless Congress enacts tax legislation designed to stimulate savings and investment by both corporations and individuals, Congress will repeatedly face the same dilemma. Policies that stimulate demand in the short run do not necessarily generate new supplies. At the end of World War II, there was plenty of industrial capacity and available manpower so that demand-oriented economics could work effectively. But as the U.S. went through each business cycle, conditions became less and less favorable for expanding supplies. Thus, more and more of the increase in demand resulting from government stimulus led to higher inflation rates.

Basically, our policy would be both to encourage investment and soften the impact of payroll tax increases. We believe such a policy would increase the effectiveness of countercyclical policy. Results indicate how effective the capital gains tax cut was in 1978 compared to any reduction in tax revenues. We believe a policy of further cuts in capital gains taxes and/or a reduction in the maximum tax on investment income would continue these results and provide an important incentive for individuals to increase their savings and investment.

COMPARISON OF INDIVIDUAL TAXATION OF LONG AND SHORT TERM CAPITAL GAINS ON PORTFOLIO STOCK INVESTMENTS IN TEN COUNTRIES

(Prepared for the Securities Industry Association by Arthur Andersen and Co.)

COMPARISON OF INDIVIDUAL TAXATION OF CAPITAL GAINS ON PORTFOLIO STOCK INVESTMENTS IN 10 COUNTRIES

Country	Maximum short-term capital gain tax rate [1]	Maximum long-term capital gain tax rate [1]	Minimum holding period to qualify for long-term gain treatment	Maximum annual net worth tax rate
United States	70 percent	28 percent	1 yr	None.
Australia	60 percent	Exempt	1 yr	None.
Belgium	Exempt	do	None	None.
Canada	22 percent	22 percent	None	None.
Germany	56 percent	Exempt	6 mo	0.7 percent.
Italy	Exempt	do	None	None.
Japan	do	do	None	None.
Netherlands	do	do	None	0.8 percent.
Sweden	58 percent	23 percent	2 yr	2.5 percent.
United Kingdom	30 percent	30 percent	None	None.

[1] State, provincial, and local taxes not included.

This study shows that among the ten countries reviewed, only Canada includes in the taxable income of individuals a greater percentage of long-term gain than does the United States. But in Canada there is no holding period required for long term capital gain treatment and the maximum tax on income is 43 percent as compared to 70 percent in the United States. Canada includes 50 percent of long-term gain, while 40 percent is included in the United States and Sweden. These countries tax the includable gain at ordinary income tax rates. The United Kingdom taxes gains at a flat 30 percent tax rate. The remaining countries provide for total exemption of long-term gain.

In terms of the minimum holding period required to qualify for long-term gain treatment, only Sweden requires a longer holding period than does the United States. As can be seen in the table summary attached, Sweden requires a two-year holding period, the United States and Australia require one year, Germany requires six-months, and the remaining countries grant the same capital gain treatment to both long- and short-term gains.

The report provides an overview of the taxation of gains realized on the sale of portfolio stock investments by individual residents of ten countries. Only the general taxation rules have been outlined; consequently, certain specialized situations (such as the sale of stock of closely held companies or sales by individuals considered to hold the stock as inventory) are not covered in detail. In addition to the current tax status of such gains, a summary of changes which have occurred in the taxation of such gains during the past five years has been included. Also included is a description of any wealth or net worth taxes which would apply to such equity securities.

United States.—Short-term gain (holding period of one year or less) and forty percent of long-term capital gain are treated as ordinary income (maximum rate 70 percent).

Long-term capital gain may also be subject to the "alternative minimum tax," which is payable to the extent it exceeds the taxpayer's regular income tax liability (including the preference tax). The amount subject to the tax is the taxpayer's total taxable income plus the capital gain exclusion and other adjustments, reduced by a $20,000 exemption. The tax rates are as follows:

Tax rate

Amount subject to alternative minimum tax:	*Percent*
First $40,000	10
$40,000 to $80,000	20
Over $80,000	25

In 1977, the previous minimum holding period of six months and one day for long-term capital gain treatment was changed to nine months and one day; in 1978, the minimum holding period was increased to the present one year and one day, and the amount of excludable long-term capital gain was increased from 50 percent to the present 60 percent. Also in 1978, the excluded amount was removed from its previous designation as a "tax preferenced item." At the same time, the capital gain exclusion was exempted from the 15 percent "minimum tax" on tax preferences and was eliminated as an adjustment of the amount of personal service income eligible for the "maximum tax" of 50 percent on earned income. The net effect of the 1978 changes was a reduction in the maximum effective tax rate on long-term capital gain from approximately 50 percent to 28 percent (not including any tax resulting from the application of the alternative minimum tax, also introduced in 1978).

Australia.—A long-term capital gain (holding period of one year) is exempt from taxation. Short-term gain is taxed at ordinary rates (maximum 60 percent).

There have been no significant changes in the taxation of capital gains on such stock sales during the last five years. A separate capital gains tax was proposed in 1974 but was never enacted.

Belgium.—The gain is generally exempt from tax regardless of the holding period. If the investment were of a "speculative nature," the gain would not be exempt; however, situations to which this exception apply are not common. Gains of a "speculative nature" occur when an investor on a continuing basis takes risks in excess of his net worth in order to make a profit.

Canada.—One-half of the gain is taxed at ordinary rates (maximum 43 percent) regardless of the holding period. Capital gain is also subject to provincial taxation which is calculated as a percentage of federal tax. Provincial rates vary depending upon the province and range from a low of 39 percent (Alberta) to a high of 58 percent (Newfoundland).

Germany.—Long-term capital gain (six month holding period) is exempt from taxation. Short term capital gain is taxed at ordinary rates (maximum 56 percent).

Individuals are subject to an annual wealth or net worth tax. Portfolio investments are valued at market value; the tax rate is 0.7 percent.

Italy.—Under ordinary circumstances, gain on the sale of portfolio investments is exempt regardless of the holding period. Gain arising from "speculative" transactions is taxed as ordinary income at graduated rates (maximum 72 percent). This exception is rarely applied. Each case must be dealt with individually to determine whether the individual's intent was to acquire and hold the stock or to sell as soon as a reasonable profit could be realized.

Japan.—Generally, the gain is exempt from tax regardless of the holding period. However, if during a year an individual enters into 50 or more transactions involving a total of 200,000 or more shares, all short-term gain (a holding period of five years or less) and one half of long-term gain are taxed at ordinary rates (maximum 75 percent).

Netherlands.—Capital gain is exempt from tax regardless of the holding period. Individuals are subject to an annual wealth or net worth tax. A tax rate of 0.8 percent is applied to the net fair market value of assets, including portfolio investments. A deduction is allowed for standard exemptions, which are Dfl. 43,000 for single individuals, Dfl. 66,000 for married individuals, and Dfl. 15,000 for each dependent child.

Sweden.—Forty percent of long-term gain (holding period of two years or more) and 100 percent of short term gain are treated as ordinary income. Only 40 percent of short term gain is includable in income when the gain is due to a compulsory sale (where an individual is forced by governmental authorities to dispose of an asset). In determining long-term gain on shares, individuals are allowed a tax basis equal to one-half of the net sales proceeds (if greater than actual cost) plus an additional standard deduction of SKr. 1,000.

Individuals are subject to both a national tax (progressive rates up to 58 percent) and a municipal tax (maximum 33 percent), with the maximum combined tax rate being limited to 85 percent (on income exceeding SKr. 174,000).

Prior to March, 1976, the includable amount of gain was as follows:

	Percentage of gain includable
Minimum holding period of investment:	
2 years	75
3 years	50
4 years	25
5 years	10

Further, gains of up to SKr. 500 were tax-free on shares held for five years or more.

Individuals are subject to an annual net worth tax on total assets owned with a total value in excess of SKr. 200,000. Its rates range from 1 percent on total asset values between SKr. 200,000 and SKr. 275,000 to 2.5 percent on amounts in excess of SKr. 1,000,000. Publicly held securities are valued at market value.

*United Kingdom.*The first L3000 of gain is exempt; a flat tax rate of 30 percent applies to gain in excess of L3,000 regardless of the holding period.

Prior to April 5, 1977, an alternative tax was applicable under which one-half of the first L5,000 of gain was excluded from taxable income. The tax was computed as the difference in the tax liability with and without the gain (causing the includable gain to be taxed at the highest marginal rates to a maximum rate of 98 percent, including a 15 percent surcharge). The alternative tax applied only if less than the tax resulting from application of the 30 percent flat tax rate. From April 6, 1977, until April 5, 1980, the alternative tax was 15 percent on gain from L1,000 to L5,000, and 50 percent on gain in excess of L5,000.

EXECUTIVES' RESPONSES TO TAX PROPOSALS FOR INCREASING SAVINGS AND INVESTMENT

A Report On Research
Conducted For
SECURITIES INDUSTRY ASSOCIATION

Table of Contents

Opinion Research Corporation
Princeton, New Jersey
January 1980

Introduction

A series of possible tax proposals aimed at increasing savings and investment by Americans has been discussed by the Securities Industry Association. These proposals include:

1. A maximum tax of 50% on investment income
2. Roll-over of invested capital through deferral of capital gains tax
3. Reduction or elimination of double taxation of dividends
4. Reduction of the capital gains holding period to six months
5. An increase in the dividend exclusion to $500 for individuals and $1,000 for joint returns

SIA sought to learn how persons who potentially could benefit from these proposals react to and assess them, and to help determine which tax proposals would, if implemented, be most effective in stimulating savings and investment.

In addition to gauging reactions to the above proposals, SIA also asked for a reaction to an annual exclusion of up to $2,000 for funds newly invested in corporate securities and an assessment of the effects of the changes in the treatment of capital gains under the Revenue Act of 1978.

To investigate these issues, Opinion Research Corporation included a series of questions in its quarterly Executive Caravan Survey, which is a cooperative research vehicle sponsored by multiple clients, conducted via personal interviews among a sampling of top and middle managers in the "Fortune 800" companies For this study, interviews were completed with 516 executives, during the period October 15-November 15, 1979. (The Technical Appendix provides a detailed description of the sample design and characteristics of respondents in the current study)

In the interviews, respondents were **not** told that these proposals were being studied by the Securities Industry Association

The use of Executive Caravan was considered to be well suited for evaluating the potential response to lifting tax disincentives on investment, for several reasons:

1. The persons interviewed are almost all shareholders, more than nine in ten currently own stock, and nearly all the rest have owned stock in the past
2. Many also own a wide range of other investments, such as real estate, mutual funds, savings certificates, and tangible investments
3. They are a high-income group: nearly three-fourths have job incomes of $40,000 or more.
4. In terms of total securities holdings, the average executive owns around $97,000 of stocks, bonds, mutual funds, and other securities.
5. As business people, they are probably more accustomed to financial matters such as tax regulations, investment alternatives, etc, than the average individual They, thus, represent a particularly knowledgeable group on whom to test various tax proposals.

It should be cautioned, however, that data from Executive Caravan cannot be directly projected to the national population, nor to corporate shareholders in general However, by understanding the attitudes and preferences of the executive community, it should be possible to make judgements about the overall impact of the tax proposals on the investing public.

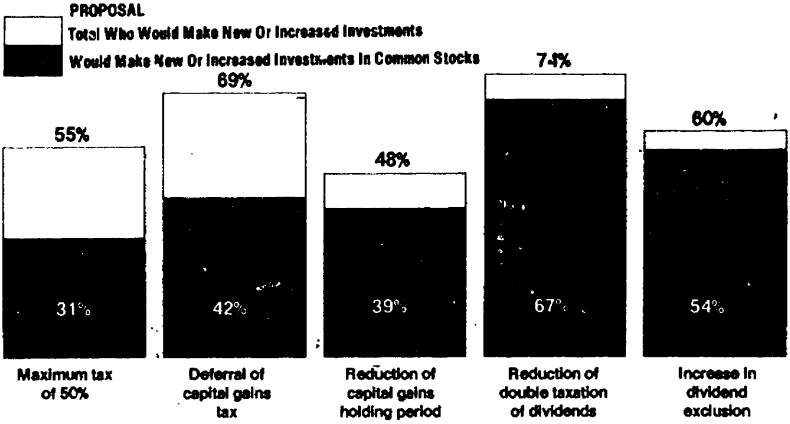
It should also be pointed out that the data from this study should not be regarded as precise predictions of behavior which would result if a particular proposal were passed, since the questions were hypothetical, and since so many factors enter into a person's decisions regarding when, how, and the amount to invest

Report Organization

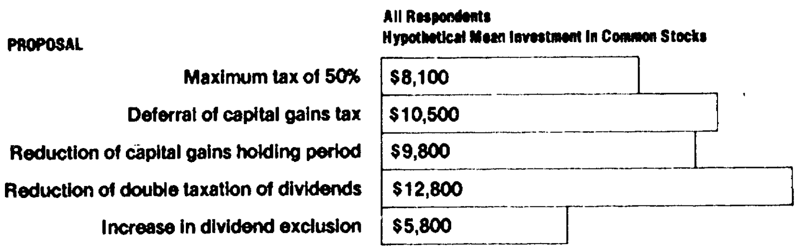
Following is a summary of the study's major findings. Then, in the detailed findings which follow, reactions to each of the five proposals are presented, followed by a summary of executives' reactions to all five proposals presented in one table, and an analysis of reactions by executives' income level, and by value of securities owned

Summary Of Findings

Executives' reactions to the tax proposals vary considerably, both in terms of the percent who say they would make new or increased investments in a variety of investment vehicles, and in terms of the percent who say they would invest in common stocks. The table below summarizes these findings.



Although each proposal elicits a significant favorable response, the proposal to reduce (or eliminate) double taxation of dividends draws the most favorable response, in terms of the percent of executives who say they would buy common stocks. This proposal also produces the highest hypothetical mean investment across the total executive sample (including both those who say they would invest, and those who say they would not), as shown below.



Executives have a rather mixed reaction to the idea of an annual exclusion for funds newly invested in corporate securities. While some say this is a highly desirable proposal, others are lukewarm to it.

One executive in four reports having made investments as a result of the changes in capital gains tax treatment brought about by the Revenue Act of 1978. And the largest proportion of these (15% of all executives) say they invested in common stocks.

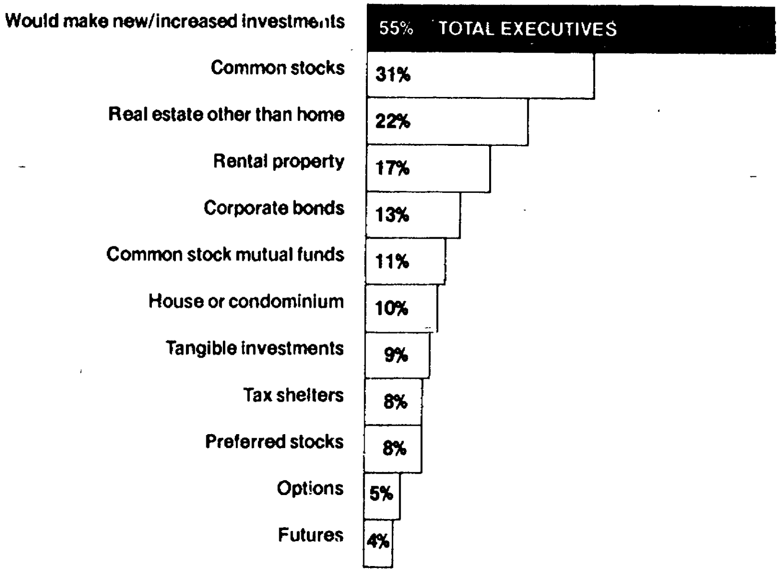
Moreover, about one executive in ten (9%) reports having **realized** capital gains during 1979, as a result of these changes in the capital gains tax law.

Detailed Findings

Reactions To Maximum Tax Of 50%

"If this proposal were enacted, would it cause you to make new investments, or increase existing investments in any of the items on this list?"

Maximum tax of 50% on all sources of income, including investment income. Current law taxes income other than wages and salaries up to a maximum rate of 70%.



About half of executives say they would make new investments or increase existing investments if the maximum tax on all sources of income were reduced to 50%.

Reacting to the maximum tax of 50%, a majority of executives (55%) say they would make new or increased investments if it were passed.

The three most frequently mentioned types of investment that would be made as a result of this proposal are common stock (31%), real estate other than a home (22%) and rental property (17%). However, each of the 11 investment vehicles is mentioned by at least a few executives.

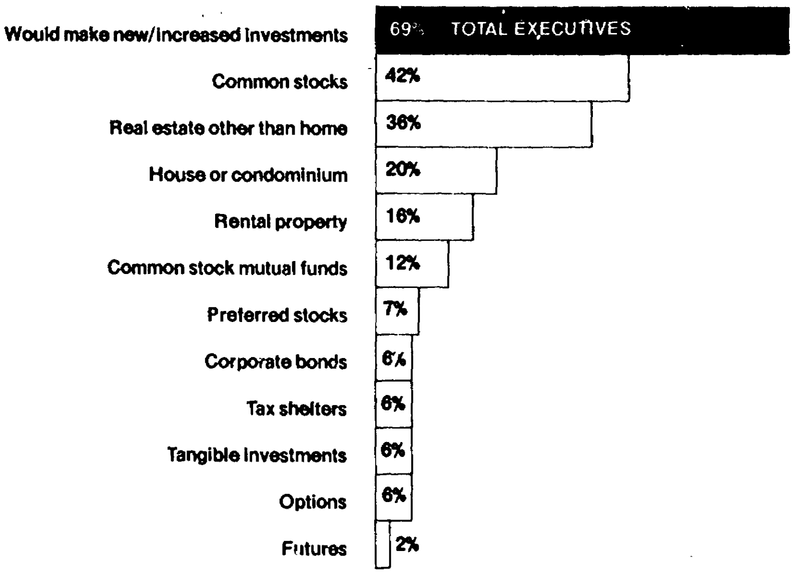
Page 11 shows data for all five proposals on the amount of money executives think they would invest in common stocks, for each of the five proposals.

A note on method: For each of the five tax proposals, respondents were shown a card (in random order) describing the proposal, and were asked whether, if the proposal were enacted, it would cause them to make new investments or increase existing investments in any of 11 investment vehicles shown on another card. Then, for each investment vehicle mentioned, respondents were asked how much they would invest.

Reactions To Deferral Of Capital Gains Tax

"If this proposal were enacted, would it cause you to make new investments, or increase existing investments in any of the items on this list?"

Deferral of tax on capital gains, if gains are reinvested within six months from when they are taken. A maximum of $100,000 in capital gains can be so deferred over the life of an individual—$200,000 in the case of a joint return.



Seven executives in ten say deferral of the capital gains tax would cause them to increase their investment activity.

Here, the four most often mentioned investment alternatives are common stocks (42%), real estate other than a home (36%), a house or condominium (20%), and rental property (16%).

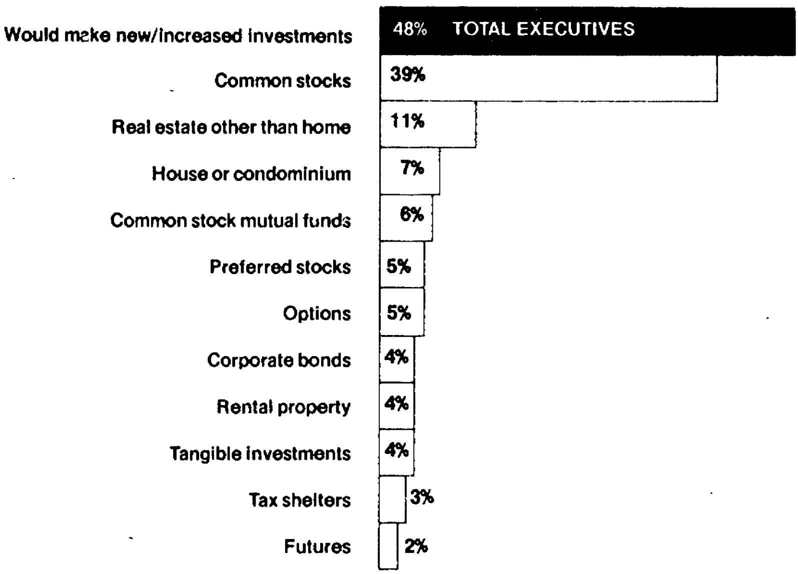
This proposal is the most attractive one to executives from the standpoint of stimulating investment in various types of real estate.

On this proposal, as on most of the others, executives who already own securities worth $25,000 or more are more likely to say they would invest in common stocks than are executives who own securities worth less than $25,000.

Reactions To Reduction Of Capital Gains Holding Period

"If this proposal were enacted, would it cause you to make new investments, or increase existing investments in any of the items on this list?"

Reduction of the capital gains holding period from one year to six months.



About half of the executives say they would be induced to invest by a reduction of the capital gains holding period to six months.

In terms of the percentage of executives who say they would make new or increased investments, 48% say they would take some action.

About four executives in ten (39%) say they would invest in common stocks.

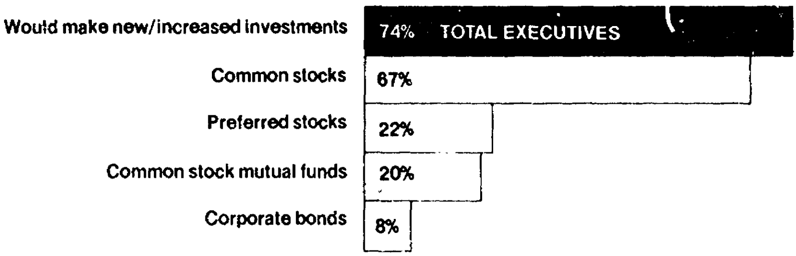
Not surprisingly, relatively few executives say this proposal would lead them to invest in assets that typically have a relatively long holding period, such as real estate, a home, rental property, or tax shelters.

At the same time, however, relatively few executives say they would invest in other vehicles which are not necessarily held for a long period, such as options or futures.

Reactions To Reduction Of Double Taxation Of Dividends

"If this proposal were enacted, would it cause you to make new investments, or increase existing investments in any of the items on this list?"

Reduction or elimination of double taxation of dividends by granting shareholders a partial credit for federal income taxes paid by the dividend-paying corporation.



Reduction or elimination of double taxation of dividends is very attractive to executives, from the standpoint of stimulating common stock investments.

About three-fourths of executives (74%) say they would step up their investments if double taxation were curtailed, and nearly all of these (67% of the total sample) say they would increase their investments in common stocks. This is the highest percentage for common stocks among the five proposals.

Some executives also say they would invest in preferred stocks (22%) or common stock mutual funds (20%), but these vehicles are clearly perceived as secondary to common stocks

Note that a small proportion of executives also mention corporate bonds Presumably, their reasoning is that the proposal, if passed would enhance the general market for all corporate securities, not just stocks

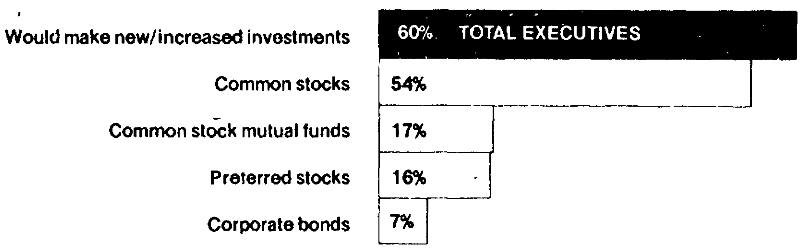
Other possible investments were not mentioned by the vast majority of respondents, who correctly perceived this proposal as enhancing the desirability of securities, but not other investments

The quite favorable response to this proposal is especially noteworthy in light of the fact that the concept statement was not explicit regarding how the credit for federal income taxes paid by the dividend-paying corporation would actually work.

Reactions To Increase In Dividend Exclusion

"If this proposal were enacted, would it cause you to make new investments, or increase existing investments in any of the items on this list?"

Increase in the dividend exclusion to $500 for individuals, and $1,000 for joint returns. The current exclusion is $100 and $200, respectively.



An increase in the dividend exclusion is also among the more attractive tax proposals for executives, from the standpoint of increasing their interest in common stocks.

In all, six executives in ten say an increase in the dividend exclusion to $500 for individuals and $1,000 for joint returns would cause them to make new or increased investments. Again, most of these (54% of the total sample) say they would invest in common stocks, though about one in six say they would invest in mutual funds and/or preferred stocks (Again, a few executives mention corporate bonds.)

As with the proposal dealing with reduction of double taxation of dividends, very few respondents mentioned other forms of investment, correctly perceiving this proposal as enhancing the desirability of securities, but not other investments.

Estimated Investments In Common Stock Under Each Proposal

	Maximum Tax of 50%	Deferral of Capital Gains Tax	Reduction of Capital Gains Holding Period	Reduction of Double Taxation of Dividends	Increase in Dividend Exclusion
Total percent who would invest in common stocks*	31%	42%	39%	67%	54%
Estimated investment during first year:					
Less than $5,000	8%	9%	10%	20%	20%
$5,000 - $9,999	8%	9%	11%	19%	16%
$10,000 - $24,999	8%	15%	9%	15%	11%
$25,000 - $49,999	3%	4%	4%	7%	3%
$50,000 - $99,999	2%	3%	3%	3%	1%
$100,000 - $499,999	1%	1%	1%	1%	†
$500,000 - $999,999	0%	0%	0%	†	0%
$1,000,000 or more	0%	0%	0%	0%	0%
Don't know/No opinion	2%	2%	1%	2%	2%
Mean investment **(Those who would**	$26,100	$25,100	$25,000	$19,100	$10,800
Median investment **invest only)**	$ 9,400	$12,500	$ 9,100	$ 8,300	$ 6,800

*Percentages below may not add to total percent who would invest in common stocks because of rounding
†Less than 0 5%

There is considerable variation in the amount executives say they would invest in common stocks, under the five proposals.

The table above summarizes executives' responses regarding how much money they would invest in common stocks during the first year after each proposal took effect (The dollar groupings shown in the table were also shown to respondents on a card)

In addition to showing the percent in each grouping who say they would invest in common stocks, the table shows the hypothetical mean and median investment, by those who say they would invest in common stocks #

In assessing the impact of each proposal two factors have to be taken into account:

1 The **proportion** who say they would invest in common stock

2 The **amount** those who would invest say they would invest

In terms of factor 1, reduction of double taxation of dividends is by far the most attractive to executives, in that 67% say they would invest in common stocks if this proposal were enacted However, in terms of mean investment (by those who say they would invest), the maximum tax of 50% produces the highest mean, though with the smallest percent response.

Combining factors 1 and 2 to produce a mean investment across the **total** executive sample, clarifies the picture On this basis, the proposals rank as follows:

Reduction of double taxation of dividends	$12,800
Deferral of capital gains tax	$10,500
Reduction of capital gains holding period	$ 9,800
Maximum tax of 50%	$ 8,100
Increase in dividend exclusion	$ 5,800

On this basis, there is a fairly clear-cut graduation in overall impact of the five proposals, with reduction of double taxation of dividends generating more than twice as many hypothetical investment dollars as the increase in dividend exclusion

#Calculation of the mean assumed that responses fell at the midpoint of each size grouping.

Reactions To Tax Proposals By Income Level

	Total Executives	Annual Income: Under $30,000	$30,000-$39,999	$40,000-$49,999	$50,000-$74,999	$75,000 and over
Maximum Tax of 50%						
Would make investments	55%	48%	50%	48%	55%	65%
Would invest in common stock	31%	17%	20%	24%	30%	48%
Mean stock investment (all execs.)	**$ 8,100**	**$ 2,000**	**$ 900**	**$ 2,700**	**$ 4,500**	**$23,000**
Mean stock investment (those who would invest only)	$26,100	$11,600	$ 4,800	$11,200	$15,000	$47,800
Deferral of Capital Gains Tax						
Would make investments	69%	71%	63%	65%	71%	74%
Would invest in common stock	42%	25%	34%	41%	42%	52%
Mean stock investment (all execs.)	**$10,500**	**$ 1,500**	**$ 3,200**	**$ 7,100**	**$10,300**	**$25,200**
Mean stock investment (those who would invest only)	$25,100	$ 6,100	$ 9,400	$17,300	$24,600	$48,400
Reduction of Capital Gains Holding Period						
Would make investments	48%	35%	49%	46%	50%	50%
Would invest in common stock	39%	19%	35%	36%	43%	44%
Mean stock investment (all execs.)	**$ 9,800**	**$ 1,300**	**$ 4,400**	**$ 3,900**	**$ 6,900**	**$16,700**
Mean stock investment (those who would invest only)	$25,000	$ 7,000	$12,500	$10,900	$16,000	$37,800
Reduction of Double Taxation of Dividends						
Would make investments	74%	75%	69%	73%	72%	77%
Would invest in common stock	67%	63%	58%	65%	67%	75%
Mean stock investment (all execs.)	**$12,800**	**$ 4,700**	**$ 4,900**	**$ 7,000**	**$13,100**	**$30,900**
Mean stock investment (those who would invest only)	$19,100	$ 7,400	$ 8,400	$10,800	$19,600	$41,200
Increase in Dividend Exclusion						
Would make investments	60%	67%	66%	71%	59%	48%
Would invest in common stock	54%	54%	52%	60%	56%	46%
Mean stock investment (all execs.)	**$ 5,800**	**$ 3,400**	**$ 3,200**	**$ 8,400**	**$ 7,000**	**$10,600**
Mean stock investment (those who would invest only)	$10,800	$ 6,300	$ 6,200	$14,000	$12,500	$23,000

Reaction to the five tax proposals varies considerably by executives' income level.

The table at left shows, for all executives and each of the five income levels by which the data were analyzed, the percent who say they would make new or increased investments if each of the five proposals were enacted, the percent who say they would invest in common stock, the hypothetical mean investment in common stock (among all executives in the particular income group, and among those who say they would invest in common stock)

As can be readily seen, the proportion of executives who say they would invest in common stock increases with income level in most cases, as do the hypothetical mean investments

Two exceptions to the above point are the proposals covering reduction of double taxation of dividends and increase in the dividend exclusion Responses to these two proposals—in terms of the percent who say they would invest in common stock—are relatively similar at all income levels (These latter two proposals also produce the most positive response among executives in the lowest income level [under $30,000] On the other hand, increase in the dividend exclusion evokes the lowest hypothetical mean investment among the highest income group [$75,000 and over] This is not surprising, since the increased exclusion in effect produced a "ceiling" on the amount of tax that would be saved)

Reactions To Tax Proposals By Value Of Securities Owned

	Total Executives	Value of Securities Owned: Under $25,000	$25,000-$99,999	$100,000 or more
Maximum Tax of 50%				
Would make investments	55%	46%	52%	69%
Would invest in common stock	31%	19%	31%	47%
Mean stock investment (all execs.)	**$ 8,100**	**$ 1,300**	**$ 4,200**	**$24,400**
Mean stock investment (those who would invest only)	$26,100	$ 7,000	$13,500	$52,000
Deferral of Capital Gains Tax				
Would make investments	69%	61%	72%	76%
Would invest in common stock	42%	31%	46%	51%
Mean stock investment (all execs.)	**$10,500**	**$ 2,600**	**$ 7,200**	**$28,400**
Mean stock investment (those who would invest only)	$25,100	$ 8,300	$15,700	$55,600
Reduction of Capital Gains Holding Period				
Would make investments	48%	42%	47%	56%
Would invest in common stock	39%	30%	38%	49%
Mean stock investment (all execs.)	**$ 9,800**	**$ 2,600**	**$ 5,400**	**$19,200**
Mean stock investment (those who would invest only)	$25,000	$ 8,700	$14,300	$39,200
Reduction of Double Taxation of Dividends				
Would make investments	74%	73%	74%	74%
Would invest in common stock	67%	62%	69%	70%
Mean stock investment (all execs.)	**$12,800**	**$ 3,300**	**$10,200**	**$31,300**
Mean stock investment (those who would invest only)	$19,100	$ 5,300	$14,800	$44,800
Increase in Dividend Exclusion				
Would make investments	60%	64%	62%	53%
Would invest in common stock	54%	55%	57%	49%
Mean stock investment (all execs.)	**$ 5,800**	**$ 4,400**	**$10,000**	**$11,700**
Mean stock investment (those who would invest only)	$10,800	$ 8,000	$17,500	$23,800

Reaction to the proposals also varies in relation to the value of securities executives already own.

Not surprisingly, the greater a respondent's current securities holdings, the more likely he is to anticipate investing in common stocks, and the larger the amount that is likely to be invested.

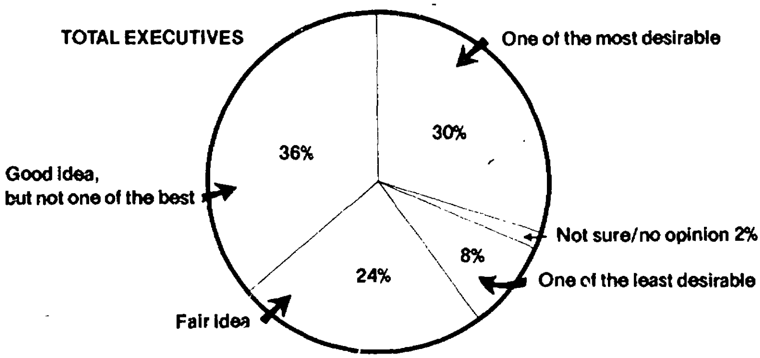
This relationship applies to the first three proposals shown in the table above; however, the two proposals relating to dividends again represent an exception. About the same proportion of executives at each level of securities ownership say they would invest in common stock in response to these two proposals. Also, unlike other proposals, the proposal to increase the dividend exclusion does not produce a markedly higher hypothetical mean investment by those executives with the largest securities holdings, for the reason cited on page 13.

Reaction To Annual Exclusion Of Up To $2,000 For Funds Newly Invested In Corporate Securities

"Now I'd like to get your reaction to one more possible change in the tax regulations."

Enactment of a provision under which funds newly invested in corporate securities could be excluded from taxable income, up to a maximum exclusion of $2,000 a year.

"Compared to the five other proposals you have just been looking at, and reacting in terms of **your own** financial situation, would you say this proposal is one of the most desirable to enact; a good idea, but not one of the best; a fair idea, or one of the least desirable."



Executives are quite divided in their reaction to an annual exclusion for funds newly invested in corporate securities.

After having reacted to each of the five proposals, executives were shown a card describing a sixth proposition—an annual exclusion for funds newly invested in corporate securities—and were asked how desirable they considered this new proposition, compared with those they had already reacted to

Three executives in ten say the proposition is "one of the most desirable" On the other hand, about three in ten say the proposition is only "a fair idea," or "one of the least desirable." The remainder fall into a middle ground, saying that it is "a good idea, but not one of the best."

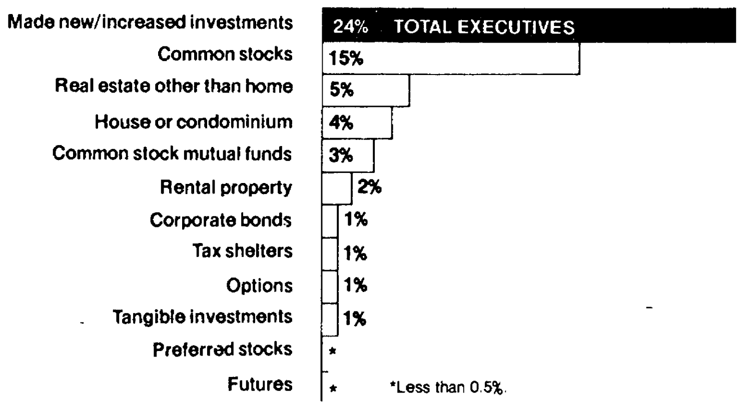
One might think that executives' reactions to this proposal might vary somewhat, based on their reactions to the other five proposals already discussed This is not the case, however For example, executives who say they would invest in common stocks if the dividend exclusion were raised are no more likely than executives generally to find this proposal desirable

There is also little variation in reactions to this proposal based on respondents' income, or the percent of their disposable income which is saved There is some variation by age, however. Forty percent of executives under age 40 say this proposal is one of the most desirable, compared with 25% of those age 50 and over.

Effect Of 1978 Changes In Capital Gains Tax Treatment

"As you may know, the Revenue Act of 1978 modified the tax treatment of capital gains in several ways. It increased the exclusion on capital gains subject to regular income tax from 50% to 60%. It also reduced the maximum effective rate on capital gains from nearly 50% to 28%.

As a result of the changes in the capital gains tax law, did you make new investments or increase existing investments in any of the items on this list **during the past year?** (If so, which ones?)"



About one executive in four reports making investments as a result of the changes in capital gains tax treatment brought about by the Revenue Act of 1978.

After they had reacted to the various tax proposals already discussed, executives were given a brief summary of the provisions of the Revenue Act of 1978, which modified the tax treatment of capital gains. They were then asked whether, **as a result** of changes in the law, they made any new or increased investments during the past year, in the same group of investment vehicles as used in assessing the previous tax proposals.

In all, about one-fourth of executives (24%) say they did make such investments as a result of changes in the tax laws. By far the largest proportion (15% of all executives) say they invested in common stocks.

The only other vehicles mentioned by more than one percent of executives are real estate other than a home (5%), a house or condominium (4%), common stock mutual funds (3%), and rental property (2%).

The mean new or additional investment by those who say they invested in common stocks is $18,000, while the median figure is $10,000.

Effect Of 1978 Changes In Capital Gains Tax Treatment

"During the last year, as a result of the changes in the capital gains tax law, did you realize any capital gains through selling investments of any kind that you would not have otherwise taken if no changes had been made in the law?"

	Total Executives	Total Value of Securities: Less than $25,000	$25,000-$99,999	$100,000 or more
Yes, realized gains because of changes in tax law	**9%**	**4%**	**7%**	**20%**
No, did not	90%	95%	92%	79%
Don't recall/no opinion	1%	1%	1%	1%

About one executive in ten says he realized capital gains during the last year as a result of the capital gains tax law.

As a follow-up to the question just reported, executives were asked whether they had realized capital gains through selling investments of any kind, again **as a result** of changes in the capital gains tax law.

In all, about one executive in ten (9%) claims to have done this.

Note in the table above that responses to this question are strongly influenced by the size of an executive's total portfolio of securities. While only 4% of those with securities worth $25,000 or less (a figure that is probably roughly similar to that of the average shareholder nationwide) realized capital gains as a result of changes in the tax law, one-fifth (20%) of those with portfolios worth $100,000 or more did so.

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Technical Appendix

Sample Design

Each Executive Caravan sample is drawn from a universe comprised of top and middle management people selected from the 500 largest manufacturing companies, and each of the 50 largest banks, utilities, transportation, merchandising, life insurance, and diversified financial companies.

Three main steps are involved in the selection of managers and executives for Executive Caravan interviews.

1. **Selection of companies.** Probability procedures are used to select companies where interviews will be conducted. The selection is stratified by size of company and by broad industry groupings

   In general, a company remains in the sample for two consecutive quarterly surveys, then drops out until its next turn for selection However, the replacement of companies in the sample is planned on a rotating basis, so that in any one Caravan survey half of the companies are carried over from the previous quarter, and half of the companies are newly selected for the sample.

2. **Selection of plants and other specific company locations.** Selection of specific company facilities is the second step in the selection of managers and executives. In general, each company in the sample is represented by its headquarters location and one or more additional locations.

   The selection of specific locations is planned within the framework of the Opinion Research Corporation National Probability Sample, which includes approximately 360 counties and all key industrial concentrations. (A detailed description of this sample is available on request.)

3. **Selection of specific managers and executives.** This selection is made from name lists furnished by selected companies to ORC sample specifications.

Cooperation of companies and their provision of name lists in accordance with carefully drawn sample specifications provide a breadth and depth of coverage not normally possible through conventional list sources.

Interviewing

In advance of the field interviewing phase of the study, a letter is mailed to each executive selected for the study. Specially trained interviewers contact executives for interview appointments at a mutually convenient time.

Definition of Top and Middle Management

"Top and middle management" includes:

(1) Corporate and divisional officers

(2) Executives, managers, and supervisory professional personnel above the level of first-line supervisors[1]

(3) Professional personnel who report directly to corporate or divisional officers

(4) Executives in staff functions (personnel, legal, etc.) who report directly to corporate or divisional officers

"Top and middle management" excludes

(1) First-line supervisors

(2) Nonsupervisory professional employees (engineers, chemists, lawyers, etc) who do **not** report directly to corporate or divisional officers

(3) Employees in staff functions (personnel, public relations, research, etc) who do **not** report directly to corporate or divisional officers

(4) All other employees not covered by items 1 through 4 above

[1]First-line supervisors are considered as those whose primary responsibility is to supervise directly the work of clerical and/or hourly production employees.

Sample Characteristics, October 1979 Executive Caravan Survey

The data in the table below present the characteristics of the Executive Caravan sample.

Age	
Under 40 years	25%
40 - 49	29%
50 years or over	46%
Education	
Less than college completed	16%
College completed	31%
Graduate work	53%
Geographic Region	
Northeast	37%
North Central	27%
South	24%
West	12%
Management Level	
Officers	35%
Nonofficers reporting to officers	40%
Managers reporting to nonofficers	25%
Job Function	
Finance/accounting/control	12%
Manufacturing or production	12%
Marketing	21%
General management	17%
Personnel	9%
Engineering/research and development	6%
All others	23%

Kind of Company	
Manufacturing	70%
Nonmanufacturing	30%
Length of Service	
Under 10 years with company	24%
10 - 19	32%
20 - 29	28%
30 years or over	16%
Income	
Under $30,000	10%
$30,000 - $39,999	16%
$40,000 - $49,999	20%
$50,000 - $74,999	29%
$75,000 or over	25%

Reliability Of Survey Percentages

Results of any sample are subject to sampling variations. The magnitude of the variation is affected by a number of factors, including the number of interviews and the level of the percentages expressing the results.

The table below shows the possible sampling variation that applies to percentage results reported from the total Executive Caravan sample of 516, and various smaller subgroups, as shown in the study's detailed tabulations. The chances are approximately 95 in 100 that an Executive Caravan survey result does not vary, plus or minus, by more than the indicated number of percentage points from the result that would be obtained if interviews had been conducted with all executives in the universe represented by the sample.

	Approximate Sampling Tolerances Applicable to Percentages At or Near These Levels†		
Size of Sample on Which Executive Caravan Survey Result Is Based	**10% or 90%**	**30% or 70%**	**50%**
Total Sample:			
516 interviews	3%	5%	5%
Subgroups:			
400 interviews	4%	6%	6%
300 interviews	4%	6%	7%
200 interviews	5%	8%	9%
100 interviews	7%	11%	12%

†Based on 95 chances in 100

For example, the table on page 9 shows that 74% of executives say they would make new or increased investments if double taxation of dividends were reduced or eliminated Because this figure is near 70%, the middle column of sampling tolerances is used as a guide. Based on the figures in the table, there is a 95% chance that if all top and middle managers in the "Fortune 800" companies had been interviewed, the results of this question would have fallen within a range of 69% to 79%; that is, within five points, plus or minus, of the specific result (74%) which was obtained in the survey (As the table also shows, the sampling tolerances are larger for relatively small subgroups among the total sample)

Sampling Tolerances When Comparing Two Samples

Tolerances are also involved in the comparison of results from different parts of any one Executive Caravan sample (and in the comparison of results between two different Executive Caravan samples) A difference, in other words, must be of at least a certain size to be considered statistically significant The table below is a guide to the sampling tolerances applicable to such comparisons

	Differences Required for Significance At or Near These Percentage Levels‡		
Approximate Size of Samples Compared	**10% or 90%**	**30% or 70%**	**50%**
500 and 500	5%	7%	8%
500 and 400	5%	8%	8%
400 and 400	5%	8%	9%
400 and 300	6%	9%	9%
300 and 300	6%	9%	10%
300 and 200	7%	10%	11%
200 and 200	7%	11%	12%
200 and 100	9%	14%	15%
100 and 100	10%	16%	17%

‡Based on 95 chances in 100

For example, 74% of all 516 executives say they would make new or increased investments if double taxation of dividends were reduced or eliminated, while 60% say they would do so if the dividend exclusion were increased (page 10). Based on the figures in the table, a difference of approximately seven percentage points is required for statistical significance, when two figures from a sample of 500 are compared, and where the figures being compared are in the neighborhood of 70% Since the difference between the two figures being compared is 14 percentage points, it can be concluded that the difference is a statistically significant one.

Quality Control Measures

Quality control measures are applied in every phase of the Executive Caravan survey.

Specialists in many fields are available for consultation with the Caravan Survey director in the development of the questionnaire

Interviewers are hired and trained, in person, to staff the probability sample, and their work is regularly checked for accuracy and validity

Questionnaires are prepared for data processing by experienced coders, under the supervision of the survey director

The processing of data is subject to rigorous internal checks designed to detect both machine and human error.

SUMMARY OF STATEMENT OF ARTHUR LEVITT, JR., ON BEHALF OF THE AMERICAN STOCK EXCHANGE AND THE AMERICAN BUSINESS CONFERENCE

1. Congress should enact a responsible, anti-inflationary tax reduction package this year. This tax cut should be targeted toward liberalizing and simplifying our depreciation laws; encouraging individuals to save and invest, particularly in small companies which have the greatest growth potential; and, compensating individuals for the impact of inflation.

2. A tax cut is necessary to reverse the long-term deterioration of our economy's productive capacity. Mid-range companies are our best source of doing this. They are in the forefront of creating new jobs and innovative technology.

3. Small and medium-sized businesses rely on individual investors as an important source of capital. We should remove the artificial roadblocks which discourage Americans from investing in equities. Based on the Exchange's experience with the 1978 capital gains tax reduction we recommend an additional reduction in these rates. We have observed several indicators of market strength which reflect that the 1978 capital gains tax reduction had a very positive effect on the ability of growth companies to raise capital and on bringing individual investors back to the market.

a. Since the 1978 tax reduction, the Amex Market Value Index has jumped more than 120 percent. And, in the first six months of this year, total trading volume on the Amex was up to 730.7 million shares, an increase of 67 percent over the total volume of shares traded in 1978.

b. In the first six months of this year, Amex listed companies issued equity raising nearly $300 million in new capital. These figures compare favorably with the first six months of 1980 during which only two Amex companies were able to bring equity offerings to the market.

c. Top executives at companies issuing new stock agreed with underwriters and retail brokers that the 1978 capital gains reduction was an important factor in strengthening the market which in turn made it feasible for mid-sized companies to raise capital.

4. We join the Securities Industry Association in recommending a reduction of the maximum tax on unearned income from 70 percent to 50 percent. We also commend to the Committee proposals from the White House Conference on Small Business to provide a credit for investment in new equity issues and a tax-free rollover for capital gains from small business investments.

TESTIMONY OF ARTHUR LEVITT, JR. ON BEHALF OF THE AMERICAN STOCK EXCHANGE AND THE AMERICAN BUSINESS CONFERENCE

Mr. Chairman and members of the Committee, my name is Arthur Levitt, Jr. I am here as Chairman of the American Stock Exchange, representing its listed companies, member firms, and individual investors, and also on behalf of the American Business Conference, a newly-organized coalition representing the interests of mid-sized growth companies.

This distinguished Committee has been asked by the Senate Democrats to fashion "a responsible, targeted, anti-inflationary tax cut to take effect in 1981", and report out such a tax bill no later than September 3, 1980.

An anti-inflationary tax package now

Mr. Chairman, the time for enacting tax legislation is now, not next year. I am sure the Senate can design a responsible anti-inflationary tax cut targeted at our economic problems. There is no reason to keep workers, investors, and business in the dark about a cut for many more months—probably until well into 1981, in view of the time involved in organizing the new Congress, holding hearings, and passing a bill. A tax cut enacted in 1980 and effective January 1, 1981 would be a downpayment on the kind of longer term restructuring needed to reduce the federal tax system's drag on economic growth and to reorient the system toward encouraging saving and investment. Without these fundamental changes in our tax system, our economy will be ill-equipped to provide the jobs, price stability, and real income growth required for the decade ahead

To be anti-inflationary, such a tax reduction package, perhaps in the range of $25 to $30 billion, should be targeted at three specific economic problems.

First, this Committee should act to modernize our outmoded depreciation laws. The growing obsolescence of America's plant and equipment is an alarming problem. Inflation has made fictional the notion that depreciation provides funds to replace plant and equipment. In my view, a complete overhaul of our depreciation system is urgently needed to begin restoring the nation's productive capacity. This goal has been endorsed by the Administration, a majority of the Congress, leading economists, and business groups representing all sectors of the U.S. economy, and it was one of the top recommendations of the White House Conference on Small Business. Thus, I urge the Committee to act on this consensus and include some form of faster and simpler depreciation in the tax bill you will report to the Senate.

Second, this Committee should act to encourage individuals to save and invest, particularly in small companies and in emerging industries where there is the greatest potential for growth. Again, there are several sound proposals before Congress to ameliorate the bias in our tax code against personal saving and investment. The one I believe would be most important is a further reduction in the capital gains tax.

Third, this Committee should act to abate the impact that the recent high rate of inflation has had on our progressive income tax. The result of this "bracket creep" has been disincentives for Americans to work, save, and invest. Therefore, I urge the Committee to enact tax cuts to reduce this increased tax burden on our productive middle class. Such carefully-fashioned tax reductions need not necessarily be inflationary.

Poor performance of U.S. economy

The direction which tax policy should take is clear from the long-term poor performance of the American economy, relative to its international trading partners. The facts are becoming all too familiar these days in discussions about the need to "reindustrialize" America:

Real economic growth in the U.S. slid to 2.9 percent per year in the 1970s from 4.1 percent per year in the previous decade.

While our productivity growth rate registered an advance in 1979 over 1978, it was eclipsed by all other major industrialized nations except Canada.

Our rate of savings as a percentage of disposable income fell last year to a low of 4.3 percent.

These trends must be reversed. We need to take a long term approach to rebuilding our productive capacity, and our first step must be to create an environment that recognizes economic growth as a fundamental priority.

The companies on whose behalf I am here today—the creative, innovative risk-taking smaller and mid-range companies—are our best source of economic growth. A recent study by David Birch at M.I.T. shows that smaller companies were the source of 86.7 percent of all new jobs between 1969 and 1976. And according to a National Science Foundation study, smaller companies produce far more innovations per research and development dollar than big business. The financing of these smaller companies is substantially drawn for individual investors and, therefore, they are dependent on the kind of economic climate which encourages risk-taking with a favorable reward ratio.

The American Stock Exchange's experience with the 1978 tax cut has led us to believe that a further capital gains tax cut could be the simplest, most effective step this Congress can take to encourage the kind of the investment we need.

Our perspective is drawn from the special role which our marketplace plays in the capital formation process. More than half of our trading is done by individual investors who provide a crucial source of capital for the 900 small and medium-sized companies whose securities are traded on the Amex.

Our companies are not household words, but among them are the Xeroxes and Polaroids of tomorrow. They are from every region of America. They include high technology firms, financial service and retail companies, producers of consumer and capital goods, miners, drillers and refiners of natural resources, and those in the housing, construction, and land development industries.

Impact of 1978 capital gains tax cut

Two years ago, Congress reduced the maximum capital gains tax for individuals from 49 percent to 28 percent, and the statutory corporate capital gains tax from 30 percent to 28 percent. There has been a great deal of debate about the effect of the tax cut on the stock market, and it is impossible to say with absolute certainty that the tax cut alone is responsible for what we have seen. However, I have come here today to tell you that we have observed several indicators of market strength which reflect that it had a very positive effect on the ability of growth companies to raise capital and on bringing individual investors back to the market: one far more marked and dramatic than its effect on the market as a whole.

1. In the first six months of 1978, 438.7 million shares changed hands on the Amex. Following the tax cut, in the first six months of 1979, our share volume increased 13 percent, to 496.3 million shares. In the first six months of this year, trading volume of shares traded on the Amex was 730.7 million, an increase of 67 percent over the same period in 1978.

2. Since November 1978, when the capital gains cut took effect, the Amex Market Value Index has jumped more than 120 percent, from 143.42 on November 1, 1978 to 316.66 last Thursday.

3. In the first six months of 1978, Amex listed companies brought only two equity offerings to the market raising some $36 million. By contrast, in the first six months of this year, 21 Amex listed companies had issued equity and raised nearly $300 million.

But the evidence as to the construction effect of the 1978 reduction is not solely in terms of statistics. We've talked to top executives of growth companies, investment bankers and stockbrokers to get their opinion on the effect of the 1978 cut.

The companies who have gone to the marketplace since 1978 believe the cut had a significant effect on the ability of smaller growth companies to raise new equity capital. Some examples are:

Universal Resources, headquartered in Texas, is an energy company, primarily engaged in exploring and producing crude oil and natural gas. In March, Universal issued 1,100,000 new shares of common stock for the purpose of retiring all of the company's floating rate debt. Charles Ponder, chief financial officer at Universal, says that prior to the 1978 capital gains tax cut, his company would have been unable to price its stock high enough to make an offering worthwhile. Universal believes the tax cut was an important factor in raising investor interest in securities in general, and that the better markets resulting from the tax cut (in addition to other legislation benefiting energy companies) meant they could price their shares at an acceptable level. Ponder added that another reduction in capital gains taxes would further improve the market.

Summit Energy Inc. is also engaged in exploration and development of oil and gas, principally in Louisiana, New Mexico, Oklahoma, Texas, and California. Four weeks ago, Summit issued 600,000 new shares of preferred stock, raising approximately $12 million for exploration and development. Jack Knox, Summit's CEO, attributes the success of that offering in part to the increasing enthusiasm in securities created by the 1978 Act. Knox noted, however, that the federal tax burden on capital gains is still substantially heavier than in other industrialized countries, and that some do not tax capital gains at all.

Adams-Russell, a high technology electronics company based in Waltham, Massachusetts, issued 400,000 shares of stock on June 20 of this year. Noting that the capital gains tax reduction made an important contribution to strengthening the market, President Jack Lynch said that "without that strength, there is no way we would have been able to do our offering." The new capital was used for construction of cable television (CATV) systems and for capital expenditures for its electronics products and telecommunications divisions.

Robert Van Tuyl, chief executive officer of Beverly Enterprises, said his company, which operates skilled and intermediate care nursing homes in seventeen states including Texas, California, Arkansas, Georgia, Florida and Michigan, had delayed issuing common stock because the market would not support a share price high enough for the company's needs. In May, Beverly Enterprises issued 1,100,000 shares of stock, bringing in over $10 million. The added capital went toward working capital, reducing Beverly's short term bank debt, acquiring a small company, and constructing additional facilities. Van Tuyl favors a further reduction in the capital gains tax.

We also spoke to several underwriters—the risk-takers who purchase an equity offering from the issuers and re-sell it to investors.

They observed that the 1978 reduction brought investors back to the securities markets, and that many who had been holding on to their investments to avoid taxation were willing to take their profits, thus unlocking additional sources of capital. They believe that the improvement in the risk-reward ratio led to an increase in market strength which enabled companies to price their stock higher and encouraged new stock offerings, and that further reductions in the capital gains tax would stimulate greater investor interest in the market and improve the availability of capital for growth companies.

Finally, we asked a number of retail brokers at our member firms, who agreed that the 1978 capital gains tax cut had had a beneficial effect on attracting investors back to the securities market and that a further reduction would augment this effect. Several noted that the more favorable rate had drawn some investors away from tax shelters and into equities.

And as others testifying before you have noted, the beneficial effect of the Revenue Act of 1978 on Amex companies has been observable in the investment market as a whole. New capital raised through initial public stock offerings totalled $506 million in 1979, more than three times the amount raised in 1977.

The value of total common stock offerings has also risen dramatically. Oppenheimer & Co. recently reported that the total value of common stock offerings for the first five months of 1980 was $3.9 billion, a record amount.

Further capital gains tax cuts

The 1978 capital gains cut was extremely successful in terms of encouraging investors to return to the market. I believe that a further reduction would unlock important sources of capital and stimulate growth.

Therefore, Mr. Chairman, I would like to now devote my remaining comments to one of the three proposals that I recommend be included in the anti-inflationary tax package you are fashioning. I urge this Committee to further reduce the capital gains tax from 28 percent to 21 percent for individuals and corporations. The maximum effective rate for individuals should be cut to 21 percent by increasing the income exclusion from 60 percent to 70 percent. The corporate gains tax should be reduced by changing the statutory corporate capital gains rate from 28 percent to 21 percent. Senator Cranston recently introduced a bill (S. 2923) which provides for this. I urge this Committee to include this reduction of the capital gains tax as part of the anti-inflationary tax package which will be reported to the U.S. Senate.

A brief history of this capital gains tax proposal and the role of the Finance Committee in shaping it are worthy of mention. In 1963 President John F. Kennedy recommended that the long-term capital gains exclusion be increased from 50 percent to 70 percent, resulting in a maximum individual capital gains tax of 21 percent. Congress then did not act on that recommendation and instead, in the tax reform acts of 1969 and 1976, substantially increased the maximum gains tax for individuals to almost 50 percent and for corporations to over 30 percent. Fifteen years later, on September 21, 1978, the Senate Finance Committee adopted the 1963 Kennedy 70 percent exclusion formula, reducing the individual maximum capital gains tax to 21 percent. It also cut the corporate capital gains tax to 28 percent. An attempt on the Senate floor to eliminate the Finance Committee capital gains tax cut failed by an overwhelming vote of 82 to 10. In the subsequent House/Senate Conference on the Revenue Act of 1978, Congress enacted a 60 percent exclusion for capital gains (a maximum capital gains tax of 28 percent for individuals) and also a corporate statutory capital gains tax of 28 percent.

The 1978 capital gains reduction has contributed to higher equity values, more venture capital, more equity capital for rapidly growing companies, and increased total stock offerings. A further reduction in the capital gains tax from 28 percent to 21 percent should have similar beneficial economic results.

Of course, in this period of federal budget restraint, one must responsibly confront the revenue implications of tax proposals including further reduction in the capital gains tax. I am sure this Committee agrees that we may look beyond traditional analyses. The immediate effect of a reduction does result in what is termed a "static" revenue loss. However, this reduction also encourages taxpayers to realize capital gains, with a concomitant revenue increase for the Treasury. It also encourages investors to provide funds for the start-up of new enterprises, and the tax revenues from them and their employees will be part of the so-called "feedback" to the Treasury.

Mr. Chairman, you, other members of the this Committee, and public witnesses including myself discussed these factors at your 1978 hearings, concluding that the "static" revenue loss might well be offset by revenue resulting from increased realization of gains and new small business activity.

I think we can conclude that this has happened. In 1978 the Joint Committee on Taxation projected that the capital gains realizations induced by the tax cut would increase revenues by $573 million in 1979 and $535 in 1980. Estimates from the Treasury itself now project a revenue increase more than 80 percent greater than the earlier estimate. In a February 28 letter to Representative James Jones (D.-Okla.), Assistant Secretary of the Treasury Donald C. Lubick stated that while no actual data is yet available, current Treasury projections of capital gains realization assume that "the 1978 law changes will increase realizations by about $8 billion in both 1979 and 1980, yielding approximately $900 million in additional income taxes in each of the two years".

In short, I urge this Committee to enact this kind of capital gains tax proposal for three reasons:

First, it is not complicated.

Second, it is nearly identical to a proposal which this Committee and the full Senate have previously approved in 1978.

Third, the 1978 capital gains tax cut has had beneficial effects on the economy and in particular on small companies, such as those listed on the Amex, where there is the greatest potential for job creation and technological breakthroughs, and where we can expect increased benefits.

In addition, I would like to join George Ball of the Securities Industry Association in suggesting that the Committee consider a reduction of the maximum tax on unearned income from 70 percent to 50 percent. Currently, a taxpayer in the highest bracket is discouraged from investing or saving, knowing that the Government will take 70 percent of the interest he would earn; and he is encouraged to spend more than he has, knowing that the government will pick up as much as 70 percent of his interest tab. This is an example of the spending bias of our tax code which must be corrected.

I would also like to take this opportunity to express support for several other tax proposals to encourage capital formation for small business which were selected as top priorities by the delegates to the White House Conference on Small Business. These include bills which would:

Create a credit against income tax for individuals who invest in new stock or debentures issues by small businesses. (The Amex has strongly supported this kind of targeted incentive, as embodied in S. 655, sponsored by Senators Weicker and Moynihan).

Create a tax-free rollover for an individual's gain from thes sale or exchange of small business stock if the proceeds from the sale are reinvested in other small business stock (as embodied in S. 653, sponsored by Senator Nelson).

CONCLUSION

There are no panaceas for our current problems, but I am convinced that this Committee can enact a well-balanced, anti-inflationary tax package which can move us toward the reindustrialized America we need. The American people are ready for the policies which will restore the climate for economic growth. We hope that the Congress will give us a clear signal now, not next year, that this country respects entrepreneurship and risk-taking and is ready to encourage the small and midrange companies which contribute so much to our economic well being.

Thank you.

Summary of Principal Points in Statement of the Investment Company Institute

To increase savings and investment, aid capital formation, provide retirement income and meet family needs for housing and education, the Congress should expand the existing Individual Retirement Account (IRA) system by—

Removing the present prohibition against use of IRAs by persons who are "active participants" in a qualified employer plan. This would greatly increase the availability of IRAs and remove the present discrimination against those who participate in employer plans but have small benefits, or who are not vested and will lose benefits if they switch jobs. Active participants could make contributions to their employer plans in lieu of contributions to IRAs.

Increase the deductible contributions to IRAs (now 15 percent of earned income with a maximum of $1,500) to 15 percent of earned income with maximum of $2,000; and allow nondeductible contributions up to $10,000 a year with a lifetime limit of $100,000. Increasing the maximum size of IRAs will reduce the expense ratio in the maintenance of the accounts and encourage their promotion and use. Nondeductible contributions are permitted in employer plans and Keogh plans and should also be permitted in IRAs.

Permit withdrawals from IRAs without the present 10 percent penalty tax (a) to purchase a first home or (b) to pay for higher education or vocational training of children. This would encourage use of IRAs because it would prevent a complete lock-in of the funds to age 59½ if they are ever required for these two prime family needs.

These changes, readily accomplished within the existing IRA structure, would greatly increase the use of IRAs. They would be neutral as between various forms of investment, would stimulate savings for retirement, housing and education and would significantly aid in capital formation.

Statement of the Investment Company Institute

My name is David Silver. I am President of the Investment Company Institute. I am accompanied by Edwin S. Cohen, of the law firm of Covington & Burling. Mr. Cohen has been outside tax counsel to the Institute for some forty years.

The Institute is the national association of the mutual fund industry. Its membership includes 544 open-end investment companies ("mutual funds"), their investment advisers and principal underwriters. The Institute's mutual fund members have assets of about $110 billion and have approximately 8.5 million shareholders. Thus, the average mutual fund shareholder account size is about $12,900.

Mutual funds provide an economical way by which an investor of modest means can obtain the same professional advice and diversification of investments as a wealthy individual or institution. A wealthy person can retain an investment adviser to select and manage his or her investments, and by investing in a number of different securities can achieve diversification of risk. Mutual funds are designed to permit thousands of investors to pool their resources as shareholders in a fund which in turn invests in a large number of stocks or debt instruments under the supervision of a professional investment adviser. The shareholders of the fund are the owners and are entitled to all of the fund's net income, which consists of the gross income generated by the fund's investments, less the fund's operating expenses such as investment advisory, custodial and accounting fees.

There are mutual funds designed for many different investment objectives: some funds invest in common stocks; some invest in bonds issued by corporations or the federal government; some invest in obligations of state and local governments; and some, known as money market funds, invest in short-term money market instruments such as certificates of deposit issued by banking institutions, commercial paper and United States Government obligations. All of the funds are regulated by the Securities and Exchange Commission under the Investment Company Act of 1940.

Mutual funds distribute their income, including capital gains as well as ordinary income, currently to their shareholders. In order to avoid placing a federal income tax burden on persons investing through mutual funds that would be heavier than the tax burden on persons who could afford to invest directly, the Internal Revenue Code for some forty years has treated mutual funds essentially as conduits. Known in the Code as "regulated investment companies," mutual funds are relieved of federal income tax at the company level if they meet various specified requirements, including prescribed diversification of their investments, provided they currently distribute all their income to their shareholders. Each mutual fund shareholder then reflects in his or her own return the income he or she receives from the fund. The government thus obtains essentially the same revenue as if the person invested directly in a pro rata portion of the mutual fund's investment portfolio.

The Institute strongly supports changes in the federal income tax laws to promote capital formation through increases in savings and investment. Personal savings by United States citizens as a percentage of disposable income fell in 1979 to a level of 4.5 percent, the lowest in some thirty years. Forecasts indicate no likelihood of increase in 1980 and 1981. Our savings rate is lower than that in other major countries, including Canada, West Germany, France and Japan.

Moreover, from 1970 through 1978 our productivity growth was less than that of any of our seven major trading partners except for Great Britain. Our productivity actually fell last year for only the second time since World War II. The decline in productivity is a major national problem.

To overcome the problems stemming from reduced productivity and savings, and to promote capital formation, expand job opportunities, and improve our ability to compete with other countries, we believe the federal tax law should be modified to provide further encouragement for individual savings. This can be accomplished in a way that would serve socially desirable and anti-inflationary purposes such as providing for retirement, housing and education.

To attain these objectives readily and simply, we believe it is desirable to build on existing programs rather than create new tax structures. For instance, these objectives could be reached with relative simplicity by using the existing Individual Retirement Account (IRA) system and eliminating the provision that prohibits its use by anyone who is an "active participant" in a qualified employer plan. This is the thrust of a bill of less than three printed pages introduced by Senator Bentsen (S. 557) and is one of the principal proposals advanced last week by Congressman Gibbons.

IRAs were introduced in ERISA in 1974 as a result of a Treasury proposal in 1971 to permit retirement savings by persons who either were not covered by employer-sponsored qualified plans or for whom the employer contributions were less than $1500. However, the difficulty of measuring the employer contribution by an employee in many plans led the Congress to make ineligible for IRAs all employees who are "active participants" in employer plans. This provision has created serious administrative complexities and has operated unfairly in many instances.

To promote savings and investment, aid capital formation and help to meet such family needs as housing, education and retirement, it would be desirable to make all persons with earned income eligible for IRAs even though they may be covered by qualified plans.[1] This would greatly expand eligibility and would be especially fair to lower and middle income groups. Often these groups are participants in plans which build on social security, with the result that the plans provide only modest amounts of retirement income. The proposal would also eliminate the present unfairness to workers whose pension rights are not fully "vested," and who may lose retirement benefits if they change jobs, yet are now ineligible for IRAs.

Currently deductible contributions to IRAs, are limited to the lesser of $1,500 or 15 percent of earned income. One of the major drawbacks to existing IRAs is that the $1,500 ceiling on annual contributions is too low. This low ceiling means that the necessary expenses of maintaining IRA accounts in a bank, insurance company or mutual fund is high in relation to the income on the $1,500 investment. Further, the small size of the account does not provide sufficient incentive to those who would advertise the availability of the accounts and promote their use. Finally, the tax advantages to the owner of such a small account are too limited to be a meaningful encouragement, particularly in light of the inflation that has incurred since 1974. Dollar limits for contributions and benefits under corporate plans are indexed under present law but those for self-employed plans and IRAs have been confined to their 1974 levels, although inflation has eaten into their value by some 40 percent. If the taxpayer could enlarge the size of the account by depositing larger deductible contributions, the expense ratio in the account would drop materially and sponsors of the account would be induced to promote their use. We therefore believe the $1,500 limit should be raised to $2,000.

Raising the deductible limits has been proposed in Chairman Ullman's Tax Restructuring Act of 1980 (H.R. 7015) and would accomplish much of the objective of Congressman Schulze's bill (H.R. 6300) that would allow a 10 percent tax credit for savings invested in stocks or securities. However, the increase in IRA deduction could be accomplished more simply and more quickly than by creating a new separate credit mechanism that would require extensive new rules or regulations.

In addition to the deductible contribution, a nondeductible contribution of $10,000 per year, subject to a lifetime maximum of $100,000, should be permitted. Nondeductible contributions are permitted to be made by employees to qualified pension and profit sharing plans and to plans for the self-employed. They should be permitted similarly for IRAs as a means of encouraging additional retirement savings and investment, and increasing the size of the IRA to absorb the costs of maintaining the account and encouraging their use. They would cost no revenues at the time of the contribution, though they would reduce revenue in future years when the tax on investment income in the account will be deferred until retirement years.

Withdrawal should be permitted from an IRA without penalty if the amounts are used either (a) to purchase a first home or (b) to pay for the post-high school education or vocational training of a child of the taxpayer. The IRA rules now prohibit withdrawal of any amounts prior to attaining age 59½, death or disability. Amounts withdrawn for other reasons are subject to a 10 percent withdrawal penalty tax. This is a severe penalty and undoubtedly has a discouraging effect upon savings of lower to middle income groups that are concerned about locking in the amounts until age 59½. Two principal concerns of those groups are the need for funds to purchase a first home and the financing of higher education for their children. Little or no revenue is obtained from the existing penalty and its removal in these two cases would greatly stimulate the use of IRAs without seriously affecting long-term retirement plans. Congressman Conable and Senator Dole have introduced legislation with a similar theme.

Amounts withdrawn, to the extent that they exceed nondeductible contributions made, would be includible in income, though without penalty tax—a factor which encourages retention of funds in the final account until retirement age without making withdrawal for purchase of a home or higher education prohibitively expensive.

A tax cut fashioned as we have described would not be inflationary. By stimulating IRAs, taxpayers would be encouraged to save; once in the IRA the funds would be invested rather than spent. Thus, there would be more money saved for capital formation, housing, education and retirement and less spent for consumption. We strongly urge that our nation's tax structure begin to encourage saving and investing for greater future income over the use of discretionary income for immediate consumption.

In sum, we submit that the existing IRA structure should be expanded by—

[1] If the employee prefers, and if the employer's plan allows or mandates, he should be permitted to place his deductible contribution in his employer's plan rather than his own IRA.

Removing the present prohibition aginst use of IRAs by persons who are "active participants" in a qualified employer plan, and permitting those persons to make the contributions to their employer plan rather than to an IRA if they so desire.

Increasing the limit on deductible contributions to IRAs (now 15 percent of earned income with a maximum of $1,500) to 15 percent of earned income with a maximum of $2,000.

Permitting nondeductible contributions to IRAs up to $10,000 a year with a lifetime ceiling of $100,000.

Permitting withdrawals from IRAs without the present 10 percent penalty tax (a) to purchase a first home or (b) to pay for higher education or vocational training of children.

We believe these proposals have major advantages in the cause of capital formation and the promotion of savings and investment because—

They utilize the existing IRA structure without requiring a new type of account with new rules and regulations to be promulgated. They merely eliminate or modify existing IRA provisions that have caused administrative complexities, significantly reduced the number of eligible users and caused the necessary expense of promoting and maintaining the accounts to be high in relation to their permitted size.

They will be neutral as between various applications of IRA funds—common stocks, preferred stocks, various types of debt instruments, government obligations, bank deposits, insured annuities, etc.

For employees who are active participants in employer plans, they will be neutral as between the employee choosing to make his contribution to the employer's plan or to his own IRA.

They will permit some withdrawal without tax penalty, though subject to usual income tax, of funds thay may be needed for prime family needs for purchasing a first home or higher education of vocational training of children.

As in the case of present IRAs, they will permit accumulation of investment income, including roll-over of capital gains, on funds in the account, but only cash can be contributed to the account and there will be reasonable ceilings on the amounts of those contributions.

We believe that this program combines in a single package the benefits of many separate proposals that have been pending in numerous bills, and that it would be of major advantage to the economy of the nation.

We would be happy to answer any questions or submit any further details the Committee may deem appropriate.

The CHAIRMAN. Mr. F. Jack Kemp, the sponsor of one of the principal tax reduction proposals, arrived in the room during the testimony of the panel. We will be pleased to hear from Mr. Kemp at this point, under the same 10-minute limitation that the rest have had.

We have a group of very prestigious witnesses today, Mr. Kemp, but you are one of the most prestigious.

Mr. KEMP. I appreciate that kind of praise from Caesar, Mr. Chairman.

STATEMENT OF HON. JACK KEMP, U.S. REPRESENTATIVE, STATE OF NEW YORK

Mr. KEMP. I want to start off by agreeing with Lawrence Klein, Mr. Chairman. All tax cuts are not created equally, and a tax reform along the lines that was discussed by the previous panel is designed to encourage the type of economic growth in real terms that would be anti-inflationary. I think that is the point to which Lawrence Klein was alluding.

Another thing that is not created equally, Mr. Chairman, is deficits. All deficits are not created equally. President Kennedy in 1963 said there are two kinds of deficits. There is a deficit that is caused by inertia in the economy, and there is a deficit that is caused over the short term by an investment in the future of the economy's ability to produce, grow, invest and save. He was suggesting that the latter approach by definition would be good for America.

At the Economic Club of New York in 1963, President Kennedy said, "Our true choice is not between tax reduction, on the one hand, and the avoidance of large Federal deficits on the other." He said, "It is increasingly clear that no matter what party is in power, so long as national security needs keep rising, an economy hampered by restrictive tax rates will never produce enough revenue to balance the budget."

Mr. Chairman, our national security needs are so great. And our economy is so hampered by restrictively high tax rates on capital and on labor, which are discouraging the ability of this Nation to growth and produce its way out of inflation, that it seems to me to require a tax cut as never before.

I would like to submit for the record my testimony, maybe pick up some of the highlights, and then answer some of the questions the committee members might have.

I appreciate the attention that you, Mr. Chairman, and this committee, particularly Senator Dole on my side of the aisle, are focusing on tax policy as it relates to economic growth.

President Carter recently said that he will not consider any reduction in taxes until he is convinced that the 1981 budget is balanced. And Treasury Secretary Miller has told this committee and the House Ways and Means Committee that the President does not believe Congress is competent, necessarily, to grapple with an important issue like tax-rate reduction in a national election year. Apparently Members of Congress are likely to be swayed by the opinions of constituents, the American people.

But I would like to point out that there is nothing new, there is nothing sudden about this effort. Yourself, Mr. Chairman, Senator Dole, and others, including Senator Roth and I, have been advocating some form of tax-rate reduction on labor and capital for 4 years or more. As far as I can see, cool heads are prevailing almost everywhere in this election year, except the White House.

In recent days, Vice President Mondale had some alarming news for the American people on the subject of taxation. He said that according to Treasury Department estimates, a 30-percent cut over 3 years in the personal income tax rates of the kind that Senator Roth and I propose would cost more than $280 billion.

I have not told you the really alarming news yet. According to the President's midyear economic review of last week, total personal income taxes will amount to $178 billion in 1981. So if Mr. Mondale predicts that in 1985 $280 billion is only 30 percent of the total income taxes, then he and Mr. Carter must have some plans that they are not telling us about to more than triple the Federal income taxes on the American people in the next 4 years.

I think that he has his numbers wrong, or at least I hope so. But the President has unwittingly put his finger on the central fact of taxation in this country, one to which you and Mr. Dole alluded. Taxes are going up, automatically and drastically, and something needs to be done to put incentives back into the economy for the producing men and women of this country.

I am trying to make the case, Mr. Chairman, that the income tax in and of itself is a tax on production. It is a tax on labor, and it is a tax on capital. And the collision of inflation an steeply graduated income tax systems is the central economic problem faced by the Western nations in the late 1970's and 1980's.

Inflation is a decline in the value of the currency, a cheapening of the currency, if you will, and when a cheapening dollar collides with our steeply progressive tax code it steadily pushes labor and capital into brackets that were never meant for either labor or capital.

The disincentive effect is alarming. I can show empirically that the steelworker or factory worker constituency that I represent in New York—has literally been working for the last 10 years for a declining share of real income.

In the last 4 years, it is impirically proven that the after-tax disposable income of the average American has literally gone down by 10 percent. As I say, this decline is caused by inflation colliding with our steeply graduated tax system.

According to the President's economic review, Federal taxes of all kinds, as high as they are today, will more than double once again between now and 1985. But the President's report contains an even more startling admission. Despite the largest 1-year tax increase in our Nation's history, the Administration has failed to balance the budget.

Thus the point is the same as it was in the early 1960's you cannot balance the budget when the tax system is discouraging the type of economic growth that ultimately produces the prosperity and the tax revenues that are needed to balance the budget.

Throughout the 1980 and 1981 budget process, many of us tried to warn the Administration of this fact, which our country learned at such great cost in the 1969 recession as well as the 1974 recession. We must remember that tax increases which cause recessions lead to larger and not smaller deficits.

The case that we are making today, Mr. Chairman, is that the tax system in and of itself is helping to increase the deficit, because it is leading to the inertia in the economy that is so rapidly causing unemployment to go up, and the output of steel, housing, farm income, automobiles, and other capital intensive industries to fall, that there is no way that you can balance the budget in the current climate.

According to the Congressional Budget Office, each 1 percentage point increase in the unemployment rate widens the deficit by $25 to $29 billion. This means that there is going to be an even bigger deficit because in the second quarter of 1980 Mr. Chairman, as you know, the GNP in real terms dropped at a rate of 9.1 percent.

And a 9.1 percent drop in the real GNP in the second quarter of 1980 will lead to an unemployment rate of at least 9.5 or 10 percent according to Alan Greenspan, and other economists. This means that this other 1.5 percent unemployment increase is going to expand the 1981 deficit by another $35 billion. There is no way, as I have said, and it is redundant but nonetheless necessary to point out, that you can balance the budget in a declining economy.

Mr. Miller said, "Those who favor across-the-board tax reduction to stimulate the economy should ponder the implications in terms of inflation." The irony, Mr. Chairman, is that the very Secretary who made that statement was former Chairman of the Federal

Reserve at a time when the inflation rate was tripling in America. Only the Federal Reserve can cheapen the currency by printing too many cf them.

It is the purpose of fiscal policy, on the other hand, to stimulate the production of goods and services and not once in the past 15 years of steadily increasing inflation have the marginal income tax rates of all Americans been cut. And the across-the-board tax increases of this Administration have failed to strengthen either our economy, our currency, or the finances of the Federal Government.

It is time to end this circular process of rising tax rates, economic decline, widening deficits, and further tax increases.

Mr. Chairman, the United States Tax Code is substantially the same today as it was in the mid-60's, as I pointed out earlier. In the early 1960's we had high capital investment, high rates of savings, full employment, and virtually no inflation, as long as the dollar was pegged to something of value, i.e., in this instance gold.

There is one major difference. Since 1966, we have had a progressively more inflationary monetary policy, and since our tax code is not adjusted for inflation the result has been to raise marginal tax rates on every taxable form of individual and corporation productivity and savings.

For 15 years, individuals have been pushed relentlessly into higher tax brackets, regardless of their earnings.

It is not just the middle-income taxpayer that needs relief. It is the poor. It is the middle. It is all levels of income . We need to put incentive and reward back into the economy for those men and women who are the productive backbone of a growing, fully employed economy without inflation. I would suggest that the time to act is now.

I apologize for putting a footnote on this. But I have added some econometric projections from Data Resources, Inc., Evans Econometrics, as well as Chase Econometric, for the committee's deliberations.

The CHAIRMAN. We operate on the early bird rule here. Mr. Dole was first.

Senator DOLE. I don't have any questions. I just want to commend my friend from New York, Jack Kemp. I note that throughout your statement you indicate your proposal as Kemp-Roth. On this side, it is referred to as Roth-Kemp. But I think that Senator Roth understands.

The point is that it has been a successful effort by Jack Kemp and Bill Roth. I do believe that there was an indication, as the distinguished Senator from New York indicated in the New York Times recently, that the Republicans are having some good ideas these days.

Senator MOYNIHAN. Mr. Chairman, a moderate correction. I said the Republicans are having some ideas these days. [Laughter.]

Senator DOLE. But you went on to indicate that that was an improvement.

Senator MOYNIHAN. Yes.

Senator DOLE. I think that Jack Kemp has been an example of solid ideas that have taken hold. I certainly agree with your statement. I would suggest, at least on this side, Jack, we can probably make some progress. The chairman, in my view, is convinced, as are most of the members of the committee, that we ought to do something this year to take effect next year. We will be looking for your help the House side, and with the administration.

You indicated that the administration is a little off on the dollar amounts. If they are that far off on their delegate counts, there may be a new administration. [Laughter.]

The CHAIRMAN. Mr. Baucus.

Senator BAUCUS. Good to see you, Jack.

Mr. KEMP. Thank you, Max.

Senator BAUCUS. One question I have is this—I certainly understand your argument, and I think that there is a lot to be said for it.

I sent out a questionnaire at home, and I am sure you have heard this from other Members of the Senate and the House who had sent out questionnaires to their constituencies. The answers come, at least in my poll, very definitely and very clearly that the majority do not want a tax cut this year if it means that we cannot balance the budget.

In your view, does this mean that the public is uninformed, or does that reflect some wiser knowledge that they have and that we don't have. I was just curious as to what your view on that is.

Mr. KEMP. It is an interesting question. I don't know how your question was worded, and I would appreciate knowing.

Senator BAUCUS. I asked a series of about 15 questions. I took the budget and all the function categories. I asked whether Montanans wanted an increase in spending in each of the categories or not. As you might guess, in every category most Montanans did not want an increase in funding, two exceptions were defense and energy.

I asked another specific question, and that specific question was. "Do you favor a tax cut this year if that means that we cannot balance the budget?"

Mr. KEMP. Isn't that, then, the answer to the question? Your question builds in a bias against tax cuts because what you say is, if we cut taxes and it leads to an unbalanced budget or more inflation, do you want it? Of course not. People want an end to inflation. They want an end to runaway prices. They want an end to the decline of our economy.

I would have asked: Do you think taxes should go up in 1981, or go down in 1981? Do you want this economy to grow and produce its way out of inflation, or do you want to let the inertia continue.

The question was biased, it seems to me, and if I asked the steelworkers in my district whether they want their tax rates lowered or raised, whether they want them indexed, I can assure you——

Senator BAUCUS. I don't think that people focus precisely on the wording of question. I think they give pretty much a gut feeling reaction to the words that they see.

Mr. KEMP. But you do admit that there is a bias in the question?

Senator BAUCUS. Let me ask the question a little differently. I think that most people probably are nervous about a tax cut. They are not too sure whether a cut weighted toward savings, investment, productivity, how that might vary from a cut that just increases consumption, that is an across-the-board income tax cut.

They are probably a little bit nervous about the argument that a tax cut this year may not balance the budget this year, but will next year, or in succeeding years, is the thrust of your argument.

Are you saying that the word really has not gotten out enough yet for people to fully understand it, or what are you saying?

Mr. KEMP. I think that if you put it to a national referendum, "Do you think that the tax rates of the American people should be reduced, phased in over 3 or 4 years by 20 percent or 30 percent," and you gave them a choice, where they did not have politicians standing in the way of something happening, the response would be positive on the reduction of tax rates.

The problem is that they have been misled for so long. People in this country have had to vote with their fingers crossed for so long. They did not know what they were getting because both parties promised lower taxes, and neither party, frankly, lowered taxes in the last 15 years, as I pointed out in my testimony.

I am not trying to find fault with either party, or other people. I am just convinced that the people don't trust the political class to do what it says it would do, and it takes a referendum or initiative like proposition 13, or whatever, to sometimes get it done.

I hope that there is a referendum on this issue in 1980, and it seems to me that there is going to be, to a certain extent, if Dole, Roth, Kemp, and others, have anything to say about it.

I don't mean to be pugnacious about it, but I do think that the American people have been misled, and if you ask a question, "Would you want a tax cut if it led to a bigger deficit," I think I would answer the question in the same way, "no." But I would take a tax cut that led to a smaller deficit, and that is the point that we are trying to make.

If the taxes are cut in the right way, we can have a smaller deficit instead of a bigger deficit. We can have growth in the private sector as opposed to growth in the public section. I think that the people want growth in the private sector of our economy.

Senator BAUCUS. Obviously, it is a question that has to be asked and answered very seriously. At first blush, a tax cut to most people seems like less revenue, and therefore more difficult to balance the budget. So I just suggest that throughout our discussion we keep that in mind.

Mr. KEMP. I would like to introduce for the record, if the chairman would allow it, an article from the San Juan, Puerto Rico, Star of May 25, the Business Outlook section, headlined, "Revenue Increase Bolsters Ramiro Tax Cut Policy." The Ramiro that they are they are referring to is Carlos Ramiro, the Governor of Puerto Rico, who since 1977 has been steadily reducing the marginal income tax rates of all the people of Puerto Rico by now 15 percent.

The lead says that income tax collections are running 13.5 percent ahead of the point in time in which there were higher tax rates on individual income. Not only that, but Ramiro says that there are now 150,000 new taxpayers.

He says that there is a shrinking of the subterranean economy because people are coming out of the barter and cash economy, and coming back into the money economy as they perceive that the tax system is more fair.

I think that you will find that as you make the tax system more fair, as people perceive it as being more equitable, the subterranean activity going on in America today (that Prof. Peter Gutmann at Baruch College in New York says is up to $250 billion) will start to shrink. People will pay taxes if they perceive them to be fair, and they will not evade and avoid as much as they do today.

May I have this article inserted in the record, Mr. Chairman?

The CHAIRMAN. Yes, sir, it will be included in the record.

[The following was subsequently supplied for the record:]

Business Outlook

Sunday, May 25, 1980

Revenue increase bolsters Romero tax-cut policy

By JOHN SIMON
Of The STAR Staff

Gov Romero, buoyed by reports that income tax collections are running 13.5 percent ahead of the 1979 rate, admits that he is now a confirmed disciple of Arthur B. Laffer, the economist who has gained nationwide prominence by advocating that government revenues can be increased by cutting tax rates

Romero, in a lengthy interview at La Fortaleza last week, conceded that there is evidence to support Laffer's theory in the most recent Treasury report.

Ricardo Muñiz, assistant secretary of Treasury for internal revenue, said income tax collections as of April 30 were $654.5 million, a 13.5 percent increase over the $576.4 million in the till on that date in 1979

Muñiz noted that the increase was achieved despite the 5 percent lower tax rate and tollgate tax collections that were lagging behind 1979— $36 million vs $33 million

While Muñiz said flat out that the figures prove you can reduce taxes and increase revenues, Romero was a bit more cautious

Tax cut chronology

1977	5 percent	eliminated "vampirita" of 1975
1978	5 percent	eliminated World War II Victory Tax
1979	5 percent	flat reduction but withholding tables remained unchanged.
1980	5 percent	flat reduction with new withholding tables issued to reflect 1979-80 cuts.
1981	5 percent	flat reduction approved two weeks ago.
1982	5 percent	flat reduction approved two weeks ago.

"It is extremely difficult to say it is all due to the tax cuts," the governor said. "but the things Laffer told us would happen are happening. In fact, he guaranteed it would happen."

Romero adopted the Laffer concept early on in his administration, first eliminating the notorious "la vampirita" 5 percent tax that was imposed during the Hernandez Colon administration. That tax, incidentally, was levied on the counsel of James Tobin, a Yale economist who headed a group commissioned by Hernandez Colon in 1974 to analyze the island's economic ailments and prescribe remedies.

Romero then followed with the elimination of the 5 percent surcharge (World War II victory tax) in 1978 and a straight 5 percent reduction in 1979. He has approved another 15 percent slash in three increments of 5 percent this year, 1981 and 1982

"I'm sold that the (Laffer) theory is correct," the governor said "He wanted me to take a much bigger step initially but I couldn't. I felt I was charged with the responsibility of balancing the budget and I couldn't gamble on a 15 percent cut in one chunk. I said if it is going to show results with 15 percent it will show results with 5 percent "

Laffer, incidentally is due in San Juan this weekend and is scheduled to have lunch with Romero and his top economic aides at La Fortaleza Monday, an informed source said

The Laffer Curve

Laffer is a 38-year-old professor of business and finance at the University of California. His theory on taxation, in simplistic terms, is that there are two tax rates that produce zero revenue zero percent and 100 percent Between those extremes is a range which he expresses in a curve As tax rates move toward the high side of the curve, revenues decrease after reaching a certain level under lower rates

Laffer's philosophy, which author Jude Wannisk says reflects that of the 19th century French economist Jean-Baptiste Say, argues that the supply of goods creates a demand for goods and that supply can be increased by removing government impediments to commerce and industry, i e taxes

That notion, of course is the opposite of the one that has dominated Western economics for 40 years, demand creates supply and demand can be increased by raising consumer purchasing power through deficit financing or money creation.

Another factor that contributes to higher revenues when tax rates are lowered is what Government Development Bank President Julio Pietrantoni calls the honesty factor. "Tax payers are honest up to a point," he said. "But once the rates go higher than they feel is fair, they are going to take steps to avoid payment "

Pietrantoni, also a Laffer advocate, said he had been told by Treasury Secretary Julio Cesar Perez that there are 100,000 more taxpayers on the books this year than last.

Since that many jobs were not added to the economy, he noted, the explanation must be better enforcement and a decline in the number of taxpayers who have been rebelling against the high rates.

Joint returns may go

In other tax areas, Romero said he is definitely studying the possibility of eliminating the joint return for husband and wife requirement and also lowering the levies on estates and gifts.

"We are giving the estate and gift taxes very careful study because it can be a definite incentive to attract wealthy persons in retirement and discourage our people from making heavy investments outside Puerto Rico," he said. "I know a lot of people over the years have been moving their money to Florida so if lowering the rates here will produce revenues and stimulate the economy. I'm all for it."

On the underground economy, the governor emphatically declared there would be no tax amnesty under his administration, as was offered in previous Popular Democratic Party reigns.

"The basic thing such a tax amnesty does is it keeps people hoping there will be another one. The minute they feel that way they'll say, 'I'll wait for the next one I don't have to pay now'

"Tax amnesties that don't include requirement that all penalties and interest be paid reward those who don't pay but penalize the honest taxpayer who has to carry the burden

"The way to get that money into the economy is to increase our efforts to find the violators,' he said

Construction jobs rise

Romero and his economic advisers chalked up another victory in April when employment in the construction industry soared to 15,000 jobs, the highest level in that industry since the 1973-74 recession.

"In early 1979 I met with my economic advisors to analyze the recession that was being predicted,' he recalled "We came to the conclusion that there was nothing we could do about inflation since 80 percent of all the food and goods we consume are imported

"So we concentrated on trying to alleviate the impact of the recession We decided that it would hit in late 1979 or early 1980 so we devised a plan to counteract it

The governor said the group outlined all the capital improvement projects that were on the books and then postponed a number of them so that they would be under way within the current fiscal year, particularly at the end of 1979 and the beginning of 1980

"By doing that," he said, "we felt we could create jobs in the construction industry, if not in the housing industry. It has apparently worked, he added as he cited the April job total in the industry

Recession-proof is criterion

"We are also concentrating our efforts in industrial promotion on those industries that are recession—proof such as pharmaceuticals, electronics, chemicals and medical and scientific instrument making "

Romero ticked off Hewlett-Packard—opening a computer manufacturing plant in Aguadilla this year—and major expansions at Digital and Wang Laboratories

Romero, still fresh at the end of a long day at La Fortaleza, warmed to the subject of bright signs for the future even as dinner was getting cold in the family quarters

"We are making ground in bringing up agriculture," he noted "Since 1977, when we began the diversification program we have seen an increase in the number of jobs in that industry for the first time in 20 years

Romero's diversification program involves taking acreage out of sugar cane and dedicating it to general crops and produce

"My target is to reduce sugar planting to 7,000 acres which will yield about 200,000 tons, enough to cover our domestic needs At that volume, we should be able to bring our sugar mills to higher efficiency and show a profit on sugar production "

Telco, Navieras Off block

The governor put to rest once and for all his original intention to unload the telephone company and the maritime fleet that had been purchased by the government under Hernandez Colon

"Yes, I have had a change of heart and it has to be a permanent change of heart because you cannot have efficient administration of agencies like that without giving them a sense of permanence

"I thought it was a bad thing for Puerto Rico to get into and they were bad purchases because we definitely paid more than they worth at the time," he said. "It was precisely because of that that we could not sell them at a price that was reasonable or could be publicly defended We tried to sell them but the offers were completely unsatisfactory "We then made the decision that we would make the best of it and since we made that decision the telephone company has improved tremendously, so much so that it is now able to finance most of its capital improvement projects out of revenues it earns," Romero said. "So when we do have to sell bonds, the buyers will find them attractive "

The governor said Navieras' problems have been resolved largely by refinancing its long term debt so that it is not burdened by heavy debt retirement payments

"The original payment schedule on promissory notes and carrying charges allowed Navieras little surplus for working capital and it is difficult to operate that way

"Navieras profit expected

He revealed that Navieras will go into the black when the current year's final figures are in

Fiscally, the island is in greatly improved condition over past years, Romero said

"Our long-term debt when I took office was $1 445 billion and that has been reduced to $1 352 billion (against a gross national $322 million of $6 4 billion) and our short-term debt that was $322 million will be completely erased by July 1

"My policy has been to see that the our long-term debt increases at a lower rate than the GNP increase r "This has happened in each of the past three fiscal years and will continue when this year ends June 30 "

Turning to tourism, the governor conceded that it is an important industry but it doesn't rank with manufacturing agriculture or construction on his list of priorities

Cites Miami Experience

"For one thing, tourism is not recession proof," he noted "We have to be careful that it develops in a steady fashion so that what happened to Miami will never happen here When all those hotels and other facilities deteriorated and went to pieces it caused a tremendous increase in unemployment

"We have the things that attract the middle class family rather that the jet set who are very fickle We have the sun, the beaches, our people, our music and these are the things that tourists come to enjoy

"On the slot machines, I notice that the hotels that don't have them show no significant differences in occupancy from those that do," he said as he turned to the day's "burning controversy "

The governor declined to go along with Sen Nicolas Nogueras' characterization of slot machines as immoral but he made it clear that he dislikes them by any definition

"I'm not a gambler but from what I have seen of casinos without slot machines they seem more sociable," he said "Players are socializing, talking with each other, the dealer or the spectators But with a slot machine you are not speaking to anybody, just playing a machine that is programmed to win so many times and lose so many times I think that is demeaning "

Mafia connection feared

Romero also expressed concerned about the genesis of slot machines which are widely believed to be linked from the manufacturing end on down to Mafia interests

"Why allow that element to get a foot in the door? They start coming down to look after their interests and then they gradually expand into other busineses until you have let them all the way in the door "

The CHAIRMAN. Senator Moynihan?

Senator MOYNIHAN. Mr. Chairman, as you suggest, we have a great many witnesses today, and we want to give them all an opportunity to be heard.

I would like to thank my fellow New Yorker for his first rate testimony. I thank him for taking the initiative in making this fundamental issue that tax rates go up when inflation is in place and the schedules are not lowered. It is elemental. These are unlegislated, and in the end destructive tax rates.

We come from the highest tax jurisdiction in the country, and we know that. You may know Professor Stein at New York University who is the author of "Stein's Law of Taxation,"which is a very important and somewhat complex proposition. He says, "To tax them, you have got to catch them." [Laughter.]

We are finding out what is happening to our State with all of its taxation. We are going to lose four, possibly five Members of Congress. The same phenomenon can happen to this Nation. You don't have to produce here. You can produce offshore. One of the phenomena in Puerto Rico that Governor Carlos Romero has found out is that you can leave the mainland, and move to a different tax climate, and many people do.

I would like to ask you one question because your judgment on this would be very important to this committee. We are going to have to deal with the question of the indexation of not so much capital gains as depreciation allowances. If you are depreciating at purchase cost a piece of equipment which is double its market value now, you may, in fact, be at negative rates.

Have you given any thought to this question? It is obviously a large one. But among other things, I think corporations are showing profits which are not real profits. If they had had to replace their plant, and so forth, they would not have made any money last year at all, or they would not have made 12 percent on their actual investment. They reported 12 percent on their book investment.

You obviously understand this. What is your feeling about it?

Mr. KEMP. I share the Senator from New York's concern about what has happened to New York and the industrial Northeast, and the shift of people and producers away from those areas of high taxation.

I particularly see it in my own district of Buffalo because we have several steel plants there that are depreciating their investment in new plant and equipment on a historical cost basis. As the gentleman points out, replacement cost is quite a different thing.

So the overtaxation of inventories, and the under-depreciation of new plants, machinery, equipment, and technology, is a very serious problem, and there is pretty general agreement in the Republican Party, as in the Democratic Party, that something must be done to liberalize the depreciation schedules in America.

I would just point out one other thing to my friend from New York, Bethlehem Steel in Lackawanna, N.Y., is depreciating its investment in new equipment over 14½ years. Canadian Steel, building a plant right across Lake Erie, which will compete with Bethlehem Steel is depreciating its new plant over 2 years.

It is absolutely outrageous that America treats its capital intensive steel, auto, manufacturing, and other industries in such a debilitating way that we are no longer competitive not only in the world market, but in our own North American Continent.

I cannot think of a more important issue. I strongly support the Jones-Conable depreciation liberalization. I strongly believe that we need, ultimately, to index depreciation rates if we cannot put an end totally to inflation. I think we can, and should. I think we should index the personal rates.

I must say, just to conclude, that I think the capital gains tax rate should come down. No one had to tell the American people that capital gains taxes were too high. It just swept through the Congress under the leadership of Bill Steiger, as well as several members of this committee. I think that it was a good thing for the country. And I think we should further lower capital gains tax rates to 20 percent

Senator MOYNIHAN. I appreciate your response. Our colleague, Senator Bentsen, has been especially concerned about this whole question of depreciation schedules.

Mr. KEMP. I have read just about everything that Senator Bentsen has published on the subject, and I strongly concur.

I just would make one footnote at this point. The gentleman from New York, Mr. Moynihan, has done, I think, a great service to the country, and particularly the Northeast, in pointing out that the spending patterns of the Federal Government have redistributed income. We can debate how much, but there can be no debate that redistribution of income has taken place in this country through Federal spending policies.

But I am trying to point out, I say to my friend, that the income tax system in and of itself also redistributes income from those areas of high nominal income to areas of low nominal income.

The major reason New York fares so poorly in the Federal spending game is Federal tax policies and inflation. In fact, no area in the country has been harder hit by the collision of high inflation and our progressive tax system. Just compare New York's 1978 per capita income with North Carolina's. Before taxes: New York, $7,547; North Carolina, $5,935. But with higher incomes, and a progressive tax system, New Yorkers are also in higher tax brackets. In addition, like most northeasterners, they pay far higher state and local taxes. As a result a comparison of real, after-tax income tells a very different story. New York, $3,979; North Carolina, $4,509. The average factory worker in Buffalo, N.Y. makes less in after-tax disposable income today than he did back in 1969. It's little wonder that New Yorkers are leaving—reluctantly—for

States where their standard of living can be enhanced, and the cost of doing business won't make their products uncompetitive.

Senator MOYNIHAN. Thank you very much.

The CHAIRMAN. Senator Bentsen.

Senator BENTSEN. Thank you very much, Mr. Chairman. I will keep my remarks short with your admonition.

We are delighted to have you here, Jack. You know my strong feelings also for a tax cut. We passed before this committee my amendment in 1978 to substantially modernize the depreciation schedule. It got changed some on the floor of the Senate, and then we lost it in conference. So I have been a long proponent of trying to bring the depreciation rate into reality, and to do something about productivity. The Joint Economic Committee has been one of the leaders in that regard.

We appreciate very much your support of trying to do something about depreciation schedules and a tax cut. I very strongly feel that we ought to be doing it.

I have no questions. Thank you, Mr. Chairman.

The CHAIRMAN. I have noticed some of the reports in various publications that would seem to indicate that I am the only Democrat who is still in favor of the tax cut. I just don't think that is right, Mr. Kemp.

Senator BENTSEN. Mr. Chairman, I don't know how many times I have to say it.

The CHAIRMAN. I think that some people feel that in order to make their position known, they have to go and shout it at the top of their voice every day.

It seems to me that the Democratic members of this committee have made known their view favoring a tax cut, and they have not changed their view. I doubt very much that you are going to see a different attitude with regard to the overwhelming majority of Democrats on the floor when we bring a bill before them.

I would just hope that people would let the Senators speak for themselves, rather than to try to speak for them.

With regard to this question that Americans don't want a tax cut, it seems to me that it is fair to make this clear: They are not focusing on what the problem is. If you ask the average American, and you say. "Look, your taxes and energy costs are due to go up by $80 billion next year." Do you know that the social security withholding will increase starting in January, and your income tax rates will go up as inflation puts you in a higher bracket? So you are going to pay your share of the $80 billion.

They are talking about cutting the $80 billion increase somewhere between $20 and $40 billion, maybe a quarter, or maybe a half. Do you think that this might be a good idea?

It seems to me that if you ask the question that way, it just makes all the difference. I see that you agree with that.

Mr. KEMP. Yes, sir, absolutely.

The CHAIRMAN. I think that it is all a big misunderstanding.

Mr. KEMP. Don't you think, Mr. Chairman, there is also a problem with the confusion that is in some people's mind as to the difference between the aggregate tax burden on the back of the private sector, as opposed to the marginal tax rates?

You yourself, Mr. Chairman, have helped to draw the distinction by suggesting that a lower marginal tax rate does not necessarily mean lower aggregate tax revenue. You could actually raise more revenue from a lower rate.

There is nothing sacrosanct about a steeply progressive tax system. Where is it written that this is the only way to raise revenue?

I think that many people need to make a distinction between aggregate taxes as a total burden, as opposed to the marginal rates, which put steelworkers in New York who want to work overtime in a 49 percent marginal tax bracket by the end of the year. I will tell you why no one wants to work overtime in New York—it is not worth it.

The CHAIRMAN. I think you are right about that.

Senator Roth.

Senator ROTH. I want to welcome my distinguished colleague. I apologize for being late.

It is very interesting to me. I was in some Joint Economic hearings where the thrust of the discussion was that the problem with this is that there is no growth. The reason that there is no growth is that we are not making the same investments that our major competitors are.

Mr. Kemp, isn't it the principal purpose of Roth-Kemp, to bring some growth into the economy?

Mr. KEMP. Absolutely.

I know that it is the gentleman's goal, and it is mine. There is no way to bring about prosperity, to increase the level of income of the people, without encouraging investment and saving and entrepreneurship. Our country discourages investment, and encourages consumption.

So it is absolutely a given fact that Roth-Kemp, by lowering marginal income tax rates across-the-board, would increase the after-tax reward for those men and women, that labor and capital which is producing. So it is a production oriented tax cut. It is not a consumption oriented tax cut.

Senator ROTH. First of all, I want to congratulate you for getting the name right. [Laughter.]

Mr. KEMP. I wanted to make up for my testimony, Senator.

Senator ROTH. Seriously, what bothers me is that a number of people, particularly the administration, are saying. Wait and see. To me that is the most critical problem of all. It is already too late.

Mr. KEMP. That is the problem with conservatives, they want to maintain the status quo. Those of us who are radical in this believe that we need change, that we need to alter the existing pattern of economic policy.

So we are the heterodox economists today, and they are the orthodoxy, and they have got to defend what has happened to our economy in terms of declining real growth, declining real income, and declining opportunity for people to meet their needs in the private sector.

Senator ROTH. Let me ask you to answer two or three questions that are constantly raised.

One is that Roth-Kemp is inflationary. How would you answer that?

Mr. KEMP. How can it be inflationary to reduce the barrier between effort and reward? How can it be inflationary to encourage people to work, or save, or invest, or produce more. How can it be inflationary to encourage people to maximize their effort? How can it be inflationary to encourage output, employment, thrift, and entrepreneurship?

I would finally say that inflation is not a fiscal phenomenon. Inflation is a monetary phenomenon. Only the Federal Reserve can cheapen the currency, and it is the purpose of fiscal policy and tax reform along the lines that you and I and Governor Reagan are talking about, to encourage more output of goods and services.

So stabilizing the dollar through monetary policy, and increasing the output of goods, services, and jobs, through fiscal policy is by definition, anti-inflationary.

That is what I would say if I did not have much time. If I had more time, I would say much more. [Laughter.]

Senator ROTH. A second criticism is that this is too massive a tax cut, and that we cannot afford it.

Mr. KEMP. It is too modest. It should have been passed 4 years ago. If you believe in indexing, as the gentleman from Delaware does, you should not be satisfied because Kemp-Roth only indexes the tax rates for the last 5 years.

If we were to totally index all of the tax rates for the past 15 years, you would have to cut all the brackets by 55 percent.

So in effect, we are retroactively indexing for only about 5 years, simply repairing the damage that has been done by about 5 years of this relentless push of labor and capital into higher brackets.

So it is very modest, especially when you look at the tax increase that is planned for fiscal year 1981. It is quite modest, indeed, particularly if it is phased in over 3 years.

I believe that people, in anticipation of a greater return on their saving and their investment, will start making decisions not in 1983, when the Kemp-Roth tax rate reduction is in place totally, but they will start making those decisions immediately as they did with the capital gains tax reduction of last year.

Senator ROTH. I see my time is up, but I will ask you one more question.

The third level of attack is that this tax particularly benefits the wealthy.

Mr. KEMP. It benefits all the American people equally across the board.

The gentleman from Louisiana once said. "There are two ways to equalize the American people. We can make the rich poor, or the poor richer." I apologize if I am trespassing on the gentleman's prerogatives, but I think that a rising tide should lift all boats, and I am convinced that the best thing that we can do for the poor is to create jobs and expand their opportunity to get some wealth.

Very frankly, I think if you look at this in an honest, objective way, you will realize that this is designed to increase the reward, and increase the incentive for all Americans. Therefore, it does not qualify as an upper-class tax cut as it has been pegged by some.

Senator ROTH. Mr. Chairman, all I can say is that the witness has persuaded me.

Thank you. [Laughter.]

The CHAIRMAN. Thank you for your appearance here today, Mr. Kemp. We are very pleased to have you. We will certainly study your full statement.

Mr. KEMP. Thank you.

[The prepared statement of Mr. Kemp follows:]

TESTIMONY OF HON. JACK KEMP ON TAX-RATE REDUCTION

Mr. Chairman, I appreciate this chance to testify before the Senate Finance Committee on the need to reduce tax rates for American individuals and businesses.

As you know, President Carter has reconsidered the pledge he made in March, when he said, "I will not consider any reduction in taxes until I am convinced that the 1981 budget will be balanced."

However, Treasury Secretary Miller has told this committee, as he told the House Ways and Means Committee, that the President does not believe Congress is competent to grapple with an important issue like tax-rate reduction in a national election year. His reasoning is that Members of Congress are likely to be swayed by the opinions of their constitutents, who are also unsuited, apparently, to vote on issues of such importance.

Well, Mr. Chairman, there is nothing new or sudden about the need to cut tax rates, or most of the proposals to do so. Senator Roth and I have been advocating essentially the same tax-rate reduction plan for almost four years. And as far as I can see, cool heads are prevailing almost everywhere in this election year, except the White House.

In recent days Vice President Mondale had some alarming news for the American people on the subject of taxation. He said that, according to Treasury estimates, a 30-percent cut in personal income tax rates over three years, of the kind Senator Roth and I propose, would cost more than $280 billion a year by 1985. If this happens, Mr. Mondale said, "every single discretionary program run by the Federal government would have to be eliminated."

But I haven't told you the alarming news yet. According to the President's mid-year economic review of last week, total personal income taxes will amount to $278 billion in 1981. So if Mr. Mondale predicts that in 1985, $280 billion will be only 30 percent of total income taxes—then he and Mr. Carter must have some plans they are not telling us about, to more than triple federal income taxces in the next four years.

I believe that Mr. Mondale and the Treasury merely have their numbers wrong. At least, I hope so. But the Vice President has unwittingly put his finger on the central fact of taxation in this country. If Congress does not act to cut tax rates, they will go up—automatically and drastically.

According to the President's economic review, Federal taxes of all kinds, as high as they are today, will more than double once again between now and 1985, if current law is not changed. The report says that Federal revenues will rise from $518 billion to more than $1.05 trillion in 1985.

This means we could cut personal income tax rates 30 percent across the board, ignore the increased revenues which result from an expanding economy, ignore the spending restraint we all agree is imperative—and still it would not match the tax increases which President Carter anticipates.

But the President's report contains an even more startling admission. Despite the largest one-year tax increase in our nation's history, the Administration has failed to balance the budget. The Administration originally projected an official deficit of $29 billion in fiscal year 1980. Now it says that deficit is $61 billion, Including the so-called "off-budget" budget, the government will borrow $77 billion this year.

The Administration's estimate of the fiscal year 1981 budget, from March to July, has swung from a supposed surplus of $200 million to a $29.8 billion deficit—more than $51 billion, including "off-budget" items. And that fiscal year has not even begun.

Throughout the 1980 and 1981 budget process, many of us tried to warn the Administration of the lesson this country learned at such great cost in 1969, and again in 1974—that tax increases which cause recessions lead to larger, not smaller deficits. The Administration ignored this warning, and this painful exercise is being unnecessarily repeated once again. Of the $30 billion increase in the 1981 deficit, $29.5 billion can be attributed to the deepening recession ($18.4 billion in lost revenues and $11.1 billion in recessionary spending increases).

According to the Congressional Budget Office, each 1 percentage point increase in the unemployment rate widens the Federal deficit by $25 billion to $29 billion. This means that under the Carter Administration the Federal budget has never wasted less than $50 billion a year because of the failure to attain full employment. And that cost will rise to more than $100 billion a year next year. This strikes me as a dubious brand of fiscal discipline.

In his testimony before this committee, Treasury Secretary Miller said, "Those who favor across-the-board tax reduction to stimulate the economy should ponder the implications in terms of inflation."

The irony is that this statement should come from a man who, as Chairman of the Board of Governors of the Federal Reserve System, presided over a tripling of the inflation rate in barely three years. The Treasury Secretary should ponder the fact that tax rates do not affect the number of dollars in circulation, or the value of each dollar. Only the Federal Reserve Board can cheapen the currency.

Not once in the past 15 years of steadily increasing inflation have marginal income tax rates been cut. And the across-the-board tax increases of this Administration have failed to strengthen either our economy, our currency, or the finances of the Federal government.

It is time to end this circular process of rising tax rates, economic decline, widening deficits, and further tax increases. I believe we must cut tax rates beginning next January first. I also believe we should have cut tax rates last January first, and the one before that. Our object is not only to return to work those millions of Americans who have lost their jobs in this unnecessary recession. We must restore *permanent* incentives to provide the climate of lasting prosperity we need to get our fiscal house in order, and to meet the many challenges which face us at home and abroad.

The United States tax code is substantially the same today as it was back in the mid 1960s, when the American economy enjoyed record capital investment, full employment, and virtually no inflation. But there has been one major change. Since about 1966 we have had a progressively more inflationary monetary policy. Because our tax code is not adjusted for inflation, the result has been to raise marginal tax rates on virtually every taxable form of individual and corporate productivity and saving.

For 15 years, individuals have been pushed relentlessly into higher tax brackets—regardless whether their earnings increased in real terms, or merely because of inflation.

Inflation has combined with historical-cost depreciation schedules to tax away profits that would normally be reinvested to replace worn-out equipment.

Capital gains are not adjusted for inflation, which has meant that investors have faced effective marginal tax rates of 100 percent and more.

Confiscatory estate tax rates have combined with speculative land values—another consequence of Federal Reserve Policy—to accelerate the wholesale liquidation of America's family farms and businesses.

New taxes have been added, like the recent excise tax on domestic oil, and still others are proposed.

These are the main problems with our tax code. They have been clearly defined and painstakingly documented during the past four years of Congressional hearings and debate.

The tax reform which is necessary to correct these flaws would amount to a "retroactive indexing" of the tax code. This is necessary, not only to prevent future tax increases, but to reverse the past 15 years of rising marginal tax rates on both individuals and businesses.

This requires substantial, permanent, across-the-board reduction in personal income tax rates; indexing of these new rates to prevent future tax increases; some measure to offset the overtaxation of profits caused by inflation and historical-cost depreciation; indexing of the basis for capital gains; instead of a complicated indexing of estate taxes, we could abolish this tax completely, since it raises less than 1 percent of all Federal revenue; and repeal of the so-called "windfall profits" tax.

It may not be possible to begin all of these necessary reforms in the first year. And to fight inflation and economic stagnation at the same time, they must be part of an economic package which includes meaningful spending restraint and an end to the Federal Reserve's practice of monetizing Federal debt.

But I believe that the Republican Party has proposed a prudent and achievable beginning—a 30-percent cut in personal income tax rates over three years, together with the Jones-Conable plan for accelerated depreciation. I would like to address myself specifically to the income tax rate reduction.

There is a lot of talk these days that a "supply-side" tax cut means a tax cut for business. I disagree. That is nothing but a repackaged version of the failed idea of demand management.

The school of demand management was based on the idea that individuals matter only as consumers. The driving force of the economy was supposed to be consumer spending—how many paper dollars people had in their pockets to spend. More dollars in people's pockets meant less unemployment and more inflation, and fewer dollars in people's pockets meant more unemployment and less inflation. This is where the idea came from that the reason for cutting income taxes is to put more paper dollars into people's pockets.

But individuals are producers as well as consumers. In fact, before they can consume anything, they must first produce something to trade for it, a good or service. Every dollar of our national income is earned by individuals—whether as wages, salaries, dividends, interest, rent, royalties, capital gains or pensions. And all of it faces the income tax, which is a tax on production, a tax on saving, a tax on both labor and capital. It is not levied on consumption or leisure. Profits are the one-tenth or so of our national income which is taxed twice.

If there is a single lesson we have learned about taxes in the past four years, it is this: Only a change in marginal tax rates has any direct effect on the real economy.

Economic stagnation is the failure of our economy to produce more this year than last year. If we want our economy to grow, we have to increase the incentive for producing an additional unit of goods, effort, or saving—that is, lower the marginal income tax rate. Nothing else will affect the behavior of individuals and businesses.

Consider the income-tax rebate which Mr. Miller has been talking about. It is supposed to offset payroll tax increases. But it does not reduce either the marginal payroll tax rate or the marginal income tax rate. Therefore, it will provide no incentive for an individual to work overtime, accept a new job, or otherwise increase his or her productivity. What's more, the tax rebate is only temporary.

A tax rebate is a reward for producing what would have been produced anyway. This holds true in its effects on business, too. Since the proposed tax rebate is offered against profits, the business must presumably already be earning a profit to benefit. This does not help to create new businesses, which are now being prevented by prohibitive marginal tax rates. The rebate can be claimed only if the business becomes more labor-intensive, which may or may not be the most economically efficient approach. And, once again, the rebate is not permanent, so it will have no permanent effect on employment.

I would like to turn now to the reduction in marginal income tax rates proposed by Senator Roth and myself. The Kemp-Roth package would do three things: cut all marginal income tax rates for individuals by 10 percent a year for three years; index the new tax rates for inflation after the third year; and limit Federal spending to a share on GNP which declines from 21 percent the first year to 18 percent by the fourth year.

Table I contains the official revenue estimates of the Kemp-Roth tax-rate reduction by the Joint Committee on Taxation. These are "static" revenue estimates, which means they are noteworthy in two respects.

First, they do not include any of the positive revenue "feedback" which can be expected as the economy expands as the result of cutting tax rates.

Second, they do not include any of the negative revenue feedback which will occur if tax rates continue to increase every year under current law. These estimates of expected revenue are based on economic assumptions devised by the Congressional Budget Office. They include the assumption that despite a doubling of income taxes in four years, the economy will continue to grow indefinitely at an annual rate of 3.8 percent in real terms. But the CBO itself has stated that these projected tax increases are not compatible with 3.8 percent real annual growth.

According to the CBO's Five-year Budget Projections: Fiscal Years 1981-1985, "If the revenues and outlays shown in the current law projection were actually achieved, the economic growth path assumed for this period would probably not be attainable. The rapid rise in revenues and real decline in outlays would impose a drag on the economy that would make the assumed economic growth of 3.8 percent a year very unlikely." (p. 12)

Keeping in mind that these estimates are grossly overstated because they do not include any positive feedback from tax-rate reduction, or any of the negative feedback from continued automatic tax increases, let's take another look at Table I. The Joint Committee on Taxation has provided a comparison of the Kemp-Roth tax-rate reduction with the tax increases on personal income which will take place under current law.

TABLE I.—KEMP-ROTH II TAX-RATE REDUCTION COMPARED WITH TAX INCREASES CAUSED BY INFLATION, SOCIAL SECURITY

[In billions of dollars]

	1981	1982	1983	1984	1985
CALENDAR YEAR					
Tax increases:					
Income tax	23.4	45.9	72.8	103.0	138.4
Social security	13.7	18.4	21.2	24.1	40.5
Total tax increases on personal income	38.1	64.3	94.0	127.1	178.9
Kemp-Roth tax cut (no revenue feedback)	31.8	64.9	113.8	148.7	189.5
Net tax cut/(increase) (no revenue feedback)	(6.3)	0.6	19.8	21.6	10.6
BUDGET YEAR					
Tax increases:					
Income tax	14.6	37.4	62.7	91.6	125.0
Social security	9.8	17.5	20.5	23.4	36.4
Total tax increases on personal income	24.4	54.9	83.2	115.0	161.4
Kemp-Roth tax cut (no revenue feedback)	19.8	52.4	95.4	136.0	174.6
Net tax cut/(increase) (no revenue feedback)	(4.6)	2.5	12.2	21.0	13.2

Source: Joint Committee on Taxation, U.S. Congress.

As you can see from the comparison, the Kemp-Roth bill is startling in its modesty. For the first two years, it does not provide any tax reduction at all in dollar terms. The net impact on the budget never exceeds $21 billion, once again ignoring revene feedback.

These numbers mean that a 30-percent cut in marginal income tax rates would do nothing, in dollar terms, but keep effective or average tax rates on individuals from increasing. Luckily for the American people, however, the economic effect of a tax cut depends on marginal, not effective tax rates.

I would like to submit data from three studies of the economic effect of the Kemp-Roth package, which were presented recently to the Joint Economic Committee.

The first study, by Data Resources Inc., analyzed what would happen if Kemp-Roth were a tax rebate of the same dollar size, instead of a cut in marginal tax rates. In Table II, the DRI model shows conventional effects of an increase in aggregate demand. Despite a rise in employment, there is little revenue feedback, although, interestingly enough, the same study showed that the personal savings rate would double to 8.1 percent. Essentially, the increase in government borrowing is merely offset by an increase in private savings.

The results of the second study are listed in Table III. Evans Economics Inc., estimates that the Kemp-Roth tax-rate reduction alone, without any spending restraint, would substantially reduce unemployment and increase real growth. There is a negligible increase in the rate of inflation over five years.

TABLE II.—DATA RESOURCES INC., SIMULATION OF TAX REBATE OF SAME DOLLAR SIZE AS KEMP-ROTH TAX-RATE REDUCTION

	1981	1982	1983	1984	1985
Policy change (change in billions of dollars):					
Personal tax revenues	−29.9	−66.7	−115.5	−1287.1	−137.1
Federal deficit (NIA)	−24.7	−53.2	−97.3	−118.3	−146.8
Effects (percent difference in levels):					
Real GNP	0.7	1.8	2.8	2.6	2.6
Real potential GNP	0.1	0.5	1.1	1.6	1.9
Labor supply	0.1	0.3	0.4	0.4	0.3
Productivity	0.2	0.6	1.4	1.8	1.9
Difference in rates:					
Unemployment	−0.5	−1.1	−1.3	−0.9	−0.8
Inflation rates:					
GNP deflator	0.1	0.5	1.2	1.8	1.8
Core inflation	−0.1	−0.1	0.0	0.5	1.1
Wages	0.1	0.7	1.4	1.7	2.0

Source: Otto Eckstein, President, Data Resources Inc.; "A Time for Supply Economics," testimony submitted to Joint Economic Committee, May 21, 1980.

TABLE III.—EVANS ECONOMICS INC., SIMULATION OF KEMP–ROTH TAX-RATE REDUCTION WITH AND WITHOUT KEMP-ROTH SPENDING LIMITATION EFFECT ON UNEMPLOYMENT AND INFLATION

Fiscal year—	Tax rate reduction alone					Tax rate reduction with spending limitation					
	Reduction in unemployment	New unemployment rate	Effect on inflation			Reduction in Unemployment	New unemployment rate	Effect on inflation demand side/supply side			
			Demand side	Supply side	Total			Less unemployment	Less C	Less T	Total
1981	0.3	7.6	0.0	0.0	0.0	0.1	7.8	0.0	0.0	0.0	0.0
1982	0.9	6.4	+0.6	−0.3	0.3	0.3	7.5	0.1	−0.2	−0.3	−0.4
1983	1.6	5.3	+1.2	−0.9	0.3	0.7	6.2	0.4	−0.8	−0.9	−1.3
1984	2.0	4.5	+3.5	−2.7	0.8	1.3	5.2	1.3	−1.6	−2.7	−3.0
1985	2.4	3.7	+6.6	−4.8	1.8	1.8	4.3	2.3	−2.6	−4.8	−5.1

Source: Michael K. Evans, president, Evans Ecoinomics Inc.; "New Developments in Econometric Modeling: Supply-Side Economics", Testimony for Joint Economic Committee, May 21, 1980.

TABLE IV.—ECONOMIC AND FEDERAL TAX REVENUE EFFECTS OF KEMP-ROTH TAX REDUCTION [1]

[Dollar amounts in billions of 1979 dollars]

	1980	1981	1982	1983	1984	1989
Increase or decrease in:						
Employment (thousands of full-time equivalent employees)	1,920	2,910	3,690	4,120	4,570	6,670
Annual wage rate	$540	$660	$700	$800	$990	$1,940
Gross national product:						
Total	122	166	188	235	288	601
Business sector	104	144	165	200	239	473
Gross private domestic investment:						
Total	53	112	138	178	227	139
Nonresidential	31	78	95	109	134	119
Consumption	68	54	50	58	61	412
Federal tax revenues:						
Net of feedback	−2	−10	−30	−33	−36	−38
Initial impact	−24	−39	−62	−66	−71	−108

[1] These estimates assume that the tax cuts would be effective beginning with the 1980 taxable year.

Note.—The figures are the differences between the estimated amount of the respective economic magnitudes under the tax change and under present law in each year.

Amounts shown with minus signs are decreases from present law in that year, not from the preceding year under the tax change. Estimates of employment effects are rounded to the nearest 10,000; estimates of annual wage effects are rounded to the nearest $10; estimates of effects on GNP, capital outlays, consumption, and Federal revenues are rounded to the nearest $1 billion.

Source: Norman B. Ture, president, Institute for Research on the Economics of Taxation.

The same study shows that the whole Kemp-Roth package, including both tax-rate reduction and spending restraint, would balance the budget in two years, reduce the unemployment rate to 4.3 percent, and most significantly, reduce the inflation rate by 5,1 percent by 1985.

The third study, shown in Table IV, is by Dr. Norman B. Ture, or the Institute for Research on the Economics of Taxation (IRET). The IRET's econometric model is known as the ATIM (Analysis of Tax impacts Model). This study shows even larger increases in employment than the Evans model. It also shows that as much as three-quarters of the increase in real GNP is due to added investment; the remainder, additional consumption.

Mr. Chairman, if I could summarize: unless Congress cuts tax rates, taxes will increase drastically. The Kemp-Roth bill would barely offset the aggregate real tax increase on personal income which will take place under current law. If we cut marginal tax rates 30 ercent, even ignoring revenue feedback, the net effect will be merely to keep effective or average tax rates the same.

The Administration has failed in its attempt to balance the budget through across-the-board increases in tax rates. In fact, the deficit has steadily widened. This casts doubt on the Administration's contention that cutting tax rates across the board would lead to larger deficits.

Only a cut in marginal tax rates—not a tax rebate—will have the effect we desire on employment, saving, investment, and real economic growth. With a sound monetary policy, we can substantially reduce the inflation rate at the same time.

The situation we face was described accurately 17 years ago by President Kennedy, when the country faced a similar economic and financial problem.

He said: "Our true choice is not between tax reduction, on the one hand, and the avoidance of large Federal deficits on the other. It is increasingly clear that no matter what party is in power, so long as our national security needs keep rising, an economy hampered by restrictive tax rates will never produce enough revenue to balance the budget—just as it will never produce enough jobs or enough profits. . . . In short, it is a paradoxical truth that tax rates are too high today and tax revenues are too low—and the soundest way to raise revenues in the long run is to cut rates now."

And he said: "The purpose of cutting tax rates, I repeat, is not to create a deficit but to increase investment, employment, and the prospects for a balanced budget."

Mr. Chairman, I have been pushing for across-the-board tax-rate reduction for individuals for almost four year now, and I have only one reservation about the Kemp-Roth bill. Because of the extraordinary magnitude of the tax increases which have occurred, and which are projected to continue, I am afraid that a 30-percent tax-rate reduction over the next three years may have become too modest.

DISTRIBUTION OF KEMP-ROTH TAX-RATE REDUCTION

Expanded income class	Percent of taxes paid	Percent of tax cut
Under $5,000	0.2	0.3
$5,000 to $10,000	3.6	4.4
$10,000 to $15.000	8.1	8.8
$15,000 to $20,000	11.3	11.9
$20,000 to $30,000	24.5	25.2
$30,000 to $50,000	23.8	24.0
$50,000 to $100,000	14.5	14.5
$100,000 to $200,000	6.6	6.0
$200,000 and over	7.3	5.0

Source: Joint Committee on Taxation.

The CHAIRMAN. Let me now call a panel consisting of William S. Cashel, Jr., vice chairman and chief financial officer of American Telephone & Telegraph Co.; Mr. Edward A. Brennan, president and chief operating office of Sears, Roebuck & Co.; Mr. Robert L. Strickland, chairman of the board of Lowe's Co's.; and Mr. Ronald L. Ludwig, chairman of the legal advisory committee of the Employee Stock Ownership Plan Association of America.

Mr. Cashel, you are appearing here today on behalf of Mr. Brown, the chairman of the board, who had to go on vacation. I thought that it would be fair to let him have his vacation, but I think it ought to be clear that you are speaking for the American Telephone & Telegraph Co. in the views that you are expressing here today.

Mr. CASHEL. That is the fact, Mr. Chairman. Mr. Brown left me in charge of the business, and presumably I can be in charge of this testimony before the committee this morning. I am sure you would welcome him back for an appearance at a later time.

The CHAIRMAN. Your views do reflect the views of your chief executive officer?

Mr. CASHEL. They do, indeed.

The CHAIRMAN. Thank you. You may proceed.

STATEMENT OF WILLIAM S. CASHEL, JR., VICE CHAIRMAN AND CHIEF FINANCIAL OFFICER, AMERICAN TELEPHONE & TELEGRAPH CO.

Mr. CASHEL. My name is William Cashel, and I am vice chairman of the board. I do appreciate the opportunity to come before the committee on behalf of the Bell System.

Specifically, Mr. Chairman, with respect to the proposed amendments to the employee stockownership provision of the Internal Revenue Code, in the Bell System we have supported the idea that employees should participate in corporate ownership over many years and in many ways. ESOP's are an excellent way of furthering that effort.

We recognize that ESOP's help toward the goal of accomplishing three major objectives. First, they provide a means of employees acquiring ownership in the business in which they work, and a sense of proprietorship not only in that company, but in the entire American economic way of life.

Second, such plans provide investment assets, real assets, and investment earnings to those workers. They provide a source of new capital to corporations, which is needed for the innovation and productivity that we all seek.

In our company, the A.T. & T., we established an ESOP in 1976, and today it covers 840,000 employees, many of whom might not otherwise be shareholders in their own enterprise. Our employees receive about one share of stock per $10,000 of their salary. Through the end of last year, 4.5 million shares have been contributed to the fund in our particular case. I can assure you that this is a popular employee benefit.

This S. 1240 contains several key amendments to the ESOP provisions of the tax code, importantly it provides that the ESOP sections become permanent, which would enable corporate taxpayers to avail themselves of a credit equal to 1 percent of their employees' compensation as an alternative to the present credit.

Those provisions are good. They assure a corporation that the funding source will not be cut off after 1983. The choice of credit base is advantageous to many labor intensive industries whose investment progress should be enhanced by this feature.

Another feature that we find attractive, Mr. Chairman, would provide a tax deferral on a lump sum distribution from an ESOP of up to $5,000 of employer securities. That $5,000 would be taxed only when sold, and that would encourage the employee to retain his ownership in the corporation.

Finally, this would also extend the existing antiflow through provisions applicable to credits based on investment to the credit based on compensation, and this, of course, is vital to us, and to all utilities, really, to prevent regulators from treating this particular ESOP credit as a reduction of tax expense for ratemaking purposes, thus forcing the utility to pass the credit to the customers in the form of lower rates immediately. It would subvert the purpose of the credit which is to provide employee benefits, and promote capital formation rather than to reduce prices.

We are pleased to support the objectives of S. 1240 of making ESOP's available to more American workers. I think that this is a form of tax reduction which benefits employees directly, and at the same time industry is being provided an additional means of capital formation which is a current and certainly a continuing need.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, sir.

Next let's hear from Mr. Edward A. Brennan, president and chief operating officer of Sears, Roebuck & Co.

STATEMENT OF EDWARD A. BRENNAN, PRESIDENT AND CHIEF OPERATING OFFICER, SEARS, ROEBUCK & CO.

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

My name is Edward A. Brennan. I am president of Sears, Roebuck & Co. I am delighted to be here today to discuss Sears and our experiences with profit sharing.

The Sears Profit Sharing Fund was created on July 1, 1916, over 64 years ago. From the start, one of its principal purposes was to invest in shares of Sears stock so that our employees could gain a proprietary interest in the business, and perform not only as employees, but as owners of that business. We think over the years that this program has been very beneficial for both the company and for the employees.

At the end of 1979, the Fund owned almost 69 million shares of Sears stock. That represented about 22 percent of the company's outstanding shares. The value of the Sears stock was approximately $1.25 billion in the fund, and represented about 60 percent of its assets.

The remaining 40 percent of the assets were invested in a diversified portfolio entitled, "General Investments." Again, at the end of 1979, the value of the General Investments was about $858 million, making the total value of the fund over $2 billion.

The fund at that time had about 268,000 participants, all of whom were fully vested.

Sears stock is allocated to members' accounts in shares. The members are entitled to instruct the trustees on how to vote their stock at the company's annual meeting. Upon withdrawal, shares of Sears stock are distributed in kind, unless the member requests payment in cash.

We also have a pension plan, which together with profit sharing, provides for a balanced retirement program.

We see great value for our employees and for the company, in the employee ownership of our stock. I guess you might say that our profit-sharing fund has created literally tens of thousands of capitalists, Mr. Chairman. Last year, over 14,000 employees withdrew almost 4.2 million shares of Sears stock from the fund when their membership ended.

Most of these shares went to persons retiring from the company. They then became the registered owners of their stock, and of course began receiving dividends. These dividend checks became an important part of their retirement security.

The profit-sharing fund is also of great value to the company in terms of motivation. While it is difficult to attribute to a single factor the success or failure of a business, we feel that the profit Share fund has been one of the most important factors in building our company to the prominent position that it enjoys in the industry.

The present tax laws allow an additional 1 percent investment tax credit if that amount is contributed to an employee stock ownership plan. The law, of course, also allows an additional one-half percent tax credit if the employee makes a matching contribution.

Sears has not set up a tax credit ESOP to give its employees the advantage of the additional contribution. The investment tax credit discriminates against retailers. As a result the dollar amounts involved per employee are too small to justify the additional administrative cost of the plan.

Retailers are labor-intensive employers. The greater part of retailers' capital investments are in buildings which are denied an investment tax credit under existing law. Accordingly, the amount of the allowable investment tax credit in relation to compensation is small.

For example, in 1979 if Sears and its subsidiaries contributed the maximum additional 1.5 percent investment tax credit to an ESOP covering the employees now in our profit-sharing fund, the most we could have allocated to any single employee would have been about $23.76. However, this amount would have been considerably less for a substantial number of the participants, including those who would not have elected to make the additional one-half percent matching contribution.

We feel that a tax credit for ESOP based on employee compensation would be a step in the right direction. It would provide the incentive that labor-intensive employers need to start or strengthen their stockownership plans. It would act to expand employers' ownership of their employers' stock, and give the employees the reward of such stock ownership.

Mr. Chairman, I would like to conclude by saying that at Sears we have always shared your views that stockownership in American business is good for business, it is good for the employees, and it is good for the country.

Thank you.

The CHAIRMAN. Thank you very much, Mr. Brennan.

Now let's hear from Mr. Robert L. Strickland, chairman of the board of Lowe's Co's.

STATEMENT OF ROBERT L. STRICKLAND, CHAIRMAN OF THE BOARD, LOWE'S CO., INC.

Mr. STRICKLAND. Mr. Chairman, and members of the Senate Finance Committee, good morning.

My name is Robert L. Strickland, and I appreciate the opportunity to be here.

First, I would like to express vigorous support for the tax cut being considered by this committee. I understand, Mr. Chairman, that the effective date that you and the committee are working for is January 1, 1981, and in my view that is the exact date the country needs one.

What is being conveniently overlooked by critics, and I was happy to see it come out in earlier testimony and by you, Mr. Chairman, if we don't get a tax cut, we are going to have an effective tax increase in the country in 1981.

Here is an article from the Tax Foundation called, "Taxflation Wipes Out Pay Gains." It illustrates a $10,000-earner in 1979, who happens to get a 14.5 percent pay increase for 1980. But due to inflation, and increases in Federal income and social security taxes, he actually lost 1.7 percent in buying power. So individual wage earners are hurt badly by inflation, and so are corporations.

Price Waterhouse has released a study that shows that 37 major retail corporation's income tax rate was 44 percent in 1979, using normal historical accounting. Under inflation adjusted accounting the effective tax rate for those 37 corporations was 74 percent of the total income.

I believe that inadequate depreciation is one of the big villains. I know Senator Dole is supporting the 10-5-3 proposal. That, and other supply side tax cuts which have been discussed earlier, and which Senator Roth has long been a proponent of, would be helpful in my judgment.

I want to express specific support for the two bills enhancing the employees' stockownership movement. The first one by you, Mr. Chairman, and the other by Senator Talmadge.

Mr. Chairman, you know the Washington Redskins are made up of three different teams: offensive, defensive, and specialty. Those three teams have a shared goal, to win, and to be successful. When one considers four important forces in this country—employees, management, shareholders, and government—it is getting to be a national tragedy that instead of cooperation and teamwork toward accomplishing shared goals, we are developing adversary relationships that are getting increasingly acrimonious and nonproductive.

Here is an article done by Mr. Daniel Lankolovich on worker attitudes. It states that traditional incentives mean nothing to 44 percent of the work force. It means, in this country, we are not playing with a full team.

Robert Blyburg, the editor of Barron, wrote last July 4 about mounting conflicts between shareholders and management.

Mr. Chairman, it seems to me that we can look at Japan, and we can look at OPEC, and we can see clear examples of how national and international teamwork can seize economic initiative and translate it into successful and competitive growth.

I believe, sir, that improved economic teamwork must be a priority national strategy. I know that increased employee stockownershp is a powerful tactic by which we can implement that strategy.

At a recent annual meeting of the National Investor Relations Institute, two influential institutional investors, one of Baltimore and one of New York, expressed concern about separation of interest between management and shareholders, large and small. They both view employee stockownership very positively as a solution.

Mr. Chairman, I was privileged to testify before this committee 2 years ago in support of S. 3241, and I told the Senators at that time about Lowe's 17 years of successful, productive stockownership. At Lowe's it was indeed a fact, not a theory.

Last November I testified before Senator Proxmire's committee on the Chrysler bill, which I was delighted to support because it had that ESOP provision, as you know. In the attemnt to both save time today, and to provide testimony regarding Lowe's historical success with the employee stockownership, I incorporated many of those prior statements into the written record.

The 44 percent Mr. Lankolovich discussed was made up of two different groups. Seventeen percent is made up of young, aggressive middle managers, and 27 percent is made up of low-income bluecollar workers. At Lowe's those are precisely the two groups that ESOP helps motivate.

Our young, aggressive store managers can check on their wealth every weekday by looking up Lowe's in the New York Stock Exchange listings, and our bluecollar workers understand headlines like this when the local newspaper talks about a $125 a week worker who retires rich thanks to the employee stockownership.

Lowe's sales per employee last year were $155,000, almost three times that of the big three retailers. Our net earnings per employee were $4,300, or about twice that of the big three.

Prior to employee stockownership, our corporate tax income tax paid, per average employee, average about $1,900 each per year. Last year it was $3,900.

I strongly support your bill, Mr. Chairman. Lowe's is not capital intensive. It is people intensive. Once the 1 percent of payroll tax credit provision, and the dividend deductibility becomes law, Lowe's will be able to do some things that it would not. We will have 1 percent more people than we would be able to otherwise.

We will build more stores. It would have a cumulative multiplier economic effect.

Thank you.

The CHAIRMAN. Thank you, sir.

We will now hear from Mr. Ronald L. Ludwig, chairman of the Legal Advisory Committee of the ESOP Association of America.

STATEMENT OF RONALD L. LUDWIG, LUDWIG AND BUSHMAN LAW CORP., SAN FRANCISCO, CHAIRMAN, LEGAL ADVISORY COMMITTEE, ESOP ASSOCIATION OF AMERICA

Mr. LUDWIG. Mr. Chairman, this committee has heard for several days now about the problems of increasing capital growth in this country, increasing productivity, and providing new tax incentives to accomplish these objectives.

Our association of ESOP companies strongly believes that increased incentives for employee stock ownership will help solve the problems of increasing productivity, and provide a means for increasing new capital formation.

Many studies have shown that employee stock ownership increases the productivity of employees. Many studies have also shown that the greatest increases in productivity and profitability of corporations come as a result of large proportionate employee ownership. A 100 percent employee owned company provides greater incentive for employees than when the ownership share of employees is less.

We certainly applaud the efforts the chairman and this committee have made in the last 7 years in providing legislation encouraging the formation of ESOP's. We believe, however, that the time has come to provide incentives which will remove some of the barriers that now exist under the Internal Revenue Code for financing 100 percent employee ownership.

The problem arises from the historical treatment of ESOP's under the same Internal Revenue Code provisions as pension and profit-sharing plans. We believe that it is necessary to remove some of the present limitations to provide for accelerated employee ownership, accelerated capital growth, and accelerated productivity.

We are certainly encouraged by the recent introduction of two new ESOP bills, S. 2953, which was introduced by Senator Talmadge last week, and S. 2982, which you, Mr. Chairman, introduced yesterday.

S. 2953 provides added incentives for 100 percent employee ownership of businesses. One of the greatest problems in financing employee buy outs has been the present Code limitations on ESOP contributions. Senator Talmadge's bill would provide a modification of the present limitations on contributions made to an ESOP maintained by a 100 percent employee owned company for payments on an ESOP loan which was used to buy the company.

This would provide added incentives for 100 percent leverage buy out by employees, by modifying the present deduction limitations and treating ESOP's differently from conventional pension and profit-sharing plans. We feel that this bill will provide a tremendously increased incentive for total employee buyouts.

The bill also provides certain technical amendments to the code which would recognize the special nature of a 100 percent employee owned company, by providing special distribution provisions, and special provisions for the valuation of stock of that company.

We believe that it is extremely important for this committee, in considering at tax cut legislation, to provide special incentives for the 100 percent employee buy out situation.

In addition, S. 2953 provides a special relief procedure from a technical problem that has been created for TRASOP's. There is a technical problem in the present code provisions where a division or subsidiary of a TRASOP company is spun off. The present code provisions would limit the ability of making distributions to the employees of the divested division.

Therefore, we think that it is important for all the provisions of S. 2953 to be enacted, particularly with reference to the 100 percent leveraged employee buy out provisions.

In addition, we strongly favor the provisions of S. 2982 which was introduced yesterday in the Senate. This bill would make the TRASOP permanent, as the present provisions would now expire at the end of 1983. It would provide for the 1 percent of pay alternative to the additional investment tax credits allowed for TRASOP contributions.

This bill creates important provisions relating to the deductibility of dividends on ESOP stock where they are paid out currently to employees. We think this would be a tremendous incentive for companies to pay out dividends and allow employees to share in an additional benefit from the ownership of the company.

S. 2982 also provides special provisions which would start treating ESOP loan payments differently from regular contributions to qualified employee plans.

We strongly support both of these bills. We encourage the committee to continue its excellent work, and encouragement of ESOP concept, and to provide greater incentives to promote employee ownership, through additional tax incentives.

Thank you.

The CHAIRMAN. Let me thank each one of you, gentlemen, for coming and testifying. I believe, and I think most of you do, that the strength and the future of American capitalism is going to depend on the extent to which we are able to make the Americans feel a part of it. I think that to the extent that we fail to make Americans feel a part of our system, they are going to feel alienated from our system.

I appreciate what all of you have said. I think you have all made a magnificent contribution. I want to assure Mr. Brennan that if it is within my power, we are going to modify this law so that the companies that are not capital intensive can participate fully in it. I think that that is an oversight, and it can be taken care of.

The incentive that we provide should be greater, and to the extent that I can increase that, I am going to fight to do it, too.

Mr. BRENNAN. Thank you, Mr. Chairman.

The CHAIRMAN. I appreciate what American Telephone & Telegraph has done as far as your employees are concerned. I suppose that you have more shareholding employees than any other company in America now, don't you?

Mr. CASHEL. I would think we do, Mr. Chairman, yes.

The CHAIRMAN. I certainly admire what you have done, and appreciate this outstanding example that Mr. Strickland has given us here today. We thank you very much, gentlemen, for your presentation.

[The prepared statements of the preceding panel follow:]

STATEMENT OF WILLIAM S. CASHEL, JR., VICE CHAIRMAN OF THE BOARD AND CHIEF FINANCIAL OFFICER, AMERICAN TELEPHONE & TELEGRAPH CO.

SUMMARY

The Bell System has maintained an employee stock ownership plan (ESOP) since 1976. The plan now covers 840,000 employees and is a popular benefit.

We strongly support employee stock ownership plans because they accomplish three important objectives:

They provide a means for employees to gain the benefits of ownership in their companies;

They provide investment assets and investment earings to employees;

And they provide a source of new capital for America's corporations.

The Bell System also supports the objectives of bills which seek to enhance ESOPs. S. 1240 is such a bill. We fully endorse those provisions which would: (1) Make the ESOP sections of the Tax Code Permanent: (2) allow an alternative credit based on employees' compensation; (3) provide a tax deferral on a lump-sum distribution of up to $5,000 of employer securities from an ESOP; and (4) extend the existing anti flow-through provisions to the new credit based on compensation.

We believe that these provisions would make employee stock ownership plans more attractive and encourage their adoption and expansion by other industries. Such enhancements would provide American business with needed additional capital and give American workers a greater share in the free enterprise system of which they are such an integral part.

STATEMENT

My name is William S. Cashel, Jr. and I am Vice Chairman of the Board and Chief Financial Officer of the American Telephone and Telegraph Company. I appreciate this opportunity to appear before you today on behalf of the associated companies of the Bell System, which are listed on the attachment, with respect to the proposed amendents to the employee stock ownership provisions of the Internal Revenue Code.

Over the years, the Bell System has strongly supported the idea that employees should participate in corporate ownership by owning shares of stock in their company. Employee stock ownership plans ("ESOP") are an excellent way of accomplishing this. We believe ESOPs help accomplish three important objectives:

They provide a means for employees to gain the benefits of ownership in their companies, thus promoting a sense of proprietorship not only with respect to those companies but our econmic way of life as well;

They provide investment assets and investment earnings to employees;

And they provide a source of new capital for America's corporations—capital needed to finance the heavy investments which will be required to spur innovation and to resume productivity advances.

Investment tax credit ESOPs are particularly useful in accomplishing the first two objectives for a broad body of employees, many of whom might not otherwise be able to afford participation in a stock ownership plan.

AT&T established its ESOP in 1976. Today, our plan covers some 840,000 employees, both management and non-management. Over 520,000 employees who might not otherwise be shareowners have been added to our shareowner family through participation in the Bell System ESOP. Our eligible employees have been receiving about one share of AT&T stock per $10,000 of salary. Through 1979, four and one half million shares have been contributed to the ESOP trust and an employee attitude survey shows that ESOP is a popular employee benefit.

S. 1240 contains several amendments to the ESOP provisions of the Tax Code. The chief provisions would make the ESOP sections permanent and would enable corporate taxpayers to avail themselves of a tax credit equal to one percent of their employees' compensation as an alternative to the present credit based on qualified investment in depreciable property. We believe both of these provisions merit the support of the Committee because they will encourage additional corporations to establish ESOPs by (1) assuring them that an important source of funding will not be cut off after 1983 and (2) providing them with a choice between a cridit based on investment or one based on compensation. In fact, for many labor intensive industries, this change would make the ESOP credit meaningful for the first time and eliminate a criticism of the present provisions.

Another feature of the bill which we favor would provide a tax deferral on a lump-sum distribution from an ESOP of up to $5,000 of employer securities. This amount would be taxed to the employee only when sold, thus encouraging the employee to retain ownership of the shares.

The bill would also extend the existing anti flow-through provisions—applicable to the credit based on investment—to the credit based on compensation. This is absolutely vital to utilities to prevent regulatory agencies from treating the ESOP credit as a reduction of tax expense for rate-making purposes, thuse forcing utilities to pass the credit through to customers in lower rates. This would subvert the purpose of the credit, which is to provide employee benefits and promote capital formation, rather than reduce prices.

We are pleased to support the objective of S. 1240, of making tax credit ESOPs available to more American workers. Tax credit ESOPs are, in effect, a form of tax reduction whose benefits flow to employees. And they have the important further advantage of providing industry with an additional means of capital formation—certainly a pressing need in today's economy.

Senator Long's proposed ESOP enhancements will provide American business with needed additional capital and will give American workers a greater share in the free enterprise system of which they are such an integral part.

Thank you again for this opportunity.

Bell System Companies

American Telephone Telegraph Company.
The Bell Telephone Company of Pennsylvania.
The Diamond State Telephone Company.
Bell Telephone Laboratories, Incorporated.
The Chesapeake and Potomac Telephone Company.
The Chesapeake and Potomac Telephone Company of Maryland.
The Chesapeake and Potomac Telephone Company of Virginia.
The Chesapeake and Potomac Telephone Company of West Virginia.
Cincinnati Bell, Inc.
Illinois Bell Telephone Company.
Indiana Bell Telephone Company, Incorporated.
Michigan Bell Telephone Company.
The Mountain States Telephone and Telegraph Company.
New England Telephone and Telegraph Company.
New Jersey Bell Telephone Company.
New York Telephone Company.
Northwestern Bell Telephone Company.
The Ohio Bell Telephone Company.
Pacific Northwest Bell Telephone Company.
The Pacific Telephone and Telegraph Company, and Bell Telephone Company of Nevada.
South Central Bell Telephone Company.
Southern New England Telephone Company.
The Southern New England Telephone Company.
Southwestern Bell Telephone Company.
Western Electric Company, Incorporated.
Wisconsin Telephone Company.

Statement of Edward A. Brennan, President, Sears, Roebuck & Co.

Summary

1. Sears Profit Sharing Fund was established over 64 years ago with one of its principal purposes to invest in Sears stock so employees could acquire a proprietary interest in the Company, thereby sharing in its earnings as both an employee with an interest in Profit Sharing and as an owner.
2. At the end of last year the Fund had approximately 268,000 participants owning almost 69 million shares of Sears stock, representing about 22 percent of the Company's outstanding shares.
3. Sears has other stock ownership plans and has always encouraged ownership of the stock by its employees.
4. Employee stock ownership has been of great value both to the employees and to the Company.
5. Under present tax law, the dollar incentive per employee is too small to justify the administrative costs of a Tax Credit ESOP.
6. A tax credit based on annual compensation would encourage retailers and other labor intensive businesses to establish Tax Credit ESPOs.

STATEMENT

My name is Edward A. Brennan. I am President of Sears, Roebuck and Co. I am happy to be here today to discuss Sears and its employees' experiences with Profit Sharing.

The Sears Fund was created on July 1, 1916, over 64 years ago. From the start, one of its principal purposes was to invest its assets in Sears stock so employes could acquire a proprietary interest in the Company, thereby sharing in its earnings as both an employee with an interest in Profit Sharing, and as an owner. The incentives derived by the employees from investing in Sears stock and becoming owners of the Company have been beneficial to both the Company and the employees.

I understand Mr. Chairman that you have often stated "the only thing wrong with capitalism is that there are not enough capitalists." We agree with you—but, at Sears through Profit Sharing, all the employes have the opportunity to become capitalists.

I now would like briefly to describe Sears Profit Sharing Fund.

Sears profitsharing fund

One of the significants provisions in the rules of the Sears Profit Sharing Fund is the clause allowing the Investment Committee to invest up to 100 percent of the assets of the Fund in Company shares. At the end of 1979, the Fund owned almost 69 million shares of Sears stock representing about 22 percent of the Company's outstanding shares, with a market value of approximately $1¼ billion.

About 60 percent of the assets of the Fund are invested in Sears stock. The remaining 40 percent are invested in a diversified protfolio called "General Investments." At December 31, 1979, the General Investments portfolio was valued at approximately $858 million.

At the end of last year, there were about 268,000 participants in the Fund. Profit Sharing members can elect to deposit either two, three, four or five percent of the first $15,000 of annual compensation, up to a maximum of $750 per employee. The Company's contribution is six percent of profits before taxes.

Company's annual contribution is allocated to employees' accounts in proportion to their own deposits for the year. But with the maximum annual deposit set at $750, higher paid executives are prevented from benefiting from the Company's contribution at the expense of lower paid employees.

Every Fund member receives an annual statement showing the number of shares of Sears stock in his or her account and the dollar value of the account's General Investments. Also, each year, members may instruct the Trustees of the Fund on how to vote their shares of Sears stock at the Company's annual meeting.

The Fund provides its members with full and immediate vesting. Upon withdrawal, shares of Sears stock are distributed in kind unless the members request payment in cash. General Investments always are paid in cash based on their current market value.

Other retirement plans

To supplement the Profit Sharing Plan, Sears also maintains a Pension Plan for its employees. The Pension Plan covers all full time employees and certain part time employees. Benefits are based both on service and final compensation and are tied to Social Security. The purpose of the Pension Plan is to provide retirees with a retirement income not dependent on the market values of securities. In addition, all employees are covered under Social Security.

We at Sears believe our retirement program gives employees balanced retirement benefits that equal or exceed similar programs of other employers in our industry.

Other stock ownership plans

Besides encouraging employees ownership of Sears stock through the Profit Sharing Fund, the Company, for more than 50 years, has encouraged direct ownership through a variety of stock purchase plans. In the past 25 years, we have issued more than 67,000 stock option contracts, granting employees the right to buy more than 32 million shares of our stock.

Let me add that our option contracts have not been limited to top management. They traditionally have been issued to most of our salaried employees. In 1980 for example, non-qualified option contracts were distributed to more than 18,000 salaried employees. Our thought has been that it is good both for the Company and for employees to have a large number of employees sharing an ownership stake in the Company—either through Profit Sharing, direct stock ownership, or both.

Value of employee stock ownership

We see great value for our employees and for the Company in the employee ownership of our stock.

Our Profit Sharing Fund has created literally tens of thousands of capitalists. Last year alone, over 14,000 employees withdrew almost 4.2 million shares of Sears stock from the Fund when their membership ended. Many of these shares went to persons retiring from the Company. They then became registered owners of their Sears stock. For most, this was the first time they had ever received a dividend check, and this became an important part of their retirement security. They were now also entitled to sell or otherwise dispose of the stock, if they so desire.

It is clear that our employees value the opportunity to become shareholders. Even in a year when the market value of Sears stock declined, withdrawing members took delivery of almost two shares of stock for each share they asked to be converted to cash as their employment ended. And we know that retirees maintain their attachment for the Company's stock. Altogether, we estimate approximately 40 million shares are owned by former employees—not including shares that have passed by gift and inheritance to later generations. In addition, present employees through Profit Sharing own approximately 70 million shares. Thus, past and present employees own approximately 110 million, or about one third of the Company's outstanding shares.

The Profit Sharing Fund is also of great value to the Company. While it is difficult to attribute significant business success or failure to any single factor or any single policy, much of our success has been due to the motivation which Sears stock ownership has provided for hundreds of thousands of our past and present employees. Stock ownership is another avenue through which our employees gain a direct economic stake in our enterprise, and they know that their labors can influence the rewards flowing to them—through changes in profits, dividends and stock price.

We are, as you know, the country's number one retailer. And we think it is significant that we also have had a policy of encouraging employee stock ownership longer than most other retailers.

Tax credit employee stock ownership plans

The presnet tax laws allow corporations an additional 1 percent investment tax credit on qualifying machinery and equipment if that amount is contributed to an Employee Stock Ownership Plan (ESOP). The law also allows an additional one half percent tax credit if the employee makes a matching contribution.

Sears has not set up a Tax Credit ESOP because the dollar incentive is so slight. The investment tax credit discriminates against retailers, and as a result the dollar amounts involved per employee are to small to justify the administrative costs of such a plan.

Retailers are labor intensive employers. The greater part of retailers' capital investments are in buildings, which are denied an investment tax credit under existing law. Accordingly, the amount of the allowable investment tax credit in relation to compensation is small. For example, last year if we were to have contributed the maximum additional 1½ percent investment tax credit to a Tax Credit ESOP covering the employees now in our Profit Sharing Fund, the most we could have allocated to any single employee would have been approximately $23.76. And even this small amount would have been considerably less for employees earning under $15,000 and for those who would not have elected to make the additional one half percent matching contribution.

In 1978, the maximum amount would have been approximately $19.33.

Obviously, these small amounts can't justify the administrative costs we would have to assume to start a Tax Credit ESOP based on present law.

For retailers, tax credits for ESOPs based on annual employee compensation would be a step in the right direction. It would provide the type of incentive retailers need to start or strengthen their stock ownership plans. It would provide the creditable incentive not found in present law to expand employees' ownership of their employer's stock, and give the employees the rewards of such stock ownership. Employer contributions could be made to new plans or through existing employee stock plans such as Sears Profit Sharing Fund.

Conclusion

Mr. Chairman, I would like to conclude by stating that we at Sears have always shared your view that broad employee stock ownership of American business is good for business, good for employees and good for our country.

Employe stock ownership plans expand individual stock ownership of American Business. They provide employees with incentives to increase productivity and thus help alleviate the effects of inflation. In turn, employees may benefit from the increased profitability of their employers.

Tax Credit ESOPs to date have only been effective for capital intensive businesses with large investment tax credits for machinery and equipment. They are not a major incentive for retailers. If the tax laws allowed a tax credit based on compensation for contributions to ESOPs, that would do much to encourage the expanded use of ESOPs by retailers and other labor intensive businesses.

Mr. Chairman, we agree with you that presently there are not enough capitalists. However, expansion and encouragement of ESOPs will help to make more of them.

Testimony of Robert L. Strickland
before the United States Senate
Committee on Finance

July 29, 1980

Summary of Principal Points:

1. *A January 1, 1981 tax cut is supported, to provide relief from "tax-flation" to individuals, and to provide increased depreciation and other supply-side tax measures to business.*

2. *U.S.A. still suffering from adversary relationships between management, employees, shareholders, and government; and Employee Stock Ownership can be a powerful solution.*

3. *Nineteen years of Lowe's Employee Stock Ownership proves that the concept motivates, creates incentive, creates growth, and creates wealth. (A historical prepared statement is provided as an appendix to today's testimony.)*

4. *Lowe's sales and earnings per employee are triple and double, respectively, the nation's "Big Three" retail companies.*

5. *Corporate taxes paid by Lowe's per average employee averaged $1,900 in four years before Employee Stock Ownership - averaged $3,900 most recent two years.*

6. *Senator Talmadge's bill on Employee Stock Ownership is supported - needed for the forthcoming reindustrialization of America.*

7. *Senator Long's bill on Employee Stock Ownership is supported - it will cause incremental growth of jobs and Employee Stock Ownership.*

Table of Contents

Mr. Chairman and Members of the Senate Finance Committee -- Good Morning!

My name is Robert L. Strickland, Chairman of Lowe's Companies, Inc. I thank you for this opportunity to be here.

First, I want to express vigorous support for the tax cut being considered by this Committee. I understand, Mr. Chairman, that the effective date you are working for is January 1, 1981, and in my view that is the exact date that the country needs one.

What is being conveniently overlooked by critics is that if we don't get a tax cut, we're going to have an effective tax increase in 1981!

This article from the Tax Foundation "Taxflation Wipes Out Pay Gains" (Exhibit 1) illustrates a $10,000 earner in 1979 who happened to get a 14 1/2% pay increase for 1980, but due to inflation, Federal Income and Social Security Tax increases, actually lost 1.7% in buying power!

So individual wage-earners are hurt badly by inflation, and so are corporations.

Price, Waterhouse released a study (Exhibit 2) that showed that 37 major retail corporations' income tax rate was 44% in 1979 using historical accounting. Under inflation-adjusted accounting, the effective tax rate was 74%! I believe inadequate depreciation is one of the big villains, and I know Senator Dole is supporting the 10-5-3 depreciation proposal. That and other supply-side tax cuts which Senator Roth has long been a proponent of would be very helpful in my judgment.

I want to express specific support for the two bills enhancing the Employee Stock Ownership movement, the one by you, Mr. Chairman, and the one by Senator Talmadge.

Mr. Chairman, the Washington Redskins are a team made up of three teams - offensive, defensive, and specialty. Those three teams have a shared goal - to win and be successful. When one considers four important forces in this country - employees, management, shareholders, and government - it's getting to be a national tragedy that instead of cooperation and teamwork towards accomplishing shared goals, we have developed adversary relationships that are getting increasingly shrill and acrimonious and non-productive.

Daniel Yankelovich, a leading authority on worker attitudes, in an article in Industry Week, August 6, 1979, states that "traditional incentives mean nothing to 44% of the work force." We aren't playing with a full team!

Robert Bleiberg, Editor of Barron's, wrote last July 4, about mounting "Conflicts between Shareholders and Management". (Exhibit 3)

Japan and OPEC are examples of how national and international teamwork can seize economic initiative and translate it into successful, competitive growth.

I believe, sir, that improved economic teamwork must be a priority national strategy, and that increased Employee Stock Ownership is a powerful tactic by which we can implement that strategy.

At the recent Annual Meeting of the National Investor Relations Institute, two influential institutional investors, Mr. George Roche, Vice President, T. Rowe Price of Baltimore, and Mr. Bruce R. Grier, Vice President, Morgan Guaranty Trust of New York, both expressed concern about separation of interests between management and shareholders large and small, and both view employee stock ownership very positively as a solution.

Mr. Chairman, I was privileged to testify before this Committee in 1978 in support of S3241, and I told the Senators about Lowe's 17 years of successful, productive employee stock ownership - that at Lowe's it was a fact, not a theory. And last November I testified before Senator Proxmire's Committee on the Chrysler bill, which I was delighted to support with its ESOP provision.

In the attempt to both save time today, and still provide full testimony regarding Lowe's historical success with employee stock ownership, I have included that extensive prepared statement as an appendix to the written statement submitted at this hearing.

Just to highlight some of the important happenings of Lowe's 19th year of employee stock ownership, our 6,000 employees now own 23% of the company. During the last 30 days, our stock has risen in price by $6 per share, for a gain per average employee in personal capital of $3,000!

Mr. Yankelovich's 44% who are not motivated were made up of two different groups: 17% are young, aggressive middle managers, and 27% are low income blue collar workers. At Lowe's, those are precisely the two groups that our ESOP helps motivate. Our young aggressive store managers check on their wealth every weekday by looking up Lowe's in the New York Stock Exchange listings. And our blue collar workers understand headlines like this when a "$125 Per Week Worker Retires Rich". (Exhibit 4) Thanks to Employee Stock Ownership.

And in every Annual Report we talk to all shareholders about Employee Stock Ownership - the new ESOP last year (Exhibit 5) and Motivation as the Fuel Supply of Productivity. (Exhibit 6)

Lowe's sales per employee last year were $155,000, almost three times that of the big three retailers, and our net earnings per employee were $4,300, about twice that of the big three.

Prior to employee stock ownership, our corporate income tax paid per average employee averaged about $1,900 each. During our last two fiscal years, our corporate income tax paid per average employee was $3,900 - more than double the old days.

Finally in our Annual Report, we were pleased to show the comparison between the growth of our cash dividends versus the growth of the Consumer Price Index. (Exhibit 7)

Senator Talmadge's bill would have been of great help to Lowe's employees in 1960 and 1961, when we were small and struggling to buy the stock for the employees from the estate of our founder. There will be, in the forthcoming reindustrialization of America, thousands of situations wherein Employee Stock Ownership will be enhanced by this bill.

And I strongly support Chairman Long's bill. Lowe's is not capital-intensive, but people intensive, and if the 1% of payroll tax credit provision and dividend deductibility becomes law, Lowe's will be able to do some things that we otherwise wouldn't. Our rough calculations of cash flow indicate that we could hire 1% more new workers that we otherwise would - 60 to 75 new job.

65-969 O - 80 - 7 (pt.3)

We'd build more stores, we'd do more business, and it would have a cumulative multiplier economic effect in these new communities.

Mr. Chairman, your bill could cause Lowe's management to change our current policies on our ESOP. Obviously, I've been thinking about some of them:

A. *We would have to consider issuing new shares to the ESOP - new stock - instead of cash to improve our cash flow, for growth and new capital.*

B. *We would have to consider passing through the dividend to our employee shareholders. The Honorable Louis Kelso has stated that the best ESOP communication in the world is to "give them long green" once a year. And, as a leader in the movement, we think other companies would take note of Lowe's actions, and perhaps do the same.*

Also, Senators, these two bills should give those of us who are interested in the ESOP movement nationally the ammunition with which to respond to Senator Stewart's challenge to us last month at our Association Annual Meeting - that it was time for the private sector to take the initiative in promoting employee stock ownership in corporate America. I agree with that and plan to do something about it.

Mr. Chairman, I'll close with a statement I made in a speech last August at the National Hardware Show. "In 1989, every person who has owned stock in American companies since 1979 is going to say, "God Bless America and God Bless Senator Russell Long and the United States Senate Finance Committee for their economic leadership in this country in the late '70's and early '80's."

Those were my feelings then, and they are even stronger today.

Respectfully submitted,

Robert L. Strickland

Robert L. Strickland

Exhibit 1:

MONTHLY TAX FEATURES

Volume 24, Number 6, June-July 1980

Tax Foundation, Inc.

1875 Connecticut Ave , N.W. ☐ Washington, D.C. 20009 ☐ 202-328-4500 ☐

Taxflation Wipes Out Pay Gains

U.S. workers are losing the battle against "taxflation"—even those rare persons lucky enough to get a pay hike equal to the projected 14 5 percent inflation rate for 1980, according to Tax Foundation economists

"Taxflation" is a term coined to describe what happens as inflationary pressures push workers into higher salary brackets which are in turn, subjected to higher tax rates. Among other things, this process brings the Federal government an unlegislated revenue boost each year. But while inflation may be filling the government's pockets, it is emptying the taxpayer's, according to the Foundation's researchers

Anyone who received a 14 5 percent pay boost for calendar year 1980 would, at first blush, seem to be at least staying even Not so, say Tax Foundation economists True, the $10,000-a-year family (married couple, one earner, two children) would have an annual salary of $11,450. a net "paper" gain of $1,450 But his Federal income tax would go up by $224 and his social security tax by $89, leaving him with only $10,202, a rise of $1,137 in after-tax income. At a 14 5 percent inflation rate, the 1980 dollar would be worth only 87 cents as compared to the 1979 dollar In 87-cent dollars, the $10,202 in 1980 would have the purchasing power of only $8,910 in 1979 dollars—a loss to inflation of $1,292 In sum, the losses due to higher taxes and inflation exceed this worker's salary increase by $155. His apparent gain translates to a net loss in purchasing power of 1 7 percent

(Continued on page 3)

Effect of a 14.5 Percent Increase in Income at Selected Levels, 1979 to 1980ᵃ

(Married couple, one earner, two children)

Adjusted gross income 1979	Adjusted gross income 1980	Change, 1979 to 1980: Before-tax income	After-tax incomeᵇ: Current dollars	After-tax incomeᵇ: 1979 dollars	Loss in 1980 purchasing power due to: Federal income tax	Social security tax	Inflation
$10,000	$11,450	+$1,450	+$1,137	-$ 155	$ 224	-$ 89	-$1 292
15,000	17,175	+ 2 175	+ 1 677	- 173	- 365	- 133	- 1,850
20,000	22,900	+ 2,900	+ 2 120	- 270	- 602	178	2 390
25,000	28,625	+ 3,625	+ 2,585	- 343	- 856	- 184	- 2 928
30 000	34 350	+ 4,350	+ 3,051	- 432	- 1 115	- 184	- 3 483
35,000	40,075	+ 5 075	+ 3 317	- 668	- 1 574	- 184	- 3 985
50,000	57,250	+ 7,250	+ 4,209	- 1,150	- 2 857	- 184	- 5,359

ᵃ14 5 percent is the currently projected rate of inflation in 1980
ᵇDeductions are made for Federal individual income tax and social security tax only
Source Tax Foundation computations based on Treasury Department data

Taxflation

(Continued from page 1)

Those earning at a comparatively high level fare no better, according to Foundation calculations The $35,000-a-year family (married couple, one earner, two children) would be making $40,075 before taxes with a 14 5 percent pay hike, an increase of $5,075 per year After taxes, in current dollars, this would shrink to $3,317, and in 1979 constant dollars it would actually represent a $668 decline in after-tax income, a loss of 2 4 percent in purchasing power Inflation would induce a decline in purchasing power of $3,985—while social security payroll deductions claimed another $184 and Federal income taxes took $1,574

None of the above calculations, according to Foundation economists, include the extra bite which would be taken from these earnings by state and local taxes Also, the 14 5 percent pay boost is admittedly unrealistic in the case of most U S earners According to a recent report by the Bureau of Labor Statistics, "median family weekly earnings from wage and salary employment rose by 8 percent between the first quarter of 1979 and 1980" Meanwhile, the President's Council on Wage and Price Stability continues to ask industry and labor to limit wage increases to between 7 5 and 9 5 percent per year

The table on page one gives income data for selected levels and the effect of a 14 5 percent increase on those earnings

Talking Business | with Westerfield of Price, Waterhouse

Inflation's Effect On Retailers

The impact of inflation on the retail business is not often studied in great detail. Price, Waterhouse & Company, one of the nation's leading accounting firms, decided to find out just how high costs are affecting retailers. It has just completed a study involving 37 major retailers — with some startling findings.

William U. Westerfield, chairman of Price, Waterhouse's retailing industry services group, supervised the study, which shows the effect of inflation on sales, income and dividends. The sampling included such retail giants as Sears, Roebuck & Company, the K mart Corporation, the J C. Penney Company, the F.W. Woolworth Company, Federated Department Stores, the Dayton Hudson Corporation, May Department Stores and others.

Mr. Westerfield, who is 49 years old, has been with Price, Waterhouse for 25 years and is considered one of the leading certified public accountants in retailing. Yesterday, he participated in the following discussion:

Q. What were the main findings of your study?

A. A very significant portion of the apparent success of the retailers we selected has been due to inflation. Taking into account the five years including the recent fiscal year ended Jan. 31, average growth rate in sales when adjusted for inflation shrank from 81 percent reported to 34 percent. Their average current-year income from continuing operations declined to 38 percent of the full amount they reported. Their return on net assets was reduced from an average of 17 percent in their reported financial statements to only 5 percent. And the average dividend

payout ratio was 268 percent of 1979's inflation-adjusted earnings.

•

Q. Did the study also show the actual tax rate retailers paid in inflation-adjusted dollars?

A. Yes. The annual effective income-tax rate when restated averaged 74 percent. This contrasts with an average 44 percent rate reported by retailers in the recent fiscal year. Thus, the real tax bite on the big retailers is much greater in terms of restated dollars than one would assume from the published figures.

•

Q. What is the significance of all this?

A. One aspect is that retailers in continuing to pay dividends in restated dollars seem to be going through a self-liquidating process. They are paying out more inflation-adjusted dollars than they are earning currently. They are paying income taxes in restated dollars equal to 74 percent of their income. The other aspect of the same findings is that the Government is taking more out of earnings than is left to operate the business and to pay dividends to shareholders. The main reason that so much is paid out in dividends in restated dollars is the large proportion of pretax earnings taken out by the taxing authorities.

•

Q. Aside from any changes in tax rates, what is the solution?

A. There is a measurement problem confronting retailers. Constant-dollar accounting is simply restating financial statements into units of the same purchasing power. Such restatement in constant dollars is necessary to make valid comparisons in periods of rapid inflation. But the Financial Accounting Standards Board has prescribed that the C.P.I. [Consumer Price Index] for all urban consumers is to be used for converting historical financial information into constant dollars. Some retailers, however, such as J.C. Penney and Federated Department Stores, consider the C.P.I. inappropriate and consider a more accurate measure the LIFO [last-in, first-out] inventory price index to report the impact of increasing merchandising costs. The LIFO method is used to match current costs against current revenues by adjusting costs for the effect of the current year's inflation.

•

Q. What is your own preference between C.P.I. and LIFO?

A. LIFO may not be an exact reflection of retailing but it is a closer reflection than the C.P.I.

•

Q. If so, why don't many more retailers go on the LIFO system?

A. A lot of them still don't use LIFO because they fear it will reduce their reported earnings and reduce the price-earnings multiple of their stock. Others are trying to sell their companies and are afraid that if they use LIFO the eventual purchase price will be affected. And still others who don't use it fear LIFO's so-called complexity.

Isadore Barmash

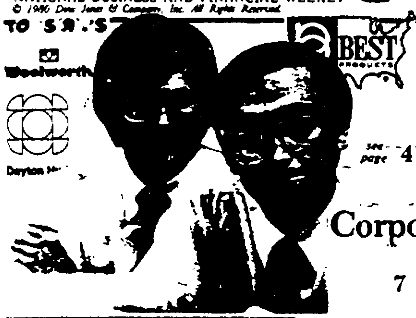
1158

Exhibit 2:

Exhibit 3:

BARRON'S

NATIONAL BUSINESS AND FINANCIAL WEEKLY — JULY 7, 1980 — ONE



Better Things in Store

see page 4

Two bargain-hunters—Kidder Pebodv's Dan Barry, Bob Simonson—turn bullish on quality retailers. Look for short recession, recovery in profit margins. Prefer growth companies like Jack Eckerd, Longs, Lowe's, Payless Cashways, Revco, Rite Aid, Standard Brands Paint, Toys 'R' Us. Woolworth also gets nod.

Corporation or Fiefdom?

7

Conflicts between shareholders, management mount on takeover bids. Onoo Capital turns down handsome premium; dissidents seeking control of United Canso fight restrictive young rule. SEC belatedly steps into Marshall Field suit. Good news, bad news for investors

—*Editorial Commentary*

"Great Train Robbery"?

9

Friends, foes clash over railroad deregulation. Despite uubity-inspired delays, measure moving toward passage. Coal-hauling carriers likely to benefit most

June Scoreboard

11

Interest sensitive, natural resource issues shared best gains. In curious market action, savings and loans, oils big winners. Lockheed heads list of losers

39 **Too Much Credit**

The surge in gold bodes ill for bonds

40 **Top of the World**

Singapore, Australia paced global bourses in first half

43 **Bringing Home the Bacon**

The trade sniffs a rise in pork bellies

UP & DOWN WALL STREET

By STEVEN S. ANREDER

PENNY FOR YOUR THOUGHTS? Whatever you do, don't treat the offer lightly. These days, it seems, pennies are rare commodities. At least hereabouts in the East, where a full-fledged shortage of the coppers has spurred merchants, bankers and now even the august authority of the local Federal Reserve Bank to implore people to empty their piggy banks lest commerce suffer.

Actually it's difficult to go along with the notion that people are hoarding. Not $1 billion pennies! Our guess is that since they buy very little these days—not even a serenade—and are worth even less, pennies have simply become pesky things to have around, and so folks have been tossing them away, perhaps into fountains. There's probably a lesson there for our national leaders and would-be replacements, but chances are they're so busy running for office, or a plane, they haven't time to notice.

Fact is that this will be a difficult summer and not just because the temperature is rising. The political climate, too, is heating up and as the opening salvos on the issues of taxes, grain embargo and the like suggest, the flak, as the gatherings in Detroit and New York draw near, is going to be hot and heavy. The stock market for the next few weeks will be preoccupied with such mundane considerations as second-quarter earnings, which are expected to range, by and large, from bad to terrible, and could give it reason for pause. But as the political debate rages, it's bound to affect the economic course of things, or surely people's perceptions of it.

The question, then, will not be whether or not investors believe the politicos. But, rather just how much politicking they can stand. In the meantime, there's this comforting thought: As measured by our good friends at *Investors Intelligence*, just under 31% of the advisory services surveyed last week were bullish, a low exceeded only once before since mid-April, when the upsurge got under way. The rest were more or less equally divided among the bears (the lowest since early March) or the undecided, which means either that they don't like what they see or that, in the case of the fence sitters, they're not brave enough to say so. Either way, it adds up to too much company, which most times is a good thing to shun.

• • •

AS WE were saying, June quarter earnings aren't going to make refreshing summer reading, since most companies will be hard put to come within range of let alone surpass, results in the like year-ago stretch. Most companies, that is, but obviously not

Continued on Page 31

EDITORIAL COMMENTARY

Corporation or Fiefdom?

Conflicts Between Shareholders, Management Mount

AS OUR Managing Editor likes to say when he's playing in Peoria, there are compensations to this line of work. But over to you, Alan. "Take, for example, a certain Friday in March 1973. The stock of a company called Equity Funding (which, it turned out, was completely bereft of either equity or funds) had been suspended from trading two days earlier. All week long, I had heard rumors that the concern, long touted in Wall Street as an innovative financial firm, had indeed demonstrated a certain creativity by putting bogus insurance policies on its books to simulate the illusion of growth.

"All through the day, we were on the phone. Little by little, we pieced the story together. By six that evening, I had the thing written—except for the final paragraph. That was reserved for Equity's rebuttal. (We have a firm policy at *Barron's* of allowing the condemned a final word.) We had one hell of a time, though, tracking anyone down at Equity. The chief executive wouldn't or couldn't come to the phone, and his aides-de-camp weren't available either. Finally, right on deadline, we flushed out some small game. A public relations man. He was dutifully informed that we had a story, that we were about to go to press with it, that we wanted a statement from the president or some other officer. I even prepared one for him. I remember reciting to him all the fraudulent practices that we had uncovered during the day.

"Okay, I asked, to say that the company flatly denies the charges? There was a pause—I think in Harold Robbins' novels, it's called a pregnant pause—and back came a weak and plaintive voice: 'Well, we deny it, but not flatly.'"

* * *

Since then a lot of water has gone out of the capitalization: after plunging into Chapter X, Equity Funding a few years ago emerged as an insurance holding company known as Orion Capital Corp. Phoenix-like, Orion Capital has enjoyed rapid growth, to the point where it recently caught the acquisitive eye of Shearson Loeb Rhoades, which made a series of tentative bids at well above market. Besides solid progress, the company today boasts a spokesman—Alan R. Gruber, chairman and president—who minces no words.

Orion Capital, he flatly told the suitor, is not for sale. Gruber proceeded to attack the proposal as "inappropriate" and the offering price as "grossly inadequate." He added: "The benefits which you suggest will flow from a merger are, in my judgment, inconsequential," citing the "dismal results" that had followed from a "costly and time-consuming" joint venture with Shearson Loeb Rhoades in life insurance. After weighing the offer for 48 hours or so, Gruber, backed unanimously by his board of directors, turned it down cold. Shares of Orion Capital Corp., which in happy anticipation had shot up from under ten to 16½ (Shearson's last offer, described as a "negotiating level," was a package of securities and cash valued at $20) sagged several points.

In the undeclared war between stockholders and management, as the foregoing affray suggests, what someone has dubbed "scorched earth" tactics remain operative policy. Last time we looked (*Barron's*, May 5, 1980), investors in Diamond International, Liggett Group and McGraw-Hill Inc. were locked in legal struggles of one kind or another with managements that had rejected tender offers at handsome premiums above previously prevailing prices. Since then there is good news and bad news to report. First the good news—after waging a bitter fight against the takeover, including soliciting a White Knight and making moves to strip itself of valuable assets, Liggett Group finally succumbed to an offer well above the original one. On the other hand, holders of Diamond International, which fought its suitor to an uneasy draw, fared less well, while those of McGraw-Hill are still on the outside looking in.

Lately the ranks of corporate victims have swelled. They now include, of course, the shareholders of Orion Capital Corp., who, however bright their long-range prospects may be, for the time being willy-nilly must settle for securities worth at least 25% less than they might have commanded. Depending on what happens when the votes are counted next week, the casualty list may or may not also include the owners of United Canso Oil & Gas Ltd., who, though free to pass judgment on a rival slate of officers and directors, in a move that would unseat the incumbents and might lead to merger, did so under corporate by-laws that severely—one tribunal has ruled illegally—restrict the right to vote. The takeover controversy has grown so fierce, indeed, that the Securities & Exchange Commission at long last has decided to take a hand. Specifically, in a case involving the abortive attempt by Carter Hawley Hale Stores to acquire Marshall Field & Co., a threat which management, at a cost to shareholders estimated at $200 million, successfully rebuffed, the SEC on Thursday filed a brief which challenges the ruling of the court in favor of the target company, and, in effect, supports the stand of the plaintiff-shareholders. Better late, we suppose, than never.

Up till now, in any case, the takeover disputes by and large have gone from start to finish without a sound from the federal watchdogs. In the litigious process, as noted, a number of stockholders have fared surprisingly well. Thus, instead of the $50 per share originally offered by Grand Metropolitan Holdings Ltd., Liggett Group, after some desperate maneuvers, including the controversial sale of one of its most profitable subsidiaries, finally agreed to a price of $69. In this affair—as in that of ERC, a reinsurance company which stubbornly persisted in fighting off a bid of $80-$90 by Connecticut General until it ultimately sold out to Getty Oil for $97—stockholders gained by management's bullheadedness. However, in other cases, notably that of Diamond International, the takeover story has had a less happy ending. Here management, in its determination to resist a bid of $45 per share (an offer which it denounced as "grossly inadequate") made a hasty acquisition of its own at a sizable premium and ultimately struck a compromise under which the bidder settled for a minority stake at $42 per share. On Friday, Diamond International closed at 37⅛.

Other companies, notably United Canso Oil & Gas Ltd. and Orion Capital Corp., lately have become embroiled in quarrels with shareholders. With respect to the former, a concern run for many years by the heirs of William F. Buckley (father of the noted columnist and of the former Senator from New York), a dissident group, consisting of U.S. and Canadian oil men, since last fall has been seeking to gain control. Among other things, it charges management with a lackluster record of operations, as well as with conflicts of interest stemming from its stakes in a number of other oil companies once controlled by the Catawba Corp., the Buckley family holding company.

Whatever the merits of the case—the legality of one transaction, involving a disputed royalty payment by United Canso to Catawba is currently in federal court, the presiding judge having turned down a motion to dismiss—the stockholders will have the final say; results of the recent vote count will be disclosed next week. However, they voted under corporate by-laws which limit individual holdings, for the purpose of the ballot, to no more than 1,000 shares, a ruling which presumably favors the incumbents. (Subject to final determination by the courts, the vote will be counted both ways.) One fact is beyond cavil. Win or lose, the Buckleys to date have retained control with a total interest of well under 1% of the outstanding stock.

As to Orion Capital Corp., management has proven nearly as ruthless in its use of "scorched earth" as the acknowledged leader in the field. Like McGraw-Hill, it made no bones about its contempt for the offerer as well as the offer. It sued shareholders who ran an advertisement urging the board of directors to "actively solicit merger or acquisition proposals," and has gone to court with another dissident. In an obvious effort to increase the number of shares outstanding, it made a hasty (and unsuccessful) bid to acquire Chase Convertible Fund of Boston. In the end, as noted, it lost no time in rejecting an offer clearly marked subject to negotiation. Yet here is another case where management—which, by the way, was originally appointed by the trustee for Equity Funding—apparently owns less than 1% of the stock. And the offer it so brusquely turned down was generous: well over book and market value, and a multiple which far exceeded that of most insurance companies. In rejecting Shearson's final offer, management said that it was "far below [Orion's] fair value." So's the $14 at which the stock was changing hands last week.

* * *

Far and away the worst case in point involves the hapless shareholders of Marshall Field & Co., which Carter Hawley Hale Stores, in late 1977 and early 1978, fruitlessly sought to take over. The episode triggered a class action suit against Marshall Field, which, though dismissed in U.S. District Court, is now pending in the Court of Appeals. Plaintiffs claim, among other things (and defendants deny), that various corporate actions, notably moves to acquire and build stores where they would compete with units of Carter Hawley Hale, were designed to trigger opposition from the federal trust-busters. The SEC, in turn, argues that the District Court, in dismissing plaintiffs' claim, undercut official strictures on full disclosure in takeovers. Be all that as it may, several facts are undisputed. Carter Hawley Hale Stores bid $42 per share for stock that last week sold at $16.50 and earlier this year got as low as $12.75. For the owners of the business, management has been no bargain.

—*Robert M. Bleiberg*

BARRON'S MAILBAG

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Ending Tonight

High, [illegible]; Low, [illegible]

The Charlotte Observer

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$125-A-Week Worker Retires Rich

Ferrell Bryant And Wife Still Unbelieving
. . . They Have A Garden, Raise Pigs

By CLYDE OSBORNE

SPARTA — Ferrell Bryant last December made his last delivery as a $125-a-week dock worker-truck driver for Lowe's, Inc. store here, returned to the store and was told that his net worth, exclusive of his week's wages, was $413,000.

It was the truth.

It hasn't sunk in fully on Bryant, or his wife, who still works as a domestic for a Sparta family, that they are wealthy.

Bryant, 47, has planted some corn on his 50-acre Alleghany County farm, is raising 11 pigs and a big garden "to have plenty to eat," and is generally relaxing after retiring from 20 years and four months of work with the 25-year-old hardware and building supply firm.

Bryant's bonanza came from Lowe's profit-sharing trust in which all employes may participate.

He was given a check for $213,000 and $200,000 worth of Lowe's stock figured at [illegible] a share on the over-the-counter market. On Friday the stock was selling at [illegible] a share, meaning that Bryant's stock is now worth around [illegible].

"I can't get used to the idea at all," said the pleasant, talkative, round-faced man.

"I had some fun when they handed me that check though. I took it to the bank. I asked for the cash. I was joking, of course. But I acted serious. And the teller, she looked at the check, and then she looked at me, then back at the check.

"Finally she said she didn't know if the bank had that much cash or not. She told me to see the manager," he grinned.

His wife, he says, just won't believe the bank balance.

"I put some in an account for her and told her to spend it. But she hasn't even spent the interest," he said.

Planning any trips, like to Nassau, or Europe?

"No. We haven't been anywhere, and we haven't really planned a trip. But we think we'll go to the Church of God convention in New York next summer," he replied.

"You know. The one thing I like about retirement is that I have time to go to

SEE TRUST Pg. 6A, C.1

Lowe's Profit Sharing made headlines in the Charlotte Observer.

Exhibit 4:

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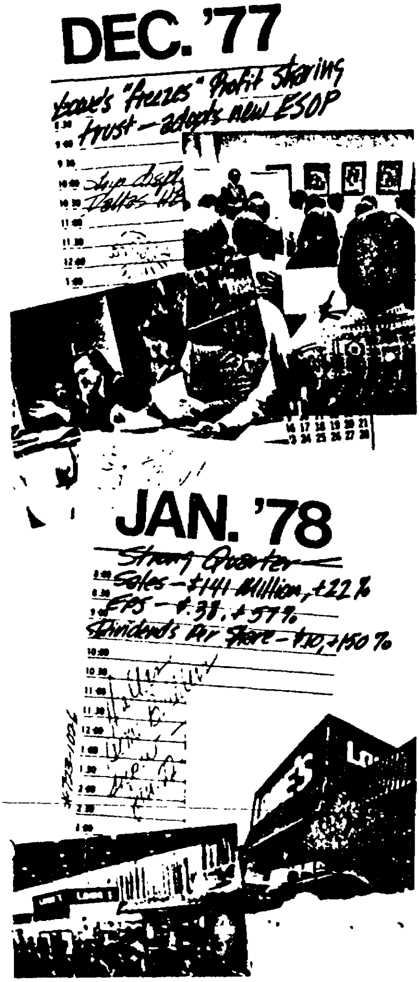
Exhibit 5:

President's Report *(continued)*



New Directions and Programs Lowe's New ESOP

On January 1, 1978, the almost legendary Lowe's Profit-Sharing Plan and Trust was succeeded by a new Employee Stock Ownership Plan. Why replace a plan that has been called "the most successful example of what employee ownership might achieve" by Louis Kelso, the noted San Francisco attorney often referred to as the "father" of the Employee Stock Ownership Trust? The answer—and the reason for a profit-sharing plan in the first place—is "motivation." Profit-Sharing plans are organizational incentives, and multi-motivational because of their unique ability to motivate and unite all participants contributing to corporate growth: employees, management, and stockholders. And, in order to sustain the highest level of motivation, it is necessary from time to time, to adapt and to update a company's profit-sharing plan. It was that time at Lowe's.

The most outstanding difference between Lowe's Profit-Sharing Plan and other profit-sharing plans has been the high incidence of Lowe's stock ownership in the Lowe's Plan. While other companies may have a portion of their total profit-sharing funds invested in their own stock, perhaps from 10% to 25%, Lowe's has had from 70% to 90% of the total profit-sharing fund balance comprised of Lowe's stock. And it is the performance of this stock since 1961, which has brought about those incredible success stories, such as the warehouseman who retired with $400,000.

The stock in the Trust was originally purchased in 1961 from the estate of Carl Buchan, Lowe's founder, in accordance with his wishes and estate plan. Shortly thereafter, a public offering of Lowe's common stock made Lowe's a public company. One additional small purchase of stock was made, but in 1971, a secondary offering of shares for liquidity purposes reduced the Lowe's stock in the Trust. Then, through the years as employees retired, taking with them their share of cash and stock, the amount of stock left in the Trust was further reduced. And as the company continued to grow at a phenomenal rate and the number of Lowe's employees increased accordingly, the average number of shares of stock per employee in the Trust had to diminish. Even so, the amount of Profit-Sharing Trust funds comprised of Lowe's stock was still about 80%, much higher than that of most companies. So it did not seem "prudent" to buy still more Lowe's stock for the Profit-Sharing Trust. The result was, that an average Plan member who had 5,000 shares of Lowe's stock in 1968, might have had only 1,000 shares in 1975.

This became a dual problem. Long-time employees were "demotivated" by the declining number of shares in their annual statements from the Trust. Also, newer employees felt that under these circumstances—growth of employees and decline of the number of shares of Lowe's stock in the Trust—

their financial future was decidedly less bright than that of people who had been with Lowe's in 1961. So we were faced with the choice of either hiring no more employees, thus stopping the growth of the company—no choice at all—or of replacing the Profit-Sharing Plan and Trust. Therefore the idea evolved to replace the Profit-Sharing Plan with an Employee Stock Ownership Plan. The Profit-Sharing Trust was not cancelled. Instead, each member was given several options as to how his balance would be held and invested until retirement. Further, after December 31, 1977, new employees will become members of the "ESOP," but not members of the Profit-Sharing Plan and Trust.

The ESOP's aim is specific to make each Lowe's employee a Lowe's stockholder and, as such, a part owner of Lowe's, the way the Profit-Sharing Plan had done in the 1960's The Employee Stock Ownership Plan's purpose, as set forth in the charter, is to provide for the purchase each year, of Lowe's stock by the Plan Trustee, for each Plan member according to the amount of the contribution made to the Plan in his behalf So, a two-fold objective was realized The erosion of stock shares in members' balances in the Profit-Sharing Trust was stopped through the freezing of membership in the old Plan. And secondly, the amount of stock per employee was again on the rise, through the purchase of new stock for the Employee Stock Ownership Plan.

After the membership freeze amendment, the amount of cash and stock shares held for each member in the Profit-Sharing Trust funds as of January 31, 1978 will remain unchanged except for dividends and income, and the entire amount will be his upon retirement We wanted the freezing of the Trust membership to be as beneficial as possible to each employee, so the concept of separate funds within the Trust was created Under this plan, each member had a choice of ten different ways to have his cash and stock held The ten different funds contain a stock/cash mix beginning with 100% cash, then going to 10% stock and 90% cash, and on up to 90% stock and 10% cash The employee response to this idea was highly favorable During the 1976 and 1977 annual meetings of the Profit-Sharing Plan and Trust Administrative Committee, a survey was taken of employee reaction to the various options contemplated for the Profit-Sharing Trust The survey in 1976 showed that the most popular fund choice was the one containing 80% stock and 20% cash, a real endorsement of the plan and of Lowe's stock in general But in 1977, the most popular fund choice was that containing 90% stock and 10% cash Enthusiasm for the idea had grown even more! A series of meetings was held in October and November of 1977, explaining to employees the change from the old Plan to the ESOP and the choice of funds in the Trust. Then forms were mailed out, allowing Plan members to select the fund in which they wished their portion of the Trust held The response was overwhelming 2,600 out of 3,300 members requested the 90% stock and 10% cash split The Trust held a total of 2 2 million shares as of December 31, 1977, and the Plan members' requests totaled 2.7 million shares! Consequently, as provided for in the option planning, the Lowe's stock shares had to be allocated proportionately among the funds. So, in effect, the Plan members said that there was not enough stock in the old Plan on December 31 to satisfy them, ***a real testimonial to their desire for Lowe's stock ownership, and to the decision to switch to the new Employee Stock Ownership Plan!***

Before the holding fund choices were offered or made, the interests in the Profit-Sharing Plan and Trust were registered with the Securities and Exchange Commission. Appropriate letters have been received from the SEC on the Employee Stock Ownership Plan. It is also currently under review by the Internal Revenue Service and management contemplates favorable action.

One of the benefits to employees from the ESOP, which the Profit-Sharing Plan did not offer, is a guaranteed contribution for each member, whether or not a profit was realized by his individual corporation Under the Profit-Sharing Plan, each separate corporation was required to make a profit for the year, before a Plan member would receive his contribution. For example, an employee of the mythical Lowe's of Denver, which did not show a profit in 1977, would receive no contribution to the Trust that year This was a decided hardship on those "trouble-shooter" employees who were often sent to a new store, to open it and get it on its feet, since new stores do not always show a profit in the first year of operation. No such problem exists with the ESOP. Under its charter, all members who are employees of Lowe's during the same Plan year will receive th. same percentage contribution.

The ESOP also has another optional benefit for the company as well as the individual plan member which the Profit-Sharing Plan did not. Under the ESOP charter, the Plan Trustee is, each year, given a certain amount of money to purchase Lowe's stock for Plan members on the open market. But the company is also allowed simply to issue a commensurate amount of stock directly to the Employee Stock Ownership Plan, rather than selling it at the market price less the brokerage commission. Consequently, the cash flow to the company would be the same as selling a new share of stock on the open market. And the Plan member would not have the amount of the brokerage fee deducted from this stock purchase. Our ESOP allows this process if and when company management thinks it prudent.

The employee response to the change in plans, to the fund choices in the Profit-Sharing Trust, and to the new Employee Stock Ownership Plan itself, as mentioned earlier, has been tremendous So, Lowe's history of phenomenal motivation goes on Now, we are set for our next fifteen and thirty years of growth—growth with its foundation in motivation of our employees. Lowe's most valuable asset does not appear on our balance sheet That asset is Lowe's people, who dedicate their time and talent to the company They entrust Lowe's with their loyalty and their careers, and through the ESOP, invest in a self-fulfilling future

Exhibit 6:

Motivation-the Fuel Supply of Productivity

When asked, as he often is, to name Lowe's most important asset, Chairman of the Board Robert L. Strickland invariably replies, "Lowe's people! Without their exceptional spirit and enthusiasm, Lowe's would be a very different company."

But, exactly what is it that makes Lowe's employees such a vital part of the company? Where do they get their motivation? It comes from a number of sources, but the one of most long range significance is Lowe's ESOP.

What is an ESOP? It's an Employee Stock Ownership Plan a means for employees to participate in the ownership of the company for which they work

Lowe's ESOP was adopted on January 1, 1978, to replace the company's Profit-Sharing Plan

By 1977, the Profit-Sharing Plan was not keeping up with the growth and needs of the company and the employees. One of its drawbacks was that an employee had to leave the company in order to gain any monetary benefit from his stock ownership And, not surprisingly many managerial people were doing just that, retiring long before they normally would have Another drawback was that employee shareholders were not treated in the same manner as were other shareholders because they could not individually vote their stock Most importantly, the percentage of employee stock ownership was dwindling, since the Trust was not actively buying stock Rather, it was dividing an ever-decreasing amount of stock by an ever-increasing number of employees As employees retired, taking with them their share of cash and stock, the amount of stock left in the Trust was continually diminishing Employee ownership had declined from about 48% in 1962 to about 17% in 1977

When the Profit-Sharing Trust was frozen members were given the option of receiving cash dividends from their profit-sharing stock and other income annually Since that time the managerial turnover rate has dropped drastically And, under the Employee Stock Ownership Plan employees can vote their stock and do

In creating the ESOP the Board of Directors decided against requiring matching funds from the employee, as do some ESOP companies. Subsequently, the Board has annually fixed the contribution rate at 15% of eligible compensation per year, the maximum allowed by law. This percentage is not fixed permanently, but it is subject to Board discretion

At the present time, there is another—though not well-known—benefit to being a member of Lowe's Employee Stock Ownership Plan Under the ESOP Lowe's employees are investors And to be a successful long-term investor, one must "buy right," that is, buy stock for the least amount possible

To many Lowe's employees, the present low price-earnings multiple of Lowe's stock represents a significant investment opportunity For example, a $3 200 ESOP contribution will buy 200 shares at $16.00, rather than only 100 at a price of $32.00 per share, which existed four years ago Since these employees have chosen to invest their careers in Lowe's, it's not surprising that they would take this enlightened long-term view of stock investment Obviously some shareholders who already own stock and intend to sell short-term would prefer a higher price But to those whose main concern is long-range growth in earnings and dividends that they have enjoyed in the past, temporary dips in price are viewed in the broader context of a drastically depressed market which will turn at some point in the future So there is a degree of common interest between the employee who invests both money and career in Lowe's and the non-employee shareholder who invests money alone Both groups are building for their futures.

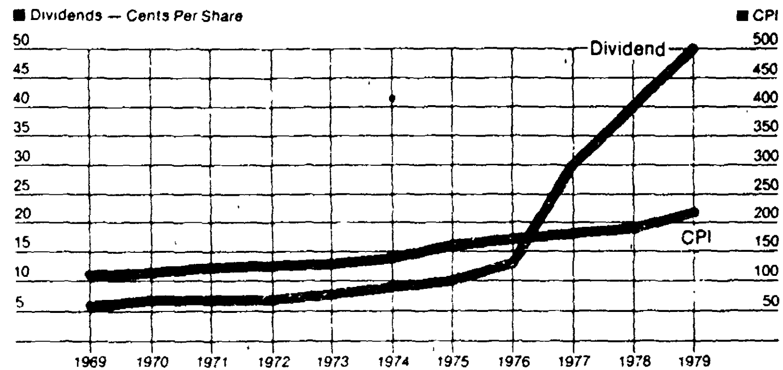
At the end of Fiscal 1979, the Employee Stock Ownership Plan was the sixth largest holder of Lowe's stock The Profit-Sharing Trust was still in first place Employees now own 20.5% of Lowe's Companies, Inc., which is a direct reversal of the declining employee ownership trend of the past few years Every employee should soon see the significance of this turnaround and the very real possibility of employee ownership of 51% of Lowe's in the future. As a motivational force what could be more important? As Personnel Director Ed Spears says, "Lowe's has always had a commitment to employee ownership The ESOP is just a more dramatic confirmation of this commitment"

Exhibit 7:

Lowe's Common Stock Dividend vs The Consumer Price Index

Year	Dividends Per Share	Consumer Price Index
1969	6¢	109.8
1970	7¢	116.3
1971	7¢	121.3
1972	7¢	125.3
1973	8¢	133.1
1974	9¢	147.7
1975	10¢	161.2
1976	13¢	170.5
1977	30¢	181.5
1978	40¢	195.4
1979	50¢	217.4

Lowe's Dividend 10-Yr. Compound Growth Rate 21.7%
CPI 10-Year Compound Growth Rate 6.5%



TESTIMONY

TO THE

UNITED STATES SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

MONDAY NOV. 19, 1979

WASHINGTON, D.C.

By

ROBERT L. STRICKLAND

Chairman of the Board

LOWE'S COMPANIES, INC.
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North Wilkesboro, N.C. 28656
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Table of Contents

Summary of Principal Points

1. *Lowe's Companies, Inc. strongly endorses value of Employee Stock Ownership.*

2. *18 years of Lowe's Employee Stock Ownership proves that the concept motivates, creates incentive, creates productivity, and creates economic growth.*

3. *Lowe's growth from 6 stores to 205, from $18,000,000 in sales to $900,000,000 inseparable from substantial Employee Stock Ownership.*

4. *Success of Lowe's and its employees publicized by FORTUNE, NEWSWEEK, and others.*

5. *Value of Employee Stock Ownership concept attested to by former and present Lowe's employees.*

6. *Lowe's experience cited by Louis O. Kelso, Esquire, widely considered as "Father" of Employee Stock Ownership concept, as "successful yardstick for all U. S. corporations to try to match."*

7. *Survey of benefits of Employee Stock Ownership for Stockholders who are not employees is cited.*

8. *Increased national Employee Stock Ownership is a powerful tactic to promote improved national economic teamwork and productivity.*

9. *Productivity measurements of sales and earnings per employee show Lowe's outstrips competition.*

10. *Lowe's expresses appreciation to Senator Proxmire and the Senate Committee on Banking, Housing, and Urban Affairs for their consideration of expansion of the Employee Stock Ownership concept.*

Mr. Chairman and Members of the Senate Banking Committee -- good morning.

My name is Robert L. Strickland, Chairman of Lowe's Companies, Inc. I welcome this opportunity to vigorously endorse the unique intrinsic value of Employee Stock Ownership.

I am a businessman who believes deeply in motivation and productivity, and through 18 years with Lowe's, I have watched employee stock ownership work, and work well! From salesmen to truck drivers, from secretaries to store managers, the motivation, productivity, and achievements of Lowe's employees are a matter of historical fact and documented public record.

Lowe's is a group of retail stores, selling building materials to home builders and home owners in the Southeastern quadrant of our nation, from Indiana to Pennsylvania to Florida to Texas, and with one-fourth our stores in North Carolina.

In 1957, when Lowe's had six stores doing about $18,000,000, I went to visit the company for a job interview. Carl Buchan, the founder and owner, took me to meet the local store manager. We walked into the warehouse and over to the damaged merchandise area. He asked the manager, "What is that?" "Why, its our damaged merchandise, sir." "Look at it more closely and tell me what you see." "Well, that's a damaged water pump, and a dented refrigerator, and windows with broken glass." Buchan said, "That's not what I see when I look over there - what I see is money - my money - because I paid for it - and before the year is out, we're going to have a plan whereby part of that will belong to you and the other employees, and then when you look you'll see money too, and you'll *take better care of your money than you're doing now, and consequently, you'll take better care of my money!"*

In July of 1957, Buchan did just that by establishing Lowe's Profit-Sharing Plan, with membership for every single Lowe's employee, and then subsequently he gave the Plan the option to buy his stock, periodically during his life, and the remainder upon his death.

He died in 1960, and in 1961, after financial settlement with his estate and a public stock offering, Lowe's employees, through the Profit-Sharing Plan, wound up with 48% ownership of the company's stock.

Lowe's employees have always been inspired by Buchan's vision, his desire for growth, and his pioneering commitment to employee stock ownership.

Today, those six stores have grown to 205 in 19 states. Our $18,000,000 annual sales volume has grown to $900,000,000. The stock, adjusted for splits and dividends, sold for $1.02 in 1961. It's trading now for about $18.00. Many of our employees became wealthy in the process, and the success of Lowe's employee stock ownership began making news.

FORTUNE magazine in 1972 quoted our former Chairman, "We are convinced that profit sharing (and its employee stock ownership) gives our employees a direct, personal self-interest in improving the company's earnings." FORTUNE went on to say "The bounty springs from the fund's portfolio, 90% of which is invested in Lowe's common stock." (Exhibit 1)

NEWSWEEK magazine in 1975 featured Charles Valentine, a $125 a week warehouseman, who retired after 17 years with $660,000 worth of Lowe's stock and cash. (Exhibit 2) NEWSWEEK said "90% of the money is invested in Lowe's stock - and that's the secret."

The CHARLOTTE OBSERVER headlined Ferrell Bryant, a truck driver who "Retired Rich." (Exhibit 3)

In Lowe's own report to employees, we featured Mrs. Mary Marsh, a secretary, (Exhibit 4) who stated, "because it is based on Lowe's stock, it's really an incentive to the employees to help make the company grow and prosper", and also our first six figure man, Mr. Spence Bumgarner (Exhibit 5) who worked for our lumber company subsidiary for 13 years. When he retired, his $150,000 fund balance was greater than the book value of the lumber company!

The Profit Sharing Research Council ran this Cover Story, "Why Lowe's Grows" and also featured a Store Manager, a Salesman, and a Warehouseman, all three of whom retired with balances ranging from $400,000 to $2,000,000. The store manager says "It wasn't until the Plan began buying Lowe's stock that we paid attention." (Exhibits 6, 7, 8, and 9) And we were delighted when in 1976 the Honorable Louis Kelso testified before the Senate Finance Committee and told the Lowe's story of employee stock ownership success. (Exhibit 10)

Mr. Kelso is the creator of the Employee Stock Ownership concept, and has said on many occasions that Lowe's Profit-Sharing Plan was in reality an Employee Stock Ownership Plan because 80 to 90% of the fund's assets were invested in company stock.

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Mr. Chairman, these success stories were created by:

A. *Employee Stock Ownership.*

B. *The motivation and productivity which was thereby created.*

C. *The growth in profitability which thereby ensued.*

D. *The increase in the price of Lowe's stock as Lowe's incentives and growth pattern were recognized by the stock market and financial community.*

But what about those shareholders who are not employees? Do they benefit from employee stock ownership? The evidence is a convincing "yes". Mr. Bert Metzger is President of the Profit Sharing Research Foundation, and his comprehensive study "Does Profit Sharing Pay" authoritatively details how all shareholders are served by employee stock ownership. I quote, "What we need today are organizational incentives - programs which can motivate all factors contributing to corporate growth-stockholders, management, and employees. Employee profit sharing (and stock ownership) is multimotivational because it focuses attention on a common goal and rewards all factors." And this has been Lowe's experience.

The charts in Exhibit 11 to this paper show that employees of profit sharing companies produced more profit per employee, more profit on sales and a higher return on shareholder equity. This resulted in higher earnings, higher dividends and higher market value per share for all shareholders, including employees. And Mr. Metzger's letter of July 5 (Exhibit 12) confirms that the high performance companies were heavily invested in their own company's stock.

Mr. Chairman, the Washington Redskins are a team made up of three teams - offensive, defensive, and specialty. Those three teams have a shared goal - to win and be successful. When one considers three important forces in this country - employees, management, and government - it's getting to be a national tragedy that instead of cooperation and teamwork towards accomplishing shared goals, we have developed adversary relationships that are getting increasingly shrill and acrimonious and non-productive. Japan and OPEC are examples of how national and international teamwork can seize economic initiative and translate it into successful, competitive growth.

I believe, sir, that improved economic teamwork must be a priority national strategy, and that increased Employee Stock Ownership is a powerful tactic by which we can implement that strategy.

Well, how do I know it works? Ho do I know that Lowe's growth wasn't influenced more by geography, or the business we're in, or management skill, etc.

In the late '50's and early '60's, there were at least five companies like ours in the Sunbelt - one in Virginia, one in South Carolina, and one in Florida, and two in North Carolina. Same geography, same business, different management of course, but not bad management. Three of the companies didn't make it on their own and sold out. The fourth company is about one-fourth our size, and they have just adopted an Employee Stock Ownership Plan. Survival of the motivated, and the productive.

We use several productivity measurements, and in our Annual Reports, we compare ourselves to major retailers and competitors in Sales per Employee, and Net Profit per Employee.

When our employee plan acquired the stock in 1961, it had a dramatic effect on both sales and profits. For the four years prior to the stock acquisition, sales per employee per year averaged $81,000 and net profits after taxes averaged $1,891 per employee per year. For the four years after the acquisition, sales declined, to an average of $73,000, but net profit per employee per year increased 19% to $2,245.

Senator Long, in a survey of ESOP companies, asked for a report of taxes paid before and after employee acquisition of stock. Taxes paid on average during these two four-year periods increased from an average of $1,893 per employee per year, to $2,278, for a 20% increase, or from $418,000 to $1,518,000.

The following table lists our progress in these important productivity measurements since then:

	Per Employee Per Year		
	Sales	Taxes Paid	Profits After Taxes
1966	$ 86,468	$2,801	$3,131
1971	$ 82,952	$3,128	$3,162
1976	$123,665	$4,555	$4,595

For 1978, although our Taxes and Profits figures are not directly comparable to our prior years, due to our change to LIFO accounting, they are comparable to, and were compared with, other major retailers in our Annual Report:

	Per Employee Per Year	
	Sales	Profits After Taxes
Sears	$ 40,000	$1,948
K-Mart	$ 48,900	$1,471
Penny	$ 48,500	$1,528
Wickes	$ 97,800	$1,973
Lowe's	$136,500	$4,084

(Sources of figures for other companies: Reprinted from the 1978 FORTUNE Directory by special permission. (c) 1978 TIME, INC.

To sum up the Revenue results of a small business that has grown fairly big, and plans to keep on growing, fueled by employee stock ownership; in 1960, we paid $641,000 in taxes - in 1979 we plan to pay $25,000,000 in taxes, and we look forward to remitting $50,000,000 in taxes, and our employees will own a larger percentage of the company than they do now.

Speaking for myself as an individual, I believe:

- *The time for renewed national teamwork is now.*
- *The time for vastly increased employee stock ownership is now.*
- *The time for Senator Riegle's bill is now.*

Mr. Chairman and Members of the Committee, Lowe's people believe in Employee Stock Ownership. We have seen it work to create incentive, productivity motivation, and wealth. We believe it is Creative Capitalism, and we are more firmly committed to the concept than ever before. We thank the Chairman and this Committee for your consideration to help make this great concept more important to this great country. Thank you, ladies and gentlemen.

Respectfully Submitted: Robert L. Strickland

Robert L. Strickland

RLS/lb

Exhibit 1:
Source: December, 1972 *FORTUNE*

FORTUNE

Lowe's Companies

Profit sharing can be profitable indeed if you work for Lowe's Companies of North Wilkesboro, North Carolina, a chain of eighty-six building-supply outlets in the South. Two store managers retired recently with $3 million apiece—believed to have been record payouts for any profit-sharing trust. Thirteen store managers, salesmen, warehousemen, and office workers who retired last year collected a total of $17,500,000. Says Lowe's Chairman **Edwin Duncan**: "We are convinced that profit sharing gives our employees a direct, personal self-interest in improving the company's earnings."

The bounty springs from the fund's portfolio, 90 percent of which is invested in Lowe's common stock. The stock has zoomed to thirty-five times its initial value since the company went public in 1961 (recent price: $56 per share). Although Lowe's has paid only $8 million into the fund, the rise in the stock has pushed the net assets to more than $161 million. Whether profit sharing is the cause or the effect, the company has increased earnings 24 percent a year for ten years, to $9 million on sales of $234,600,000 for the fiscal year ended last July. As for Duncan, who at sixty-seven has no immediate plans to retire, he would collect a mere $900,000 if he quit tomorrow. But then, he has worked for Lowe's only eleven years.

Exhibit 2:

Newsweek

BUSINESS AND FINANCE — March 31, 197[illegible]

PROFIT SHARING:

Lowe's Largesse

Charles Valentine never made more than $125 a week in his seventeen years as a warehouse laborer—yet he retired with at least $660,000. Jack A. Allen, a store manager, is 33 and thinks he may stop working in four years—with $900,000 to enjoy. And personnel manager Cecil Murray, retired at 50, can afford to lavish money on his hilltop mansion or spread it around when he goes to the racetrack, since his retirement nest egg came to $3.5 million.

The three men did not save, win or inherit their retirement fortunes, but they did share one break. All three went to work for the Lowe's Companies, Inc., of North Wilkesboro, N.C., a building-supply chain that claims to have the richest profit-sharing fund in the U.S. on a per-capita basis. More than 50 Lowe's employees have retired with an equity in six figures. Says Murray, one of a score of millionaires the program has produced: "When you work all your life and all of a sudden you don't have to work, it's fantastic." Valentine, the son of a tenant farmer, now owns a dairy farm, two cattle

Charles Valentine on his farm: 'I never believed it would happen'

farms and two houses. "I never believed it would happen," he says.

The sum that seems like a sudden windfall to Lowe's workers actually has accumulated over a period of fifteen years or more. The company, which runs 129 stores in sixteen Southern, mid-Atlantic and Midwest states, puts aside an amount equal to 15 per cent of an employee's salary each year on a store-by-store basis, if the store has met its profit goals; employees pay nothing into the fund. Ninety per cent of the money is invested in Lowe's stock—and that's the secret. The stock has performed spectacularly since it went public at $12.25 a share in 1961; allowing for splits the value of one share soared to about [illegible] in ten years. Even today, after the worst market shake-out in almost 40 years, the value of that initial share is still worth 25 times the offering price.

The profit-sharing fund is the biggest owner of Lowe's stock, and an employee may take his money and retire after fifteen years, regardless of age. The receipts are subject to regular and capital-gains taxes, which can be hefty, but there's still plenty left.

Stakes: The realization of what's at stake makes Lowe's 3,000 employees "profit-conscious and sales-conscious," according to Dwight E. Pardue, who administers the profit-sharing trust. "Quite frankly, we have the most dedicated employees in the world," he says, because "basically, they are working for themselves." Such incentive was the goal of H. Carl Buchan, Lowe's late co-founder, whose 889,180 shares of stock were sold to the fund at his death in 1960. Buchan had expanded Lowe's from a modest hardware business in North Wilkesboro into a modern, discount operation and figured the company would keep on growing if it were owned and controlled by those who built it. Buchan's faith has paid off. Lowe's sales have jumped from $119 million annually to $362 million over the past six years. Net earnings more than tripled during that time, from $4.6 million to $14.6 million. And Lowe's workers looked well-motivated indeed: profits per employee were two to three times better than those at a smoothly run pair of retailing giants, Sears and J.C. Penney.

—LYNN LANGWAY with JOSEPH B. CUMMING JR. in Atlanta

Intermittent Showers
Ending Tonight
High, 88; Low, 67
More Weather Data on Page 2A

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Ferrell Bryant And Wife Still Unbelieving
. . . They Have A Garden, Raise Pigs

$125-A-Week Worker Retires Rich

By CLYDE OSBORNE

SPARTA — Ferrell Bryant last December made his last delivery as a $125-a-week dock worker-truck driver for Lowe's, Inc. store here, returned to the store and was told that his net worth, exclusive of his week's wages, was $413,000.

It was the truth.

It hasn't sunk in fully on Bryant, or his wife, who still works as a domestic for a Sparta family, that they are wealthy.

Bryant, 47, has planted some corn on his 50-acre Allegheny County farm, is raising 11 pigs and a big garden "to have plenty to eat," and is generally relaxing after retiring from 20 years and four months of work with the 25-year-old hardware and building supply firm.

Bryant's bonanza came from Lowe's profit-sharing trust in which all employes may participate.

He was given a check for $213,000 and $200,000 worth of Lowe's stock figured at $38.75 a share on the over-the-counter market. On Friday the stock was selling at $60.25 a share, meaning that Bryant's stock is now worth around $350,000.

"I can't get used to the idea at all," said the pleasant, talkative, round-faced man.

"I had some fun when they handed me that check though. I took it to the bank. I asked for the cash. I was joking, of course. But I acted serious. And the teller, she looked at the check, and then she looked at me, then back at the check.

"Finally, she said she didn't know if the bank had that much cash or not. She told me to see the manager," he grinned.

His wife, he says, just won't believe the bank balance.

"I put some in an account for her and told her to spend it. But she hasn't even spent the interest," he said.

Planning any trips, like to Nassau, or Europe?

"No. We haven't been anywhere, and we haven't really planned a trip. But we think we'll go to the Church of God convention in New York next summer," he replied.

"You know. The one thing I like about retirement is that I have time to go to

SEE TRUST Pg. 9A, C.1

Lowe's Profit Sharing made headlines in the Charlotte Observer.

Exhibit 3:

Exhibit 4:
Source: Lowe's 1972 Profit-Sharing Annual Report

Mary Marsh... Profit Sharing the second time aound.

"You don't pay in any money. Then when you have to leave and you receive your profit sharing, you wonder, 'Do I deserve this?'" This is how Mary Marsh felt when, after 6½ years with Lowe's as a sales secretary, she left the company when she and her husband moved to Florida. Of course, she did deserve her profit sharing money, because, just like every Plan member, her efforts had helped make that profit possible. Lowe's management feels that it is in the true American entrepreneurial spirit that those who create profits should share in them. And that's why we have the profit sharing plan.

The Profit Sharing Plan was a big incentive for Mary to return to Lowe's when she moved back into the North Wilkesboro area from Florida. Now Mary is back at work as an executive secretary and is again participating in Lowe's Profit Sharing Plan.

Mary feels that the Profit Sharing Plan is really good because participation in the Plan does not cost the members anything. "And," "she continues, "because it is based on Lowe's stock, it helps keep you interested in the company. It's really an incentive to the employees to help make the company grow and prosper."

Exhibit 5:

Source: Lowe's 1972 Profit-Sharing Annual Report

Lowe's first six-figure man, Spence Bumgarner

"They worked up this thing several years ago — kept telling us what a good deal it was — but like a doubting Thomas, I didn't think it'd amount to anything. But it sure did!" Indeed it did! J. S. "Spence" Bumgarner worked at Buchan Lumber Company as a lumber grader for 13 years; when he retired his Profit Sharing amounted to $150,000 — more than the net worth of Buchan Lumber at that time! "I was surprised to death. I wasn't figuring on getting but 50%." Because Spence was 65 when he retired, he vested 100% (forfeited none) of his profit sharing. "I'd always heard it was better to be born lucky than rich, and that was one time I believed it!" Spence had also worked for the old Oak Furniture Company for 29 years as a lumber grader.

What's Spence doing with his money? Helping his children and fixing up his home. "He let it run down for 40 years," his wife said. "Now it's going to take some time building it back up." "Yes," added Spence, "and Lowe's and Buchan Lumber are getting a lot of that profit sharing money back."

Spence's plans for the future are variable; he gardens, keeps milk cows, and works around his place. "I may work me up a hobby. I've got some wood-working tools my family gave me." Whatever, we wish Spence and his wife many years of healthy, happy retirement. Spence expressed his gratitude to Lowe's emphatically, "Tell all of them I think Lowe's is the greatest!"

Exhibit 6:
Source: Profit-Sharing Council of America Monthly Bulletin

(Reprinted by special permission of
the Profit Sharing Council of America)

Exhibit 7:
Source: Profit-Sharing Council of America Monthly Bulletin

The Executive

James Fred Walters Jr., who retired from Lowe's in 1972 after managing several of their stores, joined them in 1953 straight out of the Army when they had only three stores.

"I was just out of service and looking for work and jobs were scarce. So, when I heard they were hiring — the store was just six months old then — I went down and applied."

He adds, not without some pride, "Within six months I was their leading salesman."

And, when he retired, he was the third oldest employee in point of time. His Profit Sharing fund was worth more than $2,000,000.

"When they first created the plan in 1957, many of us didn't realize what it was or what it would become. It had no significance. It wasn't until the plan began buying Lowe's stock and we saw its value multiply — almost seven times over — that we paid attention."

Walters has a clear-eyed view of what makes the plan so successful. "It's the people. It attracts good people and it keeps good people and it gives them the incentive to make good money and to make their own contribution. There's no finer place to work — even now."

Walters' windfall hasn't changed his life much. He moved back to his hometown of Asheville, North Carolina, where he first started with Lowe's, bought a new home, and it occupies most of his time now.

He also contacted a local bank and engaged a lawyer to help him manage his funds. But he'll probably go back into business on his own some day.

"I'm only 44. I've got some good years left."

Exhibit 8:
Source: Profit Sharing Council of America Monthly Bulletin

The White Collar Worker

Archie Hayes, like Walters, came straight out of service and into Lowe's. Unlike Walters, he stayed at the same store in his home town of Sparta, North Carolina, throughout his career with the giant merchandiser.

He began in 1956 as a salesman, and retired 15 years later as a millionaire. His fully vested account was worth that much in 1971.

Hayes is just 42 years old.

He was qualified for his salesman's job. In the Air Force he had been assigned to supplies and tech-order distribution, so he was familiar with merchandise. As a salesman, he handled Lowe's complete line of goods and services.

The huge payoff hasn't changed Hayes' lifestyle too much.

"We still live in the same house, and have no plans to move. I just consider it all financial security for my family."

Hayes has a daughter, 19, in college, and a son, 10, in grammar school.

He took his account partly in cash and partly in Lowe's stock, and, with it, has been investing in real estate and some stock speculation. And he's doing it without any outside advisors.

His wife's reaction to the whole thing? "She thinks it's unbelievable."

So do a few others.

Exhibit 9:
Source: Profit-Sharing Council of America Monthly Bulletin

The Blue Collar Worker

Ferrell Bryan is one of Lowe's earliest employees. He began with the firm in 1950 as a warehouse boy, and, when he retired 21 years later, the last 14 as a truck driver, he was almost half-a-millionaire.

His Profit Sharing account was worth $428,000. His top salary at Lowe's at retirement was $125 a week. He was then 47.

Bryan took his fund half in cash and half in Lowe's stock. The cash he invested in a small farm near Sparta, North Carolina, and in savings accounts, and the stock he kept is now worth considerably more. Just like Lowe's, it keeps growing.

Bryan's lifestyle made a definite change, from truck driver, at which he had a near-perfect record, to farmer. He keeps some cattle, and enough crops to feed the cattle and put food on the table.

He calls the Profit Sharing plan the "best thing that ever happened in my life." Even toward the end, he couldn't believe it.

"It wasn't until some of the other old timers started to leave, and collect their accounts, that I knew it was true."

His wife had trouble believing it, too. She refused to quit her job until he had collected his account and the money was in the bank.

Bryan is still one of Lowe's best customers. "Anything I need for the farm or the home I go into the store in town. I know I'm going to get my money's worth. They've got the best goods and services around."

He ought to know. He handled a lot of it.

Exhibit 10:
Source: Louis O. Kelso, Esquire

PRESS RELEASE

Washington, D.C.--Hold For Release Until Noon, Wednesday, March 31, 1976

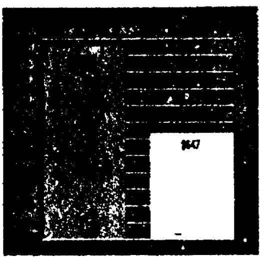
KELSO URGES SENATE TAX COMMITTEE TO MAKE AMERICAN WORKERS INTO MINI-CAPITALISTS

Louis O. Kelso testified before the Senate Finance Committee today on his proposals for restructuring the nation's tax laws to unharness America's underutilized manpower and technological potential, and to remove present tax barriers to new capital formation by making the ownership of new capital more accessible to American workers. To provide new incentives for saving capitalism and making it more relevant to our democratic ideals, Mr. Kelso called for Congress to establish as a national target for the remainder of the twentieth century the creation of opportunities for every worker, and eventually every consumer, to accumulate a tax-free capital estate of up to $500,000 over his working lifetime.

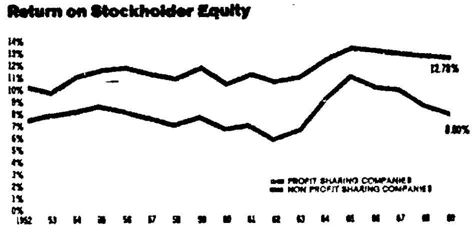
"What we are proposing is no less than the industrial counterpart to the Homestead Act", Kelso said. "Land is finite, but the potential for capital development is unlimited. Just as in 1862, when those Americans with limited means were given the chance to own and develop up to 160 acres of productive land, Americans should now be afforded the opportunity to become owners of significant holdings in our growing frontier of productive capital. By amending the nation's tax laws, we can begin to extend to every American a meaningful opportunity to carve out a personal stake in the multi-trillion dollar frontier of future capital formation."

As an example of what he hopes would be accomplished on a national scale, Kelso related the story of Lowe's Companies, Inc., a North Wilkesboro, North Carolina-based building-supply chain, where a warehouse laborer who never made more than $125 a week in the 17 years he worked for the company, retired with over $660,000 in Lowe's stock without having contributed a cent. Kelso acknowledged this as the most successful example of what employee ownership might achieve, but suggested it as a yardstick for all U.S. corporations to try to match.

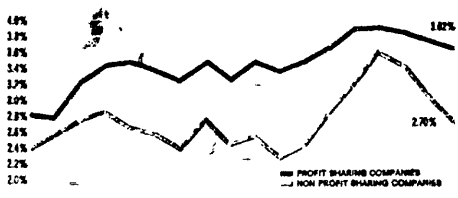
Exhibit 11:
Source: Lowe's 1971 Annual Report

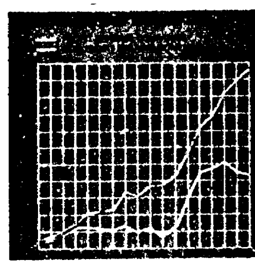


Return on Stockholder Equity

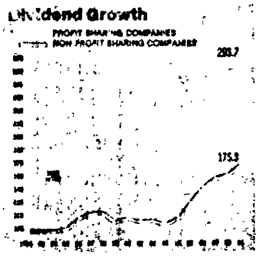


Net Profit on Sales





Dividend Growth



Market Price per Share

Exhibit 12:
Source: Bert L. Metzger, President Profit Sharing Research Foundation

PSRF

PROFIT SHARING RESEARCH FOUNDATION

1718 Sherman Avenue ■ Evanston, Illinois 60201 ■ (312) 869-8787

BERT L. METZGER, President

July 5, 1978

Mr. Henry Church
Lowe's Companies, Inc.
Box 1111
North Wilkesboro, N.C. 28656

Dear Henry:

As a follow up to your phone call the other day I am pleased to send you and Bob some information which may be helpful in preparing appropriate testimony on the value of profit sharing and employee stock ownership.

The following items warrant your attention:

1) Our 1971 study entitled Does Profit Sharing Pay? in which the 5 companies with broad coverage profit sharing programs outperformed by substantial and widening margins the companies without profit sharing. Not so incidentally, the 5 broad coverage programs were all heavily invested in own company stock.

2) "Performance" data on 38 large profit sharing companies is compared to Fortune medians reflecting return on sales and equity. This information appears under the heading "Evidence of Superior Performance" in Vol. II of Profit Sharing in 38 Large Companies for the years 1973--1976 inclusive.

3) The prevalence and growth of profit sharing and ESOP plans--ie., current trends toward defined contribution plans, profit sharing programs and ESOPs.

4) Prevalence and extent of own company stock holdings among the 38 large profit sharing trusts. Thirty-six out of 38 invested their profit sharing funds to some extent in own company stock; 17 of 38 had from 60--100% of their portfolios in own company stock. Altogether $5.9 billion out of $9.9 billion (60%) was invested in own company stock by these 38 trusts at the end of 1976.

5) Over one million employees have a "piece of the action" through these 38 profit sharing programs.

6) The financial benefits for long-term participants under these profit sharing/share ownership programs exceeded typical pension benefits by modest-to-substantial margins in almost all cases. Twenty-seven out of the 33 companies who provided such data (82%) generated benefits under their profit sharing programs which ranged from 112% to 1011% of

the "pension standard."

You might also want to check the recent survey of ESOPs undertaken by five graduate U.C.L.A. students under the auspices of the ESOP Council of America.

I do hope that Bob will not focus in too narrowly on ESOPs as the only road to broad employee stock ownership.

Most ESOPs are funded by company contributions geared to corporate performance and, therefore, are "profit sharing" ESOPs. In addition, there is only a very thin line between an ESOP and an EPSOP. The latter is an Employee Profit Sharing and Ownership Plan. I would consider Lowe's former profit sharing program and Hallmark Cards current profit sharing program to be EPSOPs. Most of the programs in Does Profit Sharing Pay? and Profit Sharing in 38 Large Companies could also be described as EPSOPs. If a profit sharing program specifically designates that up to a certain percentage of the portfolio (eg. 25%, 50% or 100%) can be invested in own company stock, we have an EPSOP. Own company stock is consonant with the nature of such a trust and Congress, it seems, should bestow like tax incentives on EPSOPs as on ESOPs.

Bob Midkiff covers this point nicely in his article on "Helping Workers to Become Owners " in our PSRF booklet, New Horizons for Capitalism.

We hope this letter and enclosures prove useful. If we can help further or answer any questions, please don't hestitate to call on us.

Best regards,

Bert

President

BIM:mm
cc: Robert Strickland

STATEMENT OF RONALD L. LUDWIG, LUDWIG & BUSHMAN LAW CORP., SAN FRANCISCO, CHAIRMAN, LEGAL ADVISORY COMMITTEE, THE ESOP ASSOCIATION OF AMERICA

SUMMARY OF RECOMMENDATIONS

1. Encourage 100 percent employee ownership of companies by modifying present limitations on ESOP contributions.
2. Approve other special provisions applicable to ESOPs which won all, or substantially all, of the stock of the employer.
3. Modify TRASOP provisions to eliminate 84-month rule in the case of a sale of a subsidiary or division.
4. Make permanent the additional investment tax credits available for TRASOP contributions.
5. Allow alternative 1 percent of payroll tax credit for TRASOP contributions.
6. Allow deduction for dividends on ESOP stock which are "passed-through" to employees.
7. Allow charitable deduction treatment for donations of stock to an ESOP by a shareholder.
8. Allow employer a tax deduction for making the "matching" TRASOP contribution for employees.
9. Allow for the purchase of nonvoting common stock from a shareholder by a leveraged ESOP.
10. Exclude contributions applied to interest payments on an ESOP loan from the present deduction and allocation limits.
11. Delete Code Section 401(a)(22), which requires a limited pass-through of voting rights to ESOP participants.
12. Allow for tax-free "rollover" of proceeds of sale of stock to ESOP into other small business stock.

STATEMENT

Mr. Chairman, it is a sincere pleasure for me to appear today before the Committee to testify in favor of legislation which, if attached to any major tax legislation which is enacted this year, could have a significant impact on the growth and development of Employee Stock Ownership Plans in the United States. I am a practicing lawyer in San Francisco and also serve as the Chairman of the Legal Advisory Committee of The ESOP Association of America. The Association is a nonprofit organization of companies which have adopted some form of employee stock ownership plan, including ESOPs and TRASOPs, for the benefit of their employees. We sincerely appreciate the past efforts which the members of this Committee have made to broaden stock ownership among employees.

Members of The ESOP Association of America, like all American businessmen, are very concerned about our declining National productivity. Clearly, something must be done to reverse a trend which has resulted in the United States having the lowest productivity gains of any industrial country in the western world during the decade 1967-77 and which has given American business a negative productivity growth during the past eighteen months. As we understand it, many of the tax proposals for this legislation will be aimed at increasing our capital investment, capital formation, and productivity.

Studies have indicated that, when employees become owners in a company, their commitment to make the company succeed increases dramatically. For example, a study done among the plywood companies in the northwestern part of the United States reflected that employee-owned plywood companies had significantly greater productivity and profitability then nonemployee-owned plywood companies. In addition, the Survey Research Center of the University of Michigan found that employee-owned companies are 150 percent more profitable than their nonemployee-owned counterparts. Finally, during this Congress, this Committee itself has conducted a survey among companies which have established ESOPs for their employees. That survey, which was answered by 72 such companies, produced results which we believe are significant. For example, these companies indicated that in the average three-year period following the establishment of the ESOP, as compared to an average twenty-four year pre-ESOP corporate existence, they experienced a 72 percent increase in sales per employee, had a 158 percent increase in corporate pretax profits, and paid 150 percent more in Federal income taxes.

If there has been a weakness in the development of ESOPs, it has been that in too many situations the employees do not own a sufficient amount of stock in their company to really appreciate the benefits of ownership. The Survey Research Center concluded that the motivational and productivity impact such a program has upon employees varies directly with the percentage of ownership they have in their company. What we are proposing is that this Committee and this Congress look for ways to increase the actual ownership share that employees have in their companies as well as ways in which to encourage more employers to provide stock ownership for their employees. A Bill introduced by Senator Talmadge last week (S. 2953) is a tremendous step forward in this regard. That Bill contains proposed amendments to the Internal Revenue Code which, if enacted, would create a strong incentive for employers to allow their employees to acquire all, or substantially all, of the stock in the company. Such an action would produce landmark results by removing obstacles which have prevented such employee purchases.

For example, one of the major problems which employees have had in trying to purchase a major ownership interest in their company has been the fact that ESOPs have been traditionally lumped together with other employee benefit plans under the Internal Revenue Code. To encourage employers to adopt and maintain plans to provide a retirement income for their employees, the Internal Revenue Code provides a tax deduction for an employer which funds such a plan. However, to assure that an employer will not use a tax incentive like this as a way of significantly reducing its Federal income taxes and simply providing a benefit for a limited number of high salaried people, the Code also imposes strict limitations on how much of a tax deduction can be available to an employer in any year for contributions to such plans and how much these contributions can benefit any individual employee. In the traditional pension plan, profit sharing plan or stock bonus plan, these limitations may have some justification.

However, when employees are attempting to buy total ownership of their company through an ESOP, these limitations have a debilitating effect.

For example, the Code provides that an employer may not contribute, on a tax deductible basis, more than 25 percent of the total wages and salaries of all employees covered under all qualified employee plans maintained by that employer. At the same time, the Code provides that not more than 25 percent of the employee's compensation may be allocated to his accounts under all defined contribution plans maintained by the employer. However, when these limitations are applied to an ESOP through which the employees are trying to buy complete ownership of the company, they can totally preclude such a transaction. This is because the amount of money which the employees can borrow through an ESOP is a directly dependent upon the length of time over which a lender will make money available to the ESOP and the speed at which the money can be repaid. Since the value of many companies is in excess of the total wages and salaries paid to its employees, a provision which limits the employer's ability to contribute to the plan to 25 percent of the wages and salaries paid to its employees is clearly a severe limitation. When this is compounded by the fact that this 25 percent limit applies to the ESOP and other plans maintained by the employer, it literally makes it impossible for the employees to buy the company. The same would be true with respect to the limitation on allocations to any employee's account under these plans. If it is ever to be possible for employees to purchase 100 percent of the stock in their employer, some relief has to be created. The provisions in Senator Talmadge's Bill simply provide that, if an ESOP is being used to acquire all or substantially all of the company as part of the traditional leveraged ESOP, then the employer contribution to the plan which can be made on a tax deductible basis, and the amount allocated to each employee's account under the ESOP, can equal 25 percent of the total pay of all covered employees irrespective of whether or not the employer maintains any other qualified plans.

Senator Talmadge's Bill also proposes that, when employees own all or substantially all of the company, the determination of the fair market value of the company should be based upon its actual book value rather than under a system of determining the value of such stock by comparing it to stock of allegedly comparable but truly unrelated publicly traded companies. One of the major reasons for promoting the growth of employee ownership is to stimulate employee motivation and productivity by making them owners. This becomes completely self-defeating when employees are told that their efforts can have a major impact on the value and profitability of the company and then in reality its value is determined by reference to companies which are unrelated and which are subject to the tremendous fluctuations in stock value in the public market. For an employee to learn that the assets and profits of his company are increasing each year and then to be advised that, because the value of his company is based upon the value of comparable publicly traded companies, especially when the value of these companies is down because the institutions buying the stock on a public market do not consider it to be a "glamorous" issue at that time, removes any motivational incentive for the employees. It would be far better in this situation if the determination of the value of that company can be based upon its own balance sheet net worth.

The process of valuing the stockd of closely held companies has specifically been recognized by the Internal Revenue Service as a "exercise in prophesy." In addition, the Department of Labor has stated that the valuation of closely held companies is "at best, a delicate art." What these Federal agencies are really saying is that there may be no effective way of determining the value of closely held stock set forth under any Federal regulations. The use of book value in the situation of a 100 percent ESOP-owned company would provide some degree of certainty for employees, would clearly make the value of the company dependent upon their efforts and the results their efforts have on the company, and would remove from these companies the high expenses which currently are required to hire a third party appraiser to utilize its prophetic abilities in what is most clearly a delicate art.

Also, Senator Talmadge's Bill would remove a requirement which has frustrated all employers which have adopted ESOPs for their employees. In the Internal Revenue Code, as a trade-off for the tax deduction which is provided for employer contributions to qualified plans and the tax-deferred treatment of employee benefits, there is a provision which imposes tax liability on these employees immediately upon receiving distribution of such benefits. This means that any employee who receives a distribution of stock from an ESOP, unless he is independently wealthy and able to pay the taxes due on the amount of his distribution, must sell the stock in order to pay his tax liability. In recognition of this anomoly, in the Revenue Act of 1978 the Treasury Department agreed to permit ESOPs to distribute a participant's benefits to him in cash, provided that the distribution may, if the employee demands, be made in stock. While this concession was at least a partial solution to a continuing problem, it still does not totally alleviate it. For an employer to issue a stock certificate, then issue a check to repurchase the stock certificate, and then cancel the stock certificate, can be an extremely costly expenditure. The reality is that almost every employee of a closely-held company will elect to receive cash rather than stock, and that those employees who elect to receive the stock almost immediately request that the stock be repurchased so that they will have sufficient cash to pay the taxes due on the distribution and have money to spend. It is important to remember that we are now referring to stock which is closely held and that there is no other market for stock. It would be far better to provide, as Senator Talmadge's Bill does, that if the employees (through the ESOP) own all, or substantially all, of the stock of the company, the benefits of all participants from the ESOP will be distributable in cash.

An additional factor must be recognized. This would only apply in a case of a totally employee-owned company. If the employees are to own all the company, then the stock should continue to remain held for the benefit of current employees rather than being distributed out to former employees or their beneficiaries. In such a case, the distributees will have no continuing interest in the success of the company and will have no input on its future economic status. Also, new employees who join the company should have access to stock ownership, and this could be provided by the stock which was in the account of a terminated participant and which remained in the plan when his benefit was distributed to him in cash.

Finally, Senator Talmadge's Bill proposes that a continuing problem for companies which have TRASOPs be resolved. There are now approximately 1000 TRASOPs in the United States. Most of these have been adopted by the large, capital intensive corporations. These corporations have numerous subsidiaries and divisions. In any economic climate, a constant series of acquisitions and divestitures of subsidiaries and divisions occurs. This has created a significant problem for employers which have adopted TRASOPs and which have extended the benefit of stock ownership to the employees of their subsidiaries and divisions.

When a subsidiary or division is sold, the employees are no longer the direct or indirect employees of the corporation which established the TRASOP and whose stock is used to fund the TRASCP.

They became totally unrelated as a result of the sale. However, when Congress created the TRASOP in 1975, there was a recognized desire to encourage employees to remain shareholders. Accordingly, a rule was established which said that an employee's benefit may not be distributed to him from TRASOP until 84 months have passed from the date the stock was allocated to his account. Although certain exceptions were created to this rule (such as actual separation from service), the sale of a division or subsidiary was not one of them. We believe that the Administration will agree that such a situation was simply not considered at the time the 84-month rule was adopted. It would be far better to permit an employee's TRASOP benefit to be distributed to him, irrespective of this 84 month rule, if the division or subsidiary for which he works is sold by the parent corporation, even if he continues his employment. At that point, he would simple be a shareholder like any other shareholder and the stock should be his to do with what he pleases.

The ESOP Association believes very strongly that (with the exception of the provision relating to TRASOPs) the other provisions in S. 2953 will have a major impact on the ability of employees to acquire an ownership interest in their companies. The TRASOP provision would clear up a technical problem which, if left unattended, will reduce the willingness of corporations to establish TRASOPs and permit employees of various divisions and subsidiaries to participate in them. None of these proposals is a "get-rich-quick" scheme. None of these proposals would work to the negative benefit of employees, since if they own all, or substantially of the stock of the company, they are the company. The possible conflict between the interests of the shareholders and the interests of the employees will simply not exist, because the same people make up both groups. In each case, we are stimulating the ability of employees to become major beneficial shareholders of their employer. For these reasons, we strongly urge the Committee to give serious consideration to the provisions of S. 2953 and to include them in any tax legislation which is enacted this year.

In addition to the provisions of S. 2953, we also encourage the Committee to act favorably upon other ESOP provisions which have been included in legislation previously introduced by the Chairman and other Senators. Some of these provisions are merely "technical" amendments to the Internal Revenue Code, intended to correct certain ESOP and TRASOP problems created under tax legislation over the past five years. Other provisions would provide additional tax incentives for companies to provide meaningful stock ownership benefits for their employees, while at the time same addressing the important issues of capital formation and employee productivity.

The "experiment" with TRASOPs since 1975 has proved to be most successful. The 1978 Revenue Act for the first time included the TRASOP as a permanent part of the Internal Revenue Code, but the additional investment tax credits available for TRASOP contributions are scheduled to expire at the end of 1983. We strongly recommend that Code Section 46(a)(2)(E) be amended to provide for permanence of the TRASOP credits.

At the same time, it is clear that the availability of TRASOPs is largely limited to larger, capital-intensive corporations. Millions of employees are being denied the opportunity of sharing in stock ownership benefits because their employers do not generate sufficient investment tax credits to make the TRASOP attractive. For this reason, we strongly recommend to the Committee that it take action to approve the concept of the "labor intensive" TRASOP which was first introduced in proposed legislation by the Chairman in 1978. Under this proposal, a tax credit equal to 1 percent of covered payroll would be available for TRASOP contributions as an alternative to the present additional 1 percent and one-half percent investment tax credits. This alternative TRASOP, if enacted, would certainly result in a significant increase in the number of TRASOPs and the number of employees benefiting from the TRASOP provisions.

We also recommend one additional modification to the present TRASOP provisions, relating to the extra one-half percent credit available when employee matching contributions are made. The present Code provisions create excessive administrative burdens and costs to employers which collect the employees contributions. It is often difficult to "match up" the amount of employee contributions to the amount of the extra investment tax credit. We suggest that the Code be amended to permit the employer to make a tax deductible contribution to the TRASOP to match the additional one-half percent credit contributions, thereby eliminating the need for collecting employee contributions We believe that many employers would take advantage of such an alternative in order to provide for more meaningful TRASOP participation by all employees.

With regard to ESOPs and leveraged ESOPs, there are a number of additional tax incentives which have been proposed as a means of further encouraging substantial "ownership sharing" for employees. We recommend that the Committee approve the Chairman's proposal to allow a corporate tax deduction for dividends paid on ESOP-held stock, so long as such dividends are "passed-through" to participating employees. This would provide a tax incentive for giving employees the same right to share currently in dividend income as is provided to direct shareholders, thus making the ESOP more meaningful to employees. This provision would not appear to have a major impact on tax revenues, as the employees would be currently taxable on those amounts which are deductible by the employer.

We also encourage the Committee to act favorably upon the Chairman's proposal to allow a "charitable" deduction (for income, estate and gift tax purposes) for a donation of stock to an ESOP by a shareholder. This provision would encourage wealthy individuals to provide additional stock to employees as an alternative to contributions to private foundations or other charitable institutions, thereby insuring that such assets will remain in private ownership, with the income thereon ultimately being subject to taxation.

Several months ago, Senator Stewart introduced S. 2677, a bill which would provide an incentive for small business owners to sell their stock to an ESOP for the benefit of employees. The bill would allow for a tax-free "rollover" of the sale proceeds into stock of other small businesses. Such treatment would encourage employee ownership as an alternative to a takeover by another corporation. It would also encourage future investments in business to assist in the creation of accelerated capital growth. We strongly recommend the inclusion of this proposed provision in tax legislation this year.

The 1978 Revenue Act and the 1979 Technical Correction Act modified the definition of "employer securities" for purposes of leveraged ESOPs. Under the present Code provisions, nonvoting common stock of a closely-held corporation is generally prohibited in connection with an ESOP loan transaction. In a number of situations, the only stock available for purchase by an ESOP is nonvoting common stock held by a shareholder of the employer. It is unfortunate that present law would not now permit the ESOP to leverage the purchase of that stock, thereby denying ESOP participants the opportunity to share in the ownership and growth attributable to that stock. We recommend that Section 409A(1) of the Code be amended to permit an ESOP to acquire nonvoting common stock of a closely-held corporation from a shareholder through the use of an ESOP loan.

The 1978 Revenue Act included provisions which require the pass-through of voting rights to ESOP participants in certain situations. Although we believe that voting rights for employees may be desirable, this requirement under the law has had a "chilling effect" on the establishment of ESOPs. This Committee has previously reported out H.R. 1212 (in December, 1979) and H.R. 2492 (in May, 1980), a bill which includes a deletion of Section 401(a)(22) from the Internal Revenue Code. We urge the Chairman and the Committee to take efforts to see that this provision is enacted at the earliest possible date.

In connection with leveraged ESOPs, we recommend that the Committee consider amending the provisions of Code Section 404(a) and 415(c) to modify the limitations on ESOP contributions which are applied to the payments on an ESOP loan. Specifically, we suggest that employer contributions which are used by the ESOP repay interest on a loan be tax deductible in addition to the normal limitations on deductions, and that such contributions not be treated as "annual additions" for purposes of the individual allocation limits applicable to ESOPs. These amendments would further encourage companies to utilize ESOP financing of capital growth, while providing stock ownership interests for employees.

We certainly recognize the outstanding efforts of the Chairman and the other members of the Committee in creating tax incentives to encourage employee ownership. We believe that the ESOP concept, as strengthened through legislation over the past seven years, has proved to be an important factor in the areas of employee benefits and corporate finance. It is now time, however, to provide more meaningful incentives in order to further expand employee ownership of American business. We are convinced that the use of ESOPs will strengthen our economy, will aid in the creation of new capital and will enhance the productivity of corporations and their employees. Our Association strongly supports the proposals for new ESOP legislation which we have discussed and urges the Committee to include meaningful ESOP incentives in this year's tax legislation.

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July 16, 1980

MEMORANDUM

TO: The Honorable Russell B. Long, Chairman
U.S. Senate Committee on Finance

FROM: Ronald L. Ludwig
Chairman, Legal Advisory Committee
The ESOP Association of America

RE: GAO Report HRD-80-88 (6/20/80)
"Employee Stock Ownership Plans:
Who Benefits Most In
Closely-Held Companies"

We have reviewed the recent GAO report on Employee Stock Ownership Plans (ESOPs) and are presenting these comments as a critique of that report. The overall "tone" of the report is quite negative with respect to the operation of ESOPs in certain closely-held companies. It largely focuses on "problems" and appears to disregard both the positive aspects of ESOPs and the benefits actually being provided to participating employees. The following specific items are noted in response to the GAO report.

SCOPE OF INQUIRY

The report reflects the GAO study of ESOPs at sixteen companies, thirteen of which are closely held and all of which are Federal contractors. GAO specifically concludes (at page 6) that the "pervasive nature" of certain problems encountered at the thirteen closely held companies are "likely", to exist at other ESOP companies.

We believe that thirteen closely held companies which happen to be government contractors certainly do not constitute a representative sample of the "universe" of ESOP companies. Throughout the country there are 2,500-3,000 ESOP companies. Although certain problems may exist with some of these ESOPs, we are convinced that the problems identified by GAO are not prevalent in most ESOPs maintained by closely held companies. Most ESOP companies are operating their ESOPs in a manner which is protective of the interests of employees and which complies with applicable ERISA requirements.

VALUATION OF CLOSELY HELD COMPANY STOCK

GAO is apparently convinced that most closely held companies "manipulate" the valuation of their stock for ESOP purposes in a manner which is adverse to the interests of employees. GAO appears to conclude that there should be some "mechanical" approach to determining "fair market value" of company stock for ESOP purposes.

GAO fails to recognize that valuation is relatively complex matter and that there is not a simple set of guidelines which may be applied to all situations. Most valuations for ESOP purposes are performed in accordance with guidelines established by IRS under Revenue Ruling 59-60. There is a long history of IRS applying these guidelines for income, estate and gift tax purposes. It would be difficult, if not impossible, for more definitive guidelines to be developed for application in each and every ESOP situation.

Determination of "fair market value" for ESOP purposes depends to a large extent upon the judgment of the appraiser. ERISA and the Internal Revenue Code provide sanctions for the use of "excessive" valuations for ESOP purposes, including loss of deductions, excise taxes and fiduciary liability. These sanctions serve to protect the interests of ESOP participants and to prevent abuses in the valuation process.

We do agree with GAO that the Department of Labor has the obligation to promulgate valuation regulations. Section 3(18) of ERISA would appear to require DOL to issue regulations defining "adequate consideration" for purposes of ESOP transactions. The ESOP Association's Valuation Advisory Committee has met with DOL officials several times and has even prepared a draft of proposed regulations for DOL, but to date DOL has not taken action in this area.

In the past, we have proposed that IRS establish a "no action" procedure, whereby an ESOP company may secure an advance ruling as to the valuation of closely held stock to be acquired by an ESOP. We believe that such a procedure, if made available on an optional basis, would assure that "fair market value" can be determined in advance in a manner which satisfies the requirements of ERISA and protects the interests of ESOP participants. We strongly believe, however, that the abuses identified by GAO are not now prevalent among most ESOP companies.

<u>MARKET FOR STOCK</u>

GAO is quite concerned that ESOPs of closely held companies may distribute "unmarketable" stock to employees. The report points out that most ESOPs do not include provisions for mandatory "put options."

It is interesting to note the comment (on page 24) that GAO observed no specific instances where ESOP participants had been denied the opportunity to "cash out" their stock in a closely held company. We believe that most ESOP companies recognize their obligation to create a "market" for stock distributed by their ESOPs. GAO merely speculates that companies are not adequately providing for this "repurchase liability."

On the other hand, GAO fails to recognize certain problems which may arise if the law were amended to require "put options" under specified terms of repurchase. If the law requires mandatory "buy-back" arrangements, a company may be faced with difficult financial problems in financing large repurchases of its stock at a particular time, thereby jeopardizing the value of the stock held in the ESOP for the benefit of continuing participants. In addition, closely held banks cannot legally repurchase their own stock, so that mandatory "put option" requirements may preclude such a bank from adopting an ESOP.

For these reasons, we oppose stringent requirements for "put options" on closely held company stock distributed by an ESOP. Unless and until actual abuses in this area are found, we believe that allowing for repurchases of stock on a flexible basis will best serve the interests of all ESOP participants.

VOTING RIGHTS

The GAO report recommends that "full and unrestricted voting rights" be passed through to ESOP participants. Again, GAO takes a one-sided approach. Certainly voting rights for ESOP participants may be desirable. However, the excessive costs and administrative burdens in effecting such a "pass-through" would have an extremely "chilling effect" on the adoption and maintenance of ESOPs, particularly in closely held companies.

We believe that the economic benefits of stock ownership for employees under ESOPs far outweigh any benefit to be derived by requiring a pass-through of voting rights. In many situations, the votes of ESOP participants can in no way effect the result of a shareholder vote. It would be most unfortunate if employees were denied the "ownership sharing" benefits of ESOPs merely because the law required a pass-through of voting rights which is objectionable to many closely held companies. The decision as to when or whether to provide voting rights to ESOP participants should be a matter of plan design (the same as eligibility, vesting, etc., provisions), to be determined by the company establishing the ESOP. It is clear that an ESOP participant receiving a distribution of company stock may exercise all voting rights attributable to that stock if he elects to remain a shareholder.

CLOSER SCRUTINY BY AGENCIES

We believe that both IRS and DOL are adequately complying with the mandate of Congress to give "special scrutiny" to ESOP transactions. Many ESOP companies have undergone extensive audits by one or both of the agencies. GAO apparently is convinced that ESOPs are being abused by closely held companies and that greater scrutiny is needed. We are convinced that such abuses are not prevalent.

The letters from the agencies which are reproduced in the GAO report clearly outline the enforcement programs relating to ESOPs under ERISA. We believe that the agencies are carefully scrutinizing ESOPs and that additional enforcement efforts are clearly not warranted.

EMPLOYEE PRODUCTIVITY

Again, the GAO report takes the "one-sided" position that ESOPs do not have a positive effect on employees. We believe that a survey limited to sixteen ESOP companies is clearly not sufficient to support this conclusion. Many ESOPs are operating in a manner which demonstrates increased company profitability at the same time as substantial economic benefits are being provided to employees. Studies by the Profit Sharing Research Foundation and others have concluded that employee ownership can be a significant factor in increased profitability and employee morale. We believe that the GAO report and its conclusions would not be justified in a more representative sample of the "universe" of ESOP companies.

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The CHAIRMAN. Next we will hear a panel of Mr. George W. McKinney, Jr., American Bankers Association; Mr. James M. Cirona, United States League of Savings Associations; Mr. John C. Fuchs, Jr., National Savings and Loan League; and Mr. Charles A. Pearce, National Association of Mutual Savings Banks.

We are very pleased to have you gentlemen here, and we will be happy to hear your statement. Summarize it in 5 minutes, if you can, please.

We will start in the order you are listed, Mr. George W. McKinney, American Bankers Association.

STATEMENT OF GEORGE W. McKINNEY, JR., AMERICAN BANKERS ASSOCIATION

Mr. McKINNEY. Mr. Chairman, I am George McKinney. I am a senior vice president of Irving Trust Co., and a member of the Economic Advisory Committee of the American Bankers Association. Our committee has given considerable thought to the possibility of a tax cut, and we appreciate this opportunity to comment on that issue.

We believe that there is a continuing need to restrain Federal taxing and spending. Because of today's shortrun unemployment problem, now is a very good time, the best time to act. It is critically important, though, to design any changes so as to lessen and certainly not to intensify the longrun inflation problem which we feel continues to be the most serious threat to the economic well-being of the American people. Accordingly, we feel that any tax cut should meet three specific criteria.

First, any tax reduction should be matched by a reduction in Government spending. It is important to guard against any increase in the Federal deficit beyond the rather substantial amounts that are now contemplated. A larger deficit would intensify the already serious inflation problem.

It would increase disposable income, and it would bring pressure on the Federal Reserve to allow faster money to finance that larger deficit. Perhaps more importantly, financial markets overseas and at home might well interpret a larger Federal deficit as an abandonment of our anti-inflation battle. If so, it would not be good news for the dollar abroad, nor for bond markets at home.

Second, any tax cut should be designed to encourage savings, investment, and productivity growth rather than to stimulate consumption. To further stimulate consumption during a period of double-digit inflation would almost certainly add more to inflation than to the growth of real output. Instead, economic policy should be pointed toward adding permanently to our real growth rate. Only through an increased flow of output can we provide improved living standards for our citizens, and only if we produce more can we supply the level of public benefits our Nation wants to make available to the less fortunate members of society. Carefully planned changes in our Nation's tax structure can markedly increase the flow of goods and services available for those purposes.

Third, any tax cut should be permanent, and should not be a temporary antirecession measure. Twenty years of experience with fine tuning a comparatively strong economy has given us an impressive body of evidence that such programs do not help our economic problems. They make them worse. Countercyclical programs over the past two decades have not lowered either the unemployment rate nor the inflation rate. In fact, they have done just the opposite. At the peak of the business cycle expansion last winter, unemployment was at levels seen only at the worst part of the recessions during the 1960's, and the lowest rate of inflation in this cycle was about the same as the peak rates of inflation in earlier cycles. Many, maybe most economic theorists today feel that attempts to fine tune the economy contributed to both the inflation and to the unemployment.

In summary, tax cuts should be designed with primary attention to their long-term effects as has been very effectively pointed out by the Joint Economic Committee. We do not need a tax cut today to counter the recession because the recession will be over before the tax cut could take hold. Only the inflationary results would linger on. But we do need to cut Federal taxes and spending today to help the Nation achieve better growth over the long run. The sooner we begin, the better the results will be.

Thank you, sir.

The CHAIRMAN. Thank you, Mr. McKinney.

Now let's hear from Mr. Cirona, United States League of Savings Associations.

STATEMENT OF JAMES M. CIRONA, UNITED STATES LEAGUE OF SAVINGS ASSOCIATIONS

Mr. CIRONA. Mr. Chairman, my name is James M. Cirona. I am president of First Federal Savings & Loan Association of Rochester, N.Y., and appear today on behalf of the United States League of Savings Associations.

My recommendations would provide greater equity in our tax laws by redressing the tax bias against savings. As Dr. Feldstein testified on Friday, tax changes today need not necessarily rekindle inflation. Instead you have this opportunity to undertake a fundamental restructuring with emphasis on stimulating savings and capital formation.

One reason that Americans save less than our industrialized competitors is that our tax laws impose a heavy burden on interest earned. The members of this committee took an important first step toward correcting this penalty on thrift by providing the $400 exclusion of interest and dividends, an opportunity which will only be available to taxpayers in 1981 and 1982.

We strongly recommend that you make this a permanent fixture of the Tax Code.

Beyond that recommendation, we have examined a broad variety of proposals for stimulating savings. We find two—the universal IRA, and incentives to reinvest—of special merit. We would recommend that you expand and update the IRA program in three important ways.

First, permit individuals to establish a separate IRA, even if covered by existing qualified pension plans, or in the alternative permit workers in qualified plans to deduct their contributions.

Second, provide full, rather than limited and supplementary coverage for the unemployed spouse.

Third, raise the annual contribution level set in 1974.

The second major incentive we commend to your attention is a tax deferred rollover for reinvested interest on deposits. This reinvested saving incentive would allow depositors to take full advantage of compound interest, like the universal IRA, encouraging savers to leave funds on deposit.

It would encourage systematic annual contributions, thus providing a stable flow of funds to institutions like our own which specialize in long-term mortgage loans for homeownership.

The universal IRA and the reinvested saving intensive would contribute mightily to a rejuvenation of our Nation's savings base, thus providing the capital to build and buy the houses, modernize the plant and equipment, and provide the jobs for a sound, noninflationary economic future.

I thank you for this opportunity to present our views, and look forward to your questions, Mr. Chairman.

Thank you very much.

The CHAIRMAN. Thank you.

Now, let's hear from Mr. John C. Fuchs.

STATEMENT OF JOHN C. FUCHS, JR., NATIONAL SAVINGS AND LOAN LEAGUE

Mr. FUCHS. Mr. Chairman, I am John C. Fuchs, president of Continental Savings & Loan Association, New Orleans, La., and one of your happy constituents, by the way.

I am appearing before you on behalf of the National Savings & Loan League. The national league is pleased to have the opportunity to participate in these hearings on tax cut proposals.

We in the savings and loans business are acutely aware of the immensity of the task before this committee in constructing a tax package that will meet the needs of the current recessionary economic environment, and provide long-range benefits without stimulating further inflation.

I would like today to focus on the question of increasing incentives for savings and investments. That such incentives are needed can hardly be in doubt.

One such savings incentive that can be built into an already existing structure is the modification and expansion of the individual retirement account. The IRA contribution amount should be increased. Eligibility should be increased to all wage earners regardless of participation in a qualified pension plan. The spousal account should be modified accordingly.

Broadening of IRA's would serve two pressing social needs. First, this action would be a useful weapon in countering inflation by encouraging additional savings, instead of consumption.

Second, the use of techniques would widen the options to the consumers in saving for retirement, and provide a positive incentive for people to plan ahead during the income-producing years to assure security in retirement.

The funds in an IRA represent longer term funds that can be used effectively to invest in housing, plant, and equipment to build our productive capacity. Since taxation of these funds is deferred rather than exempted, the ultimate revenue loss to the Treasury is lessened.

Further, the modified IRA represents a more efficient, less inflationary tax cut than substantial individual tax cuts.

There are a number of bills before this committee that propose modification of IRA's. Many of these have been sponsored by members of this committee. Representative Gibbons has encouraged the House Ways and Means Committee to change the IRA deduction to a credit, expand the amount that can be contributed, and eliminate existing eligibility rules.

While the national league does not have a specific approach to present here today, we will be happy to work with this committee to develop a practical, viable IRA. Any approach adopted, however, should at least include higher ceilings on the tax deductible amount that can be contributed, elimination of current eligibility requirements which exclude those persons participating in a qualified retirement plan, and provide ceilings and expanded eligibility for spousal IRA accounts.

The national league also would urge expansion of the tax incentive for savings authorized in Public Law 96-223, which provides for an exemption of $200 or $400 for a joint return on interest on dividends earned. While this action was definitely a step in the right direction of encouraging savings and providing equity for the small saver, and we commend this committee and the Congress for their foresight in providing this exemption, such incentive should be expanded to be more effective.

It is imperative that we stop the disastrous decline in the rate of personal saving. For this reason, we urge the Congress to act to provide further relief from taxation on interest earned on savings.

We would also like to call to the committee's attention a number of tax provisions affecting savings and loan associations outlined in our formal statement which are in need of revision and change.

While we recognize that it may not be possible to include all of these in the tax bill enacted this year, we would hope that the committee would give consideration to these means of increasing the flow of funds to the mortgage market.

We are aware that Secretary Miller has urged the Congress to postpone action on the tax cut until after the election. However, the housing and automobile industries are in a serious depreciation. Unemployment levels are rising to unacceptable levels. Productivity, investment, and savings have fallen to lower and lower levels. The tax burdens facing individuals will reach new highs in January 1981.

Now is the time to develop a long-range plan to stimulate investment, savings, and tax relief for individuals, so that we may move forward to a more vigorous and stable economic environment.

As to the exact time, and as to when the tax cut should be effective, there is still substantial disagreement among tax and economic experts. We don't profess to be any more expert than they are on the timing of a tax cut. Our primary concern is the composition of the proposed cut.

If there is to be a tax bill this year, we hope that you will include in such a bill an exemption of the IRA, and increased incentives for savings, so that we may generate the capital that would be needed for housing, plant, and equipment investment in the 1980's.

We appreciate the opportunity to present the National League's views on this important matter. I will be happy to answer any questions you may have.

The Chairman. Thank you very much, Mr. Fuchs.

Your full text will be inserted in the record. I think that it is very interesting and enlightening. I think that it will help all of us.

Now, let's hear from Mr. Charles A. Pearce from the National Association of Mutual Savings Banks.

STATEMENT OF CHARLES A. PEARCE, NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS

Mr. Pearce. Mr. Chairman, my name is Charles A. Pearce. I am chairman of the Committee on Federal Legislation of the National Association of Mutual Savings Banks, and president of the Quincy Savings Banks in Massachusetts. I appreciate the opportunity to present the views of the mutual savings bank industry. My statement will concentrate on the critically important need for increased tax incentives for individual savings.

Legislation to provide tax incentives for savings is vitally needed on many grounds. Such action would help correct the antisaver bias persisting in our tax law. It would provide increased rewards to our savers. It would stimulate our Nation's perilously low saving rate.

As a result, it would encourage increased investment and productivity growth in the economy, and thereby contribute importantly to the longrun battle against inflation.

Tax incentives for savings should, therefore, be a major element in any tax reduction package adopted by the Congress in the current environment. Inflation continues to be one of the most serious threats confronting our Nation.

Tax reduction legislation must, therefore, be framed with a view of providing major stimulus to savings, capital formation, and real economic growth. Otherwise, a major reduction in taxation at this time would greatly aggravate our already serious inflation problem.

In this regard, it is evident that support for tax relief is mounting. Support is being generated by the effect of inflation in pushing taxpayers into the higher brackets, by the scheduled rise in social security taxes, and by the impact of the economic recession. This situation provides a golden opportunity to tailor tax relief to the critical longrun need to promote noninflationary economic growth.

Our industry has long supported savings tax incentives. In line with that position, we strongly supported the $200 to $400 tax exclusion for interest and dividends which was enacted earlier this year.

We believe that this provision should be made permanent. The $200 to $400 exclusion is a useful first step in addressing the need for equity for the small saver. But it remains only a first step, which should be followed by additional tax action to encourage increased savings and capital formation.

This can best be achieved, we believe, by extending the highly successful individual retirement account program. Thus we strongly support an increase in allowable contributions and an expansion of coverage to taxpayers not now eligible for IRA's.

The result would be a broadly based, long-term tax deferral provision available generally to all individual taxpayers—I emphasize the word "all." Such a tax deferral incentive would have a continuing economic impact over the long run, and would tend to stimulate new savings rather than rewarding past savings.

Therefore, it would be ideally suited to the objective of increased longrun, noninflationary economic growth, and the tax deferral feature would permit the Treasury to recover part of its initial revenue losses, even aside from the increased tax revenue resulting from more rapid real economic growth.

We are pleased that Senator Bentsen has proposed legislation, S. 557, having the same broad purpose sought by our industry, a long-term tax deferral provision which would clearly help individuals provide for their retirement needs. This could significantly relieve the mounting pressures on the social security system.

In addition to retirement, other basic thrift purposes could also be served by such a long-term tax incentive. In our full statement we offer more detailed recommendations to achieve this objective.

Mr. Chairman, I hope that these comments will be helpful to the committee as you consider these critical issues. I will be happy to answer any questions you may have at this time.

The CHAIRMAN. Thank you very much for your statements, gentlemen. I will see that they are printed in full in the record. I find them most helpful. Thank you.

[The prepared statements of the preceding panel follow:]

Summary Statement of

George W. McKinney, Jr.

on behalf of

the American Bankers Association

on

Federal Tax Reductions

before the

Committee on Finance

United States Senate

July 29, 1980

We believe that any tax reduction should meet three criteria. Specifically, any tax cut should be matched by a reduction in expenditures sufficient to prevent an increase in the Federal deficit; the reduction should be designed to encourage savings, investment, technological advances, and innovative activity rather than consumption; and the cut should be a permanent one and not a temporary anti-recession measure. Such a tax cut would not add to inflation in the short run. Indeed a tax cut that meets all of those criteria would be an important step in our long run fight against inflation. We believe such a tax cut should be implemented as soon as possible while there is some slack in the economy because of our short run unemployment problem. In addition, delaying a tax cut that provides increased incentives for capital investment could lead to a reduction in economic activity as business delays capital spending to gain any benefits that might be included in the tax cut.

Statement of

George W. McKinney, Jr.

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Federal Tax Reductions

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July 29, 1980

Mr. Chairman and members of the Committee, I am George W. McKinney, Jr., Senior Vice President of the Irving Trust Company and a member of the Economic Advisory Committee of the American Bankers Association. The membership of our Association includes more than 13,100 full service banks - over 90 percent of the nation's total. This includes over 12,000 community banks with deposits of $100 million or less. The Economic Advisory Committee is a group of senior bank economists from banks across the country who advise the American Bankers Association on economic matters. This group met just two weeks ago and had an extensive discussion of the economic aspects of a tax cut. My remarks this morning are based on that discussion.

We appreciate this opportunity to express our views on a possible tax cut. We believe that there is a continuing need to restrain Federal taxing and spending. Because of today's short-run unemployment problem, this is a good time to act. It is critically important, though, to design any changes so as to lessen, certainly not to intensify, the long-run inflation problem which we feel continues to be the most serious threat to the economic well being of the American people. While the rate of inflation has subsided from the levels experienced during the earlier part of the year, it far exceeds the level that existed in the comparable stage of the last business cycle. In its recently released Mid-Session Review of the 1981 Budget, the Office of Management and Budget predicted that inflation as measured by the CPI would be about 12% in 1980 and slightly over 10% in 1981. During each successive business cycle since the early 1960s the rate of inflation has exceeded the rate at the comparable stage of the preceeding cycle. A continuation of this pattern poses a grave threat to the stability of our society.

The timing of such a tax cut involves several political questions that have been widely debated. I will restrict my remarks to the economics of the tax cut. We believe a properly designed tax cut, that meets the criteria we present below, would be beneficial and should be implemented before January 1, 1980. A tax cut that does not meet these criteria should not be implemented. A poorly designed tax cut presents a serious risk of increasing inflationary pressures during the expansion phase of the business cycle. Since we are in the recession phase, a tax cut that meets our criteria should be implemented as soon as possible. Delaying a tax cut that provides incentives for capital investment could lead to a reduction in investment as business postpones capital spending to gain the benefits of any tax reductions. Moreover, any tax cut which meets the criteria described below will help deal with some of the long run structural problems in our economy. Because of the critical nature of these problems, it is important that we move rapidly to deal with them.

The criteria which we believe to be essential in evaluating the various tax cut proposals are as follows:

Criterion 1
Any tax reduction should be matched by a reduction in government expenditures sufficient to prevent enlargement of the Federal deficit.

Tax legislation that increases the Federal deficit and results in additional fiscal stimulus is now inappropriate for two reasons. First, the current size of the Federal deficit suggests that fiscal policy is already quite stimulative. Second, the operation of so-called automatic stabilizers such as unemployment insurance will increase the Federal deficit as economic activity declines. For example, Federal expenditures on unemployment insurance will increase by about $5-7 billion for each percentage point increase in the unemployment rate. The additional fiscal stimulus resulting from these programs will ameliorate the current slowdown, and tax-cuts that enlarge the Federal deficit should be avoided. In the long run price stability can be achieved only if the nation consistently follows fiscal and monetary policies of moderation.

Some economists have argued that a cut in tax rates could actually increase tax revenues and reduce the deficit by stimulating investment and productive activity. We would agree that a properly structured reduction in tax rates could ultimately bring about a significant increase in savings, investment, and productive activity. However, we do not believe, in the short run, such incentives could boost incomes and the tax base enough to offset the reduction in rates, so the size of the deficit would necessarily increase unless other offsetting actions were taken.

Tax legislation that increases the size of the Federal deficit would tend to aggravate our already serious inflation problems in several ways. It would increase aggregate demand by increasing disposable income. An increase in the Federal deficit would also bring pressure on the Federal Reserve to allow the money supply to grow more rapidly in order to make it easier for the Treasury to finance the larger deficit. Finally, and perhaps most importantly, tax legislation that resulted in a larger Federal deficit could be interpreted, perhaps appropriately, as an abandonment of our anti-inflation battle. This would result in weakness in the dollar abroad and would aggravate inflationary expectations domestically.

We believe that Federal expenditures can be restrained sufficiently to allow a reduction in taxes without expanding the Federal deficit. Even if the Congress determines that defense expenditures must be increased, we believe that there is room for cutting total expenditures. In February the Congressional Budget Office released an analysis of over 70 different budget cuts under several different strategies. We appreciate the political difficulty of deciding which of these cuts to make: however, such cuts are necessary to prevent aggravating our serious inflation problems and to limit the growth of government expenditures as a percent of total output of the economy.

Criterion 2
Any tax cut should be designed to encourage savings, investment, technological advance, and innovation rather than consumption.

Increased capital investment, technological advances, and innovation are highly effective ways to increase labor productivity. Increased labor productivity is the only way to generate real wage gains and a higher standard of living. Without such productivity gains, workers' demands for higher wages must be passed on in the form of higher prices, generating inflation without any increase in living standards. The poor performance of productivity in recent years has been well documented. One of the most promising approaches to improving productivity is to encourage additional capital investment by reducing the bias against savings and investment in our tax structure. This bias can be reduced or eliminated and additional capital investment encouraged either by direct incentives for additional capital expenditures or by incentives for additional savings. Incentives for additional savings will provide a larger pool of funds for capital investment.

The bias against savings and investment in our tax code takes several forms. During periods of inflation nominal corporate profits tend to rise because depreciation is based on historical cost rather than replacement costs. These nominal gains are taxed as profits even though in real terms they may be losses. Inflation also produces nominal capital gains in securities which are taxed as capital gains when, in real terms, they may be losses. Inflation also leads to excessively high interest rates, because lenders seek to obtain inflation premiums in their debt contracts merely to offset the decline in the purchasing power of the dollar. Yet the interest return embodied in these premiums is taxed in the same ways as income which increases one's command over real resources.

Another important source of bias against savings and investment structure is the double taxation of corporate dividends. Corporate profits are taxed at the corporate level and then dividends paid out of these profits are subject to personal income taxes. This means that some productive investments are taxed twice while returns to appreciation of gold and similar unproductive investments are taxed only once. An equally important problem is the extent to which the government relies on corporate and personal income tax structures which deter savings. If these are major sources of revenue, as they are in the United States, the deterrent effect is quite large. It is for this reason that several of our major trading partners in Europe have begun to rely more heavily on a value-added tax.

Criterion 3
Any tax cut should be permanent and not a temporary anti-recession measure.

Temporary tax cuts will not produce the incentives to increase savings and investment that are necessary to deal with our long-run inflation problem. Many capital investments, particularly the most productive ones, involve long pay-back periods. Thus, investors will respond to increased incentives for capital investment only if they are convinced that such incentives will remain in existence for a long time.

Some proponents of a tax cut have pointed to the recent increases in the unemployment rate to justify such a cut. We do not believe that a tax cut that increases fiscal stimulus without addressing some of the underlying structural problems in the economy is likely to be an effective way to deal with the current unemployment problem. For example, one of the sectors in which the unemployment problem is most severe - the auto industry - is facing a long term structural adjustment problem resulting from the rise in the relative cost of energy. Additional fiscal stimulus would be of little if any help in dealing with the problems of this sector. The most efficient way to put auto workers back to work is to enact policies that generate the capital needed to retool the auto industry to produce the types of cars demanded in today's energy environment.

Structural shifts in labor markets in recent years may also limit the extent to which additional fiscal stimulus can reduce the unemployment rate. Part of the rise in the unemployment rate during the 1970s was the result of the tremendous increase in the number of workers just entering the labor force. These new workers traditionally have much higher rates of unemployment until they have been in the labor force for some time. One would expect unemployment to show a gradual downward trend in the future as these new workers gain experience and establish their own careers. Measures other than the unemployment rate tend to show that the economy has been rather successful in absorbing the tremendous growth in the work force that occurred during the 1970s. Even with the reductions in employment during recent months, total employment as a percentage of the civilian work age population stands well above the levels experienced 10 to 15 years ago when unemployment rates were much lower.

Even in the absence of these structural problems, history shows that anti-recession tax cuts often do more harm than good. Because of the lags involved in recognizing a recession and in enacting a tax cut, and the time needed for a tax cut to have some impact, the effect of a counter-cyclical tax cut often comes after the recession is over and aggravates the inflationary pressures that occur during the upswing of the business cycle. If the current recession is of average duration, a tax cut taking effect on January 1, 1981 will come during the early part of the recovery. Thus, a tax cut which enlarges the Federal deficit and fails to deal with the underlying structural problems of the economy may only complicate the inflation problem. These lags are less of a problem with the so called automatic stabilizers which automatically increase in size when the economy is declining and also automatically decline in size when the economy is expanding.

The three criteria are described above in substantial agreement with the conclusions of the bipartisan Joint Economic Committee of the U. S. Congress as set forth in their 1980 Joint Economic Report. In that Report, the Committee stated in part:

> .....there is need for a shift in the focus of monetary and fiscal policies away from short-run crisis containment toward steady long-term economic growth.....Long term policies should have a two-fold aim. First they should promote growth at rates that are in line with the economy's actual potential for noninflationary real growth. Second, they should be structured to encourage an increase in these potential growth rates for the future.

The fact that majority and minority members of the Committee endorsed this Report, illustrates the widespread agreement on this approach.

Guided by these criteria we would like to briefly discuss several tax proposals that have recently been the subject of public discussion.

<u>Reduction in Personal Tax Rates</u>

We do not believe that personal taxes should be the primary focus of any current tax reduction because other types of reductions will provide greater incentives for savings and investment per dollar of lost tax revenue. However, a reduction in personal tax rates might be included as part of a package of other tax cuts to help offset the rise in personal income tax receipts as a percentage of personal income that has resulted from inflation steadily pushing taxpayers into higher marginal tax brackets.

Accelerated Depreciation, Investment Tax Credits, Reductions in Corporate Tax Rates, Elimination of the Double Taxation of Corporate Dividends, Deductions for Dividend Reinvestment Plans

We believe that these types of tax reductions will provide substantial and enduring incentives to increase capital investment, accelerate productivity growth, and contribute meaningfully towards solving the long run inflation problem. Thus, we feel that one or more of the tax cuts in this class should be the centerpiece of any current tax reduction. Any of these measures, would strengthen the economy and enhance real growth.

Objections are occasionally made to tax cuts of this kind on grounds that the immediate beneficiaries are corporations or their stockholders. However, the ultimate distribution of benefits resulting from a tax cut often diverges considerably from the immediate distribution of tax savings. Tax reductions of the type described above result in increased savings and investment that produce new jobs and benefit those that receive no direct reduction in their taxes. Further, a good part of the burden of corporate taxes ultimately falls on those who buy the goods and services businesses produce.

Tax Deferral for Savings, Partial Exemption of Certain Types of Interest Income

We believe that these types of measures will help reduce the bias against savings in our tax system. Thus, we would also prefer these types of measures to reductions in the personal income tax rates. One example of this approach is an extension of the tax treatment of investments in IRA accounts to all savers rather than confining it to persons not covered by other retirement plans. Even less sweeping changes such as allowing depository institutions to issue long term investments on which tax on the interest income is deferred until maturity would provide increased incentives for savings. The increased savings resulting from this type of tax reduction would encourage expansion of capital investment. However, some of this savings would be used to finance the purchase of consumer goods and thus this approach would probably result in a smaller increase in productive investment than the measures designed to provide direct incentives for capital expenditures.

Conclusion

We believe that any tax reduction should meet three criteria. Specifically, any tax cut should be matched by a reduction in expenditures sufficient to prevent an increase in the Federal deficit; the reduction should be designed to encourage savings, investment, technological advances, and innovative activity rather than consumption; and the cut should be a permanent one and not a temporary anti-recession measure. Such a tax cut would not add to inflation in the short run. Indeed a tax cut that meets all of those criteria would be an important step in our long run fight against inflation. We believe such a tax cut should be implemented as soon as possible while there is some slack in the economy because of our short run unemployment problem. In addition, delaying a tax cut that provides increased incentives for capital investment could lead to a reduction in economic activity as business delays capital spending to gain any benefits that might be included in the tax cut.

STATEMENT OF JAMES M. CIRONA
On Behalf of the U. S. League of Savings Associations
To the Senate Committee on Finance
July 29, 1980

MR. CHAIRMAN:

My name is James M. Cirona. I am President of First Federal Savings and Loan Association of Rochester, New York and appear today on behalf of the United States League of Savings Associations*, where I serve as a Member of the Board of Directors, the Legislative Committee, and the Tax Analysis Subcommittee.

The U.S. League appreciates this opportunity to present its views on the subject of tax cuts. We cannot imagine a more timely undertaking by this distinguished Committee and the Congress. As a spokesman for our nation's savings and loan business, I will focus on recommendations to provide greater equity in our tax laws and redress the tax bias against savings. We believe strongly that any tax law revisions adopted by the Congress must contribute to a sound, non-inflationary economic future for our nation.

Your Committee has received important advice on the timing and magnitude of tax cuts generally. We were impressed, in particular, by the presentation last Friday of Dr. Martin Feldstein of Harvard University and his discussion of how tax changes today need not, necessarily, rekindle inflation through expanded budget deficits. Instead, you have this opportunity to undertake a fundamental restructuring of our tax laws with emphasis on stimulating savings and capital formation.

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*The United States League of Savings Associations (formerly the United States Savings and Loan League) has a membership of 4,450 savings and loan associations representing 99-2/3% of the assets of the $540 billion savings and loan business. League membership includes all types of associations -- Federal and state-chartered, insured and uninsured, stock and mutual. The principal officers are: Ed Brooks, President, Richmond, VA; Rollin Barnard, Vice President, Denver, CO; Lloyd Bowles, Legislative Chairman, Dallas, TX; William O'Connell, Executive Vice President, Chicago, IL; Arthur Edgeworth, Director-Washington Operations; and Glen Troop, Legislative Director. League headquarters are at 111 E. Wacker Dr., Chicago, IL 60601; and the Washington office is located at 1709 New York Ave., NW, Washington, DC 20006: (202) 637-8900.

As the Committee knows, the savings and loan business and home finance are among the first to falter when inflation accelerates and interest rates climb. Once again in 1979-80, the flow of funds to our thrift institutions, and then credit for the housing market in general, has collapsed in predictable fashion ... an all too visible casualty of inflationary excess. Tax incentives which build our productive base can help avert a repetition of this dismal, and unnecessary, cycle.

The International Union of Building Societies and Savings Associations recently published a study of personal savings in industrialized nations. It confirmed earlier reports that the savings rate in the United States is lower than that of its industrial competitors. For the past decade, Americans saved at an annual average of only 6.6% of disposable income; as inflation accelerated, the personal savings rate deteriorated to only 4.9% in 1978 and 3.5% last year. By contrast, the decade-long average was 18.5% in Japan, 17.2% in France, 15.3% in West Germany and 12.3% in England.

One reason that Americans save less than other people is inflation. Saving today for tomorrow's needs is unappealing when the return on savings can't keep pace with the inflated costs of tomorrow's goods and services.

The overriding reason, however, is that our tax laws impose a heavy burden on interest earned on savings. In Japan, for example, the first $5,000 in savings interest is tax-free; in many South American countries all interest is tax-exempt. In West Germany and France, families with systematic, long-term savings plans receive bonuses from the Government as well as tax incentives.

The Members of this Committee took an important first step for correcting the tax penalty on savings by amending the windfall profits legislation earlier this year to provide for a $200/$400 exclusion for interest and dividends from domestic sources. Unfortunately, the Conference on that bill (now P.L. 96-223) restricted the availability of this incentive to calendar years 1981 and 1982.

At a minimum, we recommend strongly that your Committee make the $200/$400 exclusion a permanent fixture of our tax code.

Beyond that recommendation, the special U.S. League Subcommittee on which I serve has examined a broad variety of proposals** for stimulating savings through tax code revisions. We find two -- the "universal IRA" and incentives to "reinvest" -- of especial merit.

The decision of Congress in 1974 to expand the Keogh Plan approach to provide an Individual Retirement Account for those not in qualified pension programs opened an important new source of funds for depository institutions. IRA accounts permit some wage-earners to deduct $1,500 annually (or $1,750 in a joint account with an unemployed spouse) as part of their tax planning, with taxation of contributions and earnings postponed until retirement years. This self-help incentive obviously relieves the potential burden on our Social Security and Railroad Retirement systems, while helping to compensate for the inequities imposed on retirement security by unanticipated inflation.

We would recommend strongly that the Congress expand the IRA program in three ways:

#- Permit individuals to establish a separate IRA even if they are covered by existing qualified pension plans where they work; or, in the alternative, permit workers in qualified plans to receive a tax deduction for contributions made to existing company programs;

**A detailed statement presented to the House Ways and Means Committee on January 29, 1980 examines other possibilities: exclusions, credits, other types of deferrals, taxing interest on a separate and progressive rate schedule; all would stimulate savings and we would be pleased to provide that commentary on request.

- Provide full, rather than limited and supplementary, coverage for the non-employed spouse based upon the earnings of the family wage-earner;

- Raise the annual contribution levels for which deductions are available beyond the $1,500/$1,750 limits now applicable.

In our analysis, these "universal IRA" changes are particularly effective in building the personal savings base. They provide a potent incentive to increase the nation's net new savings because of the wide range of eligible taxpayers. They also provide the greatest increase in long-term savings of any tax incentive plan we have studied since they encourage systematic, annual contributions, while locking-in funds until age 59-1/2. Like other deferral approaches, the funds invested in IRAs do not "escape" taxation fully -- though beneficiaries are generally taxed in years when lower tax brackets apply.

The appeal of the "universal IRA" is somewhat diminished for those taxpayers in their early wage-earning years ... their 20s and 30s ... because of the demands on family resources and the severity of penalties for withdrawal of funds before retirement. In recognition of this problem, the Committee might consider this further refinement: a one-time privilege to withdraw a portion of IRA funds prior to age 59-1/2 without penalty subject, of course, to reasonable limits.

The second major tax incentive for savings we commend for your attention is a tax-deferred rollover for reinvested interest on savings accounts. (This could be applied to reinvested interest from other sources or reinvested dividends from stock, as well.)

Such an incentive would encourage longer-term, systematic savings. As long-term mortgage lenders, such deposits are particularly appropriate for savings and loan associations -- though we are not suggesting that the tax break be limited to our depositors. The "reinvested savings" incentive would allow savers to take full advantage of the compound interest on the income earned from most savings

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accounts by removing the increased tax bite which now diminishes the effectiveness of such accumulations. It would also allow savers to manage their investments to a greater degree than is possible, say, under the IRA/Keogh savings plans. Again, the ultimate impact on Federal revenues is lessened since taxes are deferred, not excused.

The universal IRA and an incentive for leaving funds on deposit would contribute mightily to rejuvenating our nation's savings base -- thus providing the capital to build the houses (and we are entering a decade of unprecedented housing demand), modernize and expand the plant and equipment (to permit us to compete with our partners abroad), and provide the jobs for a sound, non-inflationary economic future.

Before concluding, we would like to mention two additional items within the jurisdiction of your Committee.

Thus far, 1980 has been an extremely difficult year for savings and loan associations. Savings costs skyrocketed -- reaching 15.7% in March on our popular Money Market Certificates -- while lending volume dried up due to high interest rates. The return on associations assets, burdened by portfolios of home loans made years ago at subpar rates, has not kept pace with the rates which must be offered to attract the public's savings. For the second quarter, the Federal Home Loan Bank Board Chairman has estimated that as many as 80% of our institutions could have operated at a loss. (Furthermore, the improvement anticipated from falling rates in recent months was frustrated when the Depository Institutions Deregulation Committee on May 28 raised rate ceilings and restructured the rate pattern for the most popular accounts.) It is apparent that a significant number of savings and loan associations will experience losses for the entire year even if general economic conditions improve.

Over the repeated objections of the U.S. League, the Treasury Department adopted a novel and unjustified regulation (initially in May, 1978, with modification in May, 1979) severely inhibiting our ability to carry back losses to offset taxes paid in prior years. The rule holds that when a net operating loss of an S&L is carried back from a year beginning in 1979 or later, the taxable income base for computation of the bad debt reserve (customarily used by savings associations) must be recomputed and reduced by the amount of the loss carried back. As a result, any tax refund resulting from carrying back such loss is diminished by about 40 percent. Our organization has met further with the IRS and the Treasury Department in 1980 on this regulatory action -- but to no avail.

As a consequence, we have no recourse but to ask the Congress to correct by statute the final regulations issued by the IRS on May 18, 1978 which restrict unnecessarily the availability of loss carrybacks for thrift institutions victimized by the rampant inflation and high interest rates of recent years. (The draft of a remedial amendment is attached to this testimony.)

On another matter of a somewhat technical nature, this Congress approved in March the Depository Institutions Deregulation and Monetary Control Act (P.L. 96-221). Title IV of that legislation broadens the investment opportunities for federally-chartered savings and loan associations to help them prepare for the eventual deregulation of the savings markets and to enable them to broaden their investment mix to include assets which adjust more readily to inflationary periods.

While these changes in the "banking" laws are welcome, they are of limited utility unless corresponding changes are made in the definitional sections of the Internal Revenue Code which apply to "domestic building and loan associations". The current law requires that 82 percent of investments consist of "qualifying real property loans" if S&Ls are to fully utilize their permitted tax treatment.

We would recommend that list of qualifying investments reflect the changes of P.L. 96-221 and that the applicable percentage be lowered to 72% -- a level, by the way, which currently applies to another type of housing-specialized thrift institution, the mutual savings bank.

This concludes the testimony of the U.S. League. To repeat, we strongly urge that any tax cuts adopted by the Committee emphasize the restructuring needed to restore our nation's savings. In this regard, we recommend that the $200/$400 tax exclusion become a permanent part of our tax laws, and that the Congress authorize tax-deferred opportunities through "universal IRA" and "reinvested savings" incentives. Finally, we call upon your Committee to correct an unjustified ruling of the IRS concerning loss-carrybacks and to modify the savings and loan definition to conform with the broadened investment purposes adopted as part of P.L. 96-221.

I thank you for this opportunity to present our views and look forward to your questions.

Attachment A

To amend the Internal Revenue Code of 1954 to reaffirm the intent of Congress respecting certain tax incidents of Section 593 institutions.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Section 593(b)(2)(E), "Reserves for Losses on Loans", of the Internal Revenue Code is amended by adding a new subdivision (vii) to read as follows:

"(vii) without regard to any net operating loss carryback."

Testimony of
John C. Fuchs, Jr.
on behalf of the
National Savings and Loan League
On Tax Cut Proposals
before the
Finance Committee of the U.S. Senate
July 29, 1980

Mr. Chairman, Members of the Committee, I am John C. Fuchs, Jr., President of Continental Savings and Loan Association of New Orleans, Louisiana. I am appearing before you today as Finance Chairman of the National Savings and Loan League, whose views I represent.

The National League is pleased to have the opportunity to participate in these hearings on tax cut proposals. We in the savings and loan business are acutely aware of the immensity of the task before this Committee in constructing a tax package that will meet the needs of the current recessionary economic environment and provide long-range benefits without stimulating further inflation.

The ultimate goal before you is to take steps that will lead to economic vitality and real economic growth. These steps include a reduction in the growth of federal spending, a reduction in the onerous tax burden facing both individuals and business, and creation of incentives for savings and investment necessary to allow for increased production. A comprehensive plan encompassing all of the above factors is a necessity if we as a nation are to regain our place as a strong productive competitor in the world market and if we are to provide an adequate standard of living for our people at home.

I would like today to focus on the question of increasing incentives for saving and investments. That such incentives are needed can hardly be in doubt.

During the fourth quarter of 1979, the rate of personal savings in the United States fell to a low of approximately 3.3%, the lowest percentage in thirty years. Such a savings rate is certainly not adequate to provide capital for investment and development and the increased productivity that is needed if we are to improve our economic picture in the future. There are several factors that account for the low rate of savings, the most important of which has been inflation. At current rising rates of inflation, people are encouraged to spend and consume, rather than to save. It is perceived as better to buy today because tomorrow the cost of the item will be much higher. In addition, interest rates on savings have not been able to keep up with inflation. Finally, inflation has pushed people into higher income tax brackets, leaving them with less disposable income in real terms and, therefore, less available funds for savings. Commerce Department figures show that while overall income increased in 1979, taxes rose at a faster rate (15.8%), depressing after-tax income to an increase of only 8.7%. The comparison of this figure with the inflation rate graphically illustrates the problem. This problem will be exacerbated when the new payroll taxes take effect in January 1981. The projected rise in federal taxes for 1981 is $86 billion dollars, of which $50 to $60 billion represents new taxes. This increase will even more adversely affect the ability of the taxpayer to save and invest.

We therefore urge this Committee to include specific incentives for saving in any tax package adopted.

Individual Retirement Accounts

One such saving incentive that can be built on an already existing structure is modification and expansion of the individual retirement account. The IRA contribution amount should be increased, eligibility should be extended to all wage earners regardless of participation in a qualified pension plan, and the spousal account should be modified accordingly.

Broadening of IRAs would serve two pressing social needs. First, this action would be a useful weapon in countering inflation by encouraging additional savings instead of consumption. Secondly, the use of such techniques would widen the options of the consumer in saving for retirement and provide a positive incentive for people to plan ahead during their income-producing years to assure security in retirement.

It is particularly imperative that we revise the laws in this area because of the effects of inflation on current individual retirements plans as well as private pension plans. While we have moved a great deal closer to the goal of universal coverage for retirement security, inflation has caused decreases in the adequacy of that coverage. Rises in the cost of living have far exceeded increases in benefits for most retirees who have private pension plans. The rising cost of living has also decreased the value of the $1,500 tax-deductible amount allowed under the provisions of the Internal Revenue Code governing the IRAs. We need to take steps now to provide people with the necessary tools to assure an adequate standard of living in retirement.

The unprecedented number of people who are now entering their thirties will, in thirty years, put a severe strain on social security and other government programs to aid older citizens. Enactment of changes in laws on individual retirement accounts would help to shift the economic burden of security in retirement from the government to the private sector and to the individual. In addition, IRAs bring the assurance of immediate vesting, portability, and personal management of funds for retirement to the individual, which is extremely important in our increasingly mobile society.

Expanded individual retirement accounts offer several positive features. The retirement savings in IRAs would increase capital formation and increase savings with relatively little revenue loss. The funds in an IRA represent longer-term funds that can be used effectively to invest in housing, plant, and equipment to build our productive capacity. Since taxation of such funds is deferred, rather than exempted, the ultimate revenue loss to the Treasury is lessened.

In addition, by the encouragement of savings and investment, the modified IRA represents a more efficient, less inflationary tax cut than substantial individual tax cuts while being beneficial to the consumer.

There are a number of bills before this Committee that propose modifications in IRAs. Many of these have been sponsored by members of this Committee. Representative Gibbons has encouraged the House Ways and Means Committee to change the IRA deduction to a credit, expand the amounts that can be contributed, and to eliminate existing eligibility rules. While the National League does not have a specific approach to present here today, we will be happy to work with this Committee to develop a practical, viable IRA. Any approach adopted should at least include:

- higher ceilings on the tax-deductible amount that can be contributed
- elimination of current eligibility requirements which exclude those persons participating in a qualified retirement plan
- revised ceilings and expanded eligibility for spousal IRA accounts.

The Appendix provides an analysis of the problems faced by retired individuals who must rely on savings income to meet day-to-day expenses. The analysis , which was authored by Mr. Gilbert N. Roessner and Mr. Reid Nagle of City Federal Savings and Loan Association in Elizabeth, New Jersey, includes reference to specific provisions of legislation introduced in the House as H.R. 6190 and in the Senate as S. 1925, The Savings Income for Retirement Act. I believe the information and statistics provided in this paper should be useful to the Committee in its deliberations.

Tax Incentives for Savings

The National League also would urge the expansion of the tax incentive for savings authorized in Public Law 96-223. P.L. 96-223 provides an exemption for $200 ($400 for joint returns) on interest or dividends earned. While this action was certainly a step in the direction of encouraging savings and providing equity for the small saver and we commend this Committee and the Congress for their foresight in providing this exemption, such incentives should be expanded to be more effective. It is imperative that we stop the disastrous decline in the rate of personal savings. For this reason, we urge the Congress to act to expand policies that encourage savings instead of penalizing those persons who save. Further relief from taxation on interest earned on savings would be of substantial assistance in efforts to increase thrift and decrease our alarming rate of consumption.

That tax incentives for savings do work is evidenced by the experience of a number of industrialized nations, particularly in Western Europe and Japan. While the level of savings in the United States has been rapidly declining, Great Britain, West Germany, France, and Japan have maintained or increased their national level of savings. For example, the British save 13% of income and the Japanese save 25%. This high rate of savings has occurred in part because these nations offer some kind of tax incentive to encourage their citizens to save.

It is time to take the consumption bias out of our tax laws and break the current cycle of inflation-consumption-low productivity-low investment-more inflation by taking a strong policy step to encourage a higher savings rate. It is particularly significant that these hearings are taking place at the beginning of the '80s. I would like to take this opportunity to relate the importance of savings to my own professional interest--housing--in the next decade. It has been estimated that roughly 43 million people will reach age 30 during the 1980s. This group will represent a major and unprecedented force in the housing market. Along with the expected household formation rate in the '80s, the projected demand for housing in the next decade is in the range of 2.2 to 2.3 million housing units each year. There must be increased savings to finance the building and acquisition of homes for those people who will reach household formation age in the coming decade. I can assure you that current tax policies will not provide us with the savings base to meet the demand of these young families seeking home financing.

Mr. Chairman, an increase in the amount of interest earned on savings which can be excluded from taxable income would provide equity to the small saver. It will give the person who does not have the funds, the expertise, or the ability to compete in other forms of investment a chance for a tax break. A survey conducted for the Savings and Loan Foundation found broad support for a tax exclusion on interest earned on savings came from persons in the $10,000 to $20,000 income bracket. These are the people who need assistance and deserve equity in the return on their savings.

Over the several years that this issue has been discussed, there have been three arguments repeatedly made against the tax incentive approach. I want to address myself to these points.

Some people have argued that the proposed policy will not cause people to save more but simply give a "windfall" to current savings account holders. Frankly, none of us can prove, in an absolute sense, that a tax incentive will produce a higher rate of savings, but the experience of other developed industrialized nations suggests that it will. Furthermore, I submit that it is human nature to save if savings is rewarded and not save if savings is punished or consumption is rewarded to a greater extent.

A second argument that has been made is that the benefits accrue disproportionately to higher-income people. This argument looks only at the fact of tax brackets and the amount of tax savings to the individual. One could just as easily argue that a $500 exclusion is more beneficial to middle- and low-income people because all or most of their interest income would be tax-free, which would be a very meaningful incentive and would encourage those who do not save at all to start a regular savings plan.

A third objection to a tax incentive for savers has been the loss of revenue to the Treasury. While the actual figure for such loss will vary depending upon the increased size and character of interest exclusion authorized, most economists agree that some, if not all, of this cost will be retrieved from increased income and employment generated by the increased capital investment. Increased investment should produce more jobs, higher productivity, and more income subject to federal income taxes. This in the long run would help to recover the initial costs to the Treasury.

In addition, one must look at the cost of continuing in our current sluggish economic situation. As the Chairman of the Joint Economic Committee stated last year in his introduction of the Joint Committee's Midyear Report, Outlook, 1980s:

> "Further, it is emphasized if no new steps are taken to address the problem of structural unemployment, lagging capital formation and a slowdown in productivity, then the American economy faces a bleak future."

We are plagued by rampant inflation, low productivity, and little or no growth in our gross national product. Continuation of this situation will prove more costly in the long run than taking the steps needed to put us back on a solid foundation of investment and savings.

An increased tax exemption on interest on savings is of particular benefit to the elderly who are on fixed incomes and who need the use of every dollar to make ends meet In addition, it would be of assistance to the younger person who is saving for a particular purpose such as a downpayment on a house.

The National League would encourage this Committee to look closely at expansion of the $200/$400 interest/dividend exclusion. At a minimum, the current two-year provision should be made permanent and the exclusion raised to a minimum of $500/$1,000.

Revision of Income Tax Treatment for S&Ls

We would also like to call the Committee's attention to a number of tax provisions affecting savings and loan associations which are in need of revision and change. While we recognize that it may not be possible to include all of these in a tax bill enacted this year, we would hope that the Committee will give consideration to these as a means of increasing the flow of funds to the mortgage market.

- Institute a Mortgage Interest Tax Credit as a substitute for the bad debt allowance under current law. The credit would be available to all financial institutions and would provide a credit against income tax equal to a specified percentage of interest received or accrued during a taxable year from qualified mortgage investments. This credit, unlike the bad debt allowance, provides the greatest benefits when mortgage funds are most needed, thereby helping to smooth the cyclical supply pattern of these funds. The credit is also directly related to the social purpose--housing finance--which it is designed to achieve.

- Elimination of the bad debt allowance as a preference item suject to minimum tax. This would remove the current penalty against savings and loans when reserves are increased. Build-up of reserves should not be penalized because they are needed for sound operation of savings and loans.

- Elimination of the IRS regulation on operating loss carry-back in 1979 or later. The IRS adopted this regulation in 1979 requiring recomputation and reduction of the bad debt reserve when a net operating loss is carried back from a year beginning in 1979 or later. This reduces the tax refund resulting from any such loss carry-back and, therefore, decreases the funds that can be used for mortgages.

- Extend full investment credit to savings and loans. Most businesses are allowed a credit equal to 10% of the cost of certain depreciable property against the first $25,000 of tax liability and 60% of the liability in excess of $25,000. For savings and loans this credit is reduced by half. Savings and loans should receive equal tax treatment with other businesses.

- Revision of IRS regulations on consolidated returns of savings and loans. IRS regulations require a pro rata reduction of the bad debt deduction of a savings and loan association included in a consolidated return of an affiliated group if any other member of the group has a loss. Prior to this regulatory amendment, adopted in 1979, a savings and loan association's bad debt deduction was based on its own separate taxable income and not that of the consolidated group.

Conclusion

We are aware that Secretary of the Treasury Miller has urged the Congress to postpone action on a tax cut until after the election. However, the housing and automobile industries are in a serious depression. Unemployment levels are rising to unacceptable limits. Productivity, investment, and savings have fallen to lower and lower levels. The tax burden faced in individuals will reach new highs in January 1981. Now is the time to develop a long-range plan to stimulate investment, savings, and tax relief for individuals so that we may move forward to a more vigorous and stable economic environment. As for the exact timing as to when the tax cuts should be effective, there is still substantial disagreement among tax and economic experts. We don't profess to be any more expert than they are on the timing of a tax cut; our primary concern is the composition of any proposed cut.

If there is to be a tax bill this year, we hope that you will include in such a bill expansion of the IRA and increased incentives for savings so that we may generate the capital that will be needed for housing, plant, and equipment investment in the 1980s.

I appreciate this opportunity to present the National League's views on this important matter. I will be happy to answer any questions you may have.

APPENDIX

By Gilbert G. Roessner and Reid Nagle

----------------SIRA------------------ SAVINGS-OF-INCOME-FOR-RETIREMENT ACCOUNTS

A Proposal to Encourage Personal Saving for Retirement and to Provide Resources for Capital Formation

I. RETIREMENT SECURITY

History. Early retirement systems in this country were largely informal with most assurances of retirement security coming from a family arrangement. Formal plans were difficult to join and frequently offered no guarantee of certainty and adequacy of benefits. Certainty refers to the liklihood of receiving benefits at retirement and adequacy implies the ability to maintain close-to-retirement standard of living for all beneficiaries.

A major social accomplishment in the forty years since the end of the Great Depression has been the establishment of a network of public and private programs which assures that nearly all Americans, upon entering old age, will receive some form of retirement security. A combination of private pension plans, government pension plans, and social security extends service-related coverage to nearly every worker; in addition, for those whose benefits under these programs fall below the poverty line, supplemental security income (SSI) was instituted in 1974 to guarantee a minimal standard of living for elderly Americans.

The Employees Retirement Income Security Act of 1974 (ERISA) brought substantial reforms to private pension plan management. On two broad fronts, it imposed mandatory guidelines on qualified corporate pension plans to protect the interests of participants and then it moved to allow pension rights (through Individual Retirement Accounts) for the employee not covered by either a corporate or Keogh plan.

Current Status. Broadened social security coverage, together with private pension plan legislation, has meant that the layers of private and public old age systems provide some form of retirement security to nearly every citizen. Expressed as a percent of total paid employment, private pension plan coverage has tripled since 1950 from 16 to 47 percent (see Table 1).

This draft version proposes and supports the Savings-of-Income for Retirement Act, legislation recently introduced in Congress by Senator Harrison Williams to encourage additional, long-term savings for retirement. The authors of this paper are Chairman of the Board and Vice President, respectively, of City Federal Savings and Loan in Elizabeth, New Jersey.

Similarly, social security coverage expanded sharply in the early fifties, from 65 to 85 percent between 1950 and 1955, since then, it has edged up to 90 percent. Government pension plans, including both state and local and federal plans, have doubled the number of covered employees in the past twenty-seven years and increased their coverage as a percent of total employment from 10 to 15.

Universality of coverage, a laudable accomplishment, has not in recent years coincided with adequacy of coverage. Particularly for participants in private pension plans, the level of benefits has not kept pace with inflation. Most private pension plans are the defined-benefit type; that is, they pay out benefits to annuitants according to predetermined formulae, usually either a flat dollar amount or a percent of past income. Calculated this way, there is seldom a benefit adjustment for inflation occurring after retirement and for many retirees this has meant a diminished standard of living. Table 2 shows that both the number of annuitants and the average per capita benefits paid by private pension plans have risen greatly between 1950 and 1972. Average annual benefits rose from $822 in 1950 to $1,900 in 1975. Since then, benefits have declined somewhat, but this no doubt reflects the increased numbers of early retirees following the 1974-75 recession and the lower benefits they generally receive.

This effect is small, however, when compared to the impact which inflation has upon the standard of living of retirees. In the ten year period between 1967 and 1977, average per capita benefits increased from $1,403 to $1,741 or 24 percent. At the same time, consumer prices rose 79 percent and as a consequence, real per capita benefits actually declined from $1,775 to $1,229 or by 30 percent (see Chart 1). Again, part of this is attributable to early retirement, but most results from the effect which inflation has had on pension payments made from defined-benefit plans.

Inflation erodes the ability of private pension plans to provide an adequate standard of living to benefit recipients. Table 3 shows the impact which inflation has on retirees covered by defined-benefit plans, assuming no inflation adjustment*. If an individual were to

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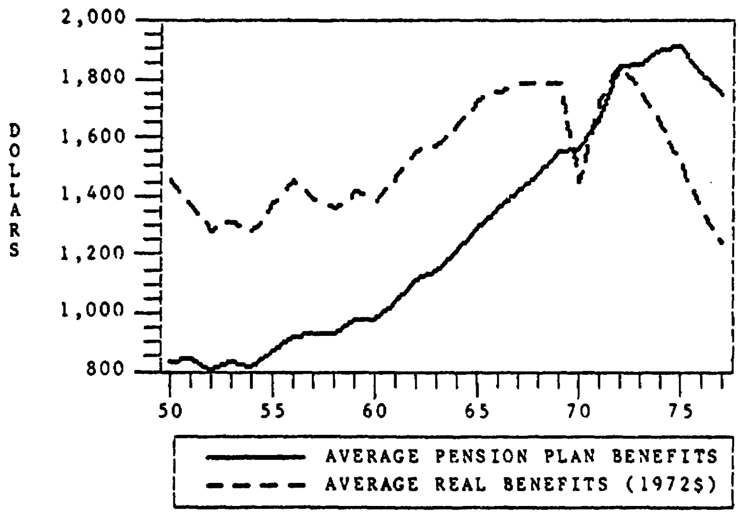
*A 1975 Banker's Trust Survey of Corporate Pension Plans indicates that one quarter of all plans did not raise benefits between 1970 and 1975. Of those that did, only a small number fully compensated for inflation occurring after the last benefit increase.

retire with benefits equal to pre-retirement income, in other words a 100 percent replacement rate, after 10 years of retirement with inflation running at 5 percent, the replacement rate drops to 61 percent. At a 10 percent rate of inflation, the replacement rate drops even further--to 39 percent. Other replacement rates, representing various lengths of retirement and levels of inflation are given in Table 3.

CHART 1

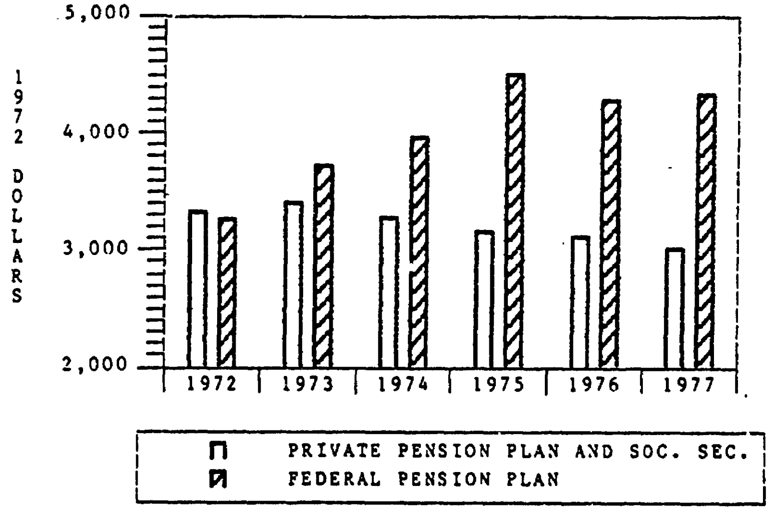
AVERAGE REAL AND NOMINAL PENSION PLAN BENEFITS 1950 TO 1977



Inasmuch as most government pension plans are indexed for inflation whereas most private plans are not, the high-levels of inflation during the seventies has resulted in a growing divergence between average benefits paid out by public and private plans. In 1972, the average retiree from the private sector received $3,304 annually (in 1972 dollars) in combined social security and private pension plan benefits, the average Federal civilian retiree received $3,223 from a government pension plan. At that time, the two benefit levels were about equal. By 1977, the real value of benefits received by the private sector retiree had declined to $2,982 while that received by the Federal civilian retiree had increased to $4,297, so that the latter on average received real benefits some 40+ percent higher. Table 4 provides the detail of this comparison and Chart 2 displays graphically the growing divergence in benefits received by private and public sector retirees.

CHART 2

AVERAGE REAL PRIVATE AND
GOVERNMENT PENSION PLAN PAYMENTS
1972 - 1977



II. RETIREMENT SAVING AND CAPITAL FORMATION

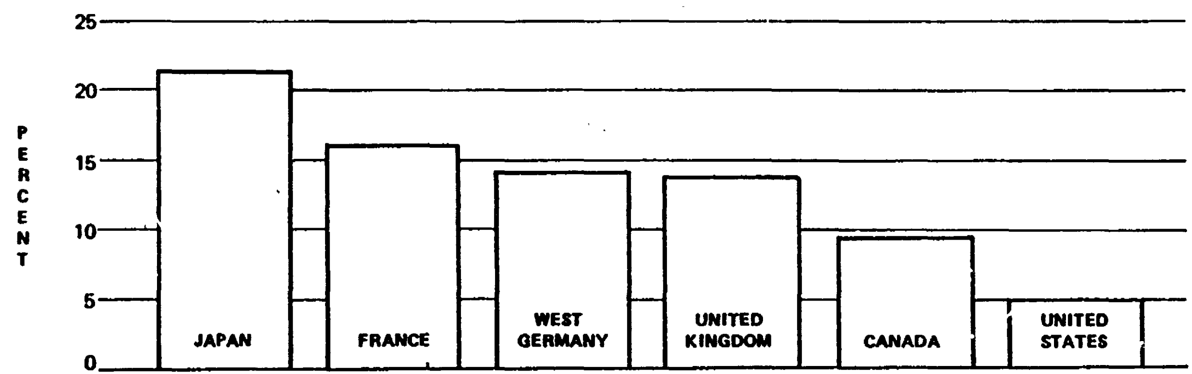
Saving by individuals provides a personal benefit in the form of retirement security, but it also yields a social good by providing funds for capital investment. In recent years, the saving rate of Americans has dropped to perilously low levels. The reasons for this are many. Expectations of long-term inflation must be regarded as a prime cause. Although the nominal return on many forms of investment has risen in recent years, when taxes on the nominal gain are taken out and adjustments for inflation are made, the real rate of return available to most small savers has been negative. Americans have learned from the inflation of the seventies the same lessons that the Germans learned in the twenties--that purchasing goods, particularly durables and housing, provides the most assured means of retaining a store of value. Consumer spending has accelerated, eased by an expansion of consumer credit, and saving as a percent of disposable personal income has fallen. From 1966 to 1975, personal saving as a percent of disposable personal income averaged 7.1 percent, for 1976-1978, that rate had declined about two points, to 5.3 percent. The fact that this low saving rate coincided with the longest peace time, postwar recovery is a source of further concern--periods of

CHART 3

COMPARATIVE SAVINGS RATES

1977

(as a percent of after-tax income)



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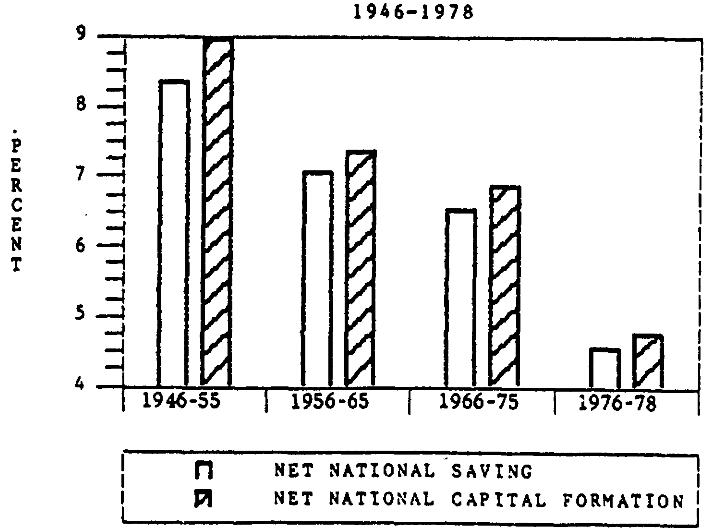
economic growth generally stimulate rather than retard the savings rate. Chart 3 shows that the United States personal savings rate during 1977 was far lower than other, major industrial countries.

The decline in personal saving comes on top of a secular decline in the net national saving rate--a term which measures all private and public saving, net of capital accumulation allowances. That rate has fallen steadily in the three decades following World War II--from 8.3 percent for 1946-1955, to 7.0 percent during 1956-1965, to 6.5 percent for 1966-1975 and down to 4.5 percent during 1976-1978. Table 5 gives the composition of net national saving over time, revealing that the contribution of corporate saving (i.e., retained earnings) has remained comparatively stable, the share of personal saving has steadily risen, and the "crowding-out" effect of government borrowing to finance deficits has been a major factor in the declining rate of net national saving.

Over the long run, a decline in the savings rate by definition translates into a reduced rate of net capital formation. When investment is adjusted to exclude depreciation, the remainder is referred to as net capital formation and can be expressed as a percent of net national product. When viewed this way, net capital investment is seen to have declined sharply over time, from an average of 11 percent during the first three decades of this century, to 8.9 percent for 1946-1955 and now to 4.7 percent for 1976-1978 (see Table 6). Chart 4 shows the intimate relationship over time between net national saving and net national capital formation. In turn, declining rates of net capital formation have resulted in a slow growth of the capital stock.

CHART 4

NET NATIONAL SAVING AND NET NATIONAL CAPITAL FORMATION AS A PERCENT OF NET NATIONAL PRODUCT 1946-1978



Why all the concern about capital formation and investment? For one thing, there is a direct relationship between the size (and technological composition) of the capital stock and the rate of productivity growth. And the higher the rate of productivity growth, the greater the standard of living in the future.

In essence, the debate surrounding capital adequacy for the future centers on a choice between present and future consumption. If the nation aims for a higher level of investment to provide for future growth, it must generate a greater amount of saving today. To generate this additional saving, either: (1) government will have to reduce the size of its deficit or (2) households will have to increase their savings rate. In either case, the decision to save more now comes at the expense of current consumption. There simply is no easy way out: if we wish to consume more in the future, we must consume less now; conversely, if we choose to increase today's consumption, it will involve a reduction in tomorrow's.

In light of a continual deterioration in national savings and investment, several factors have lead to increase in personal consumption and a consequent reduction in saving:

- A system of personal and corporation taxes which discourages saving.
- The social security system which guarantees really all workers a known real income in retirement and which, to an extent, replaces private saving.
- Inflationary expectations that accelerate personal spending, especially on durables.

One way to increase the saving rate is to alter tax policy so as to encourage saving. Our current tax structure actually discourages saving since it taxes individual income before the decision to save or consume is made. On top of that, replacement of the individual income tax with a consumption-based tax would increase the incentive for saving by increasing the after-tax return on saving. Methods of tax deferral, such as IRAs and Keoghs, effectively move the income tax closer to a consumption-based tax by deferring tax liability on long-term saving commitments. Inasmuch as consumption comprises about 94 percent of after-tax income, a consumption-based tax resulting from a tax deferral on long-term saving would generate revenues slightly below an income tax. However, the difference constitutes a deferral and not a forgiveness of tax liability, meaning that at least some of the current revenue loss to the Treasury would be recaptured in future years when retirees withdraw their tax-deferred savings and interest.

The retirement savings proposal outlined in the next section of this paper has a twofold purpose. First, it would allow individuals covered by private pension plans to protect themselves in retirement against the consequences of inflation over which they have no control. Second, it would move the United States personal income tax system closer to a true composition-based tax that would encourage a higher level of personal saving--an important ingredient in meeting the capital needs of the eighties.

III. SUPPLEMENTAL INDIVIDUAL RETIREMENT PROGRAM (SIRA)

Pension reform enacted in the Employee Retirement Security Act of 1974 moved to protect employees not covered by either a corporate pension or Keogh plan. Beginning in 1974, working individuals who were not covered by a corporate plan and ineligible to set up a Keogh plan could establish an Individual Retirement Plan with tax deductible contributions. Taxes on the contributions and interest earned on principal would be deferred until after retirement when income and hence tax rates are generally lower. ERISA restricted annual IRA contributions to the lesser of 15 percent of earned income (during the calendar year) or $1,500. Since then, the dollar limitation has been raised to $1,750 for a spousal IRA (where either the husband or wife qualifies for an IRA and the other partner is a full-time housekeeper).

Introduction of IRAs formed the last link in the chain--in addition to social security, nearly all workers in the private sector would be covered by a corporate pension plan, a Keogh plan, or an individual retirement account. Universal coverage does not imply universal equity, however. In real terms, a $1,750 IRA contribution made in 1979 equals only $1,318 in 1974 dollars. If inflation continues at 10 percent for the next five years, price increases will have reduced a $1,750 contribution to $770 worth of 1974 dollars. To correct the inflationary erosion of retirement security, the first part of this proposal recommends that the dollar limitation on IRA contributions be raised to $2,000 (beginning in taxable year 1980) provided this amount does not exceed 20 percent of earned income. In addition, this maximum will be adjusted annually by adding an inflationary adjustment calculated from the Consumer Price Index change over the prior federal fiscal year. If inflation during the year after enactment of the $2,000 limitation ran at 9 percent, imposing a $180 reduction in the real value of the maximum contribution, the limit would be raised to $2,180. Adoption of this proposal recognizes the right of individuals to freely provide for their own retirement security.

The second part of this proposal addresses the inequity resulting from insufficient private pension plan coverage. As evidence presented earlier indicated, most corporate pension plans were not formulated to deal with inflation, so that rising prices have in many cases rendered benefit levels insufficient. To remedy this situation, it is proposed that a new type of retirement savings mechanism be established (SIRAs) that will promote Savings for Retirement Income. Available to all participants in private pension plans, SIRAs would offer the same double tax advantage as an IRA, namely, the tax deferral of contributions and of interest earned on principal.* Qualifying individuals could contribute the lesser of 10 percent of earned income or $1,000 beginning in tax-year 1980. As with the IRA, early withdrawal would be subject to heavy tax penalties, thereby encouraging these funds to go into long-term saving.

Enactment of legislation providing for SIRAs would serve two purposes. First, it will enable persons working in the private sector to supplement their incomes during retirement by saving now. The $1000 per year deduction would be sufficient to provide the average worker with a constant standard of living during retirement if inflation averaged 8 percent. Without these savings to augment a private pension plan, inflation would erode the real value of pension plan benefits and cause the retiree's standard of living to deteriorate. To prevent erosion of SIRAs by inflation, indexation of the deductible amount would begin in 1981, again based on the CPI change during the prior federal fiscal year.

Second, SIRAs will promote additional, long-term saving. Unlike most proposed incentives for savers which allow deductions for interest earned on savings balances, the SIRA proposal would allow deductions only for new, long-term saving. As with IRAs, preferential tax treatment is allowed only if the contributor allows the accumulated funds to remain in the plan until he (she) reaches age 59-1/2. Any withdrawal prior to that time is subject to substantial tax penalty.

A final part of this proposal would increase the allowable Keogh contribution to the greater of $10,000 or 20 percent of earned income beginning in 1980. This amount would be indexed for inflation at the point at which the allowable IRA contribution reached $5,000 Due to inflation indexation. At an average inflation rate of 10 percent, it would take 10 years to reach this level and trigger indexation of Keogh deductions. After that point is reached, the maximum allowable deduction for Keogh contributions would be double that for IRAs, which in turn would be twice that of SIRAs.

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*Persons working for Federal, state, or local governments would not qualify for SIRAs unless they moved into the private sector. Federal workers enjoy a substantial, inflation indexed retirement plan and state and local government employees are already eligible for deferred compensation plans that are similar to SIRAs.

Incentives for long-term saving have important implications for capital formation, provided that substantial new savings are generated. Experience with IRAs suggest that SIRAs would prove popular as a savings vehicle. Table 7 shows that annual IRA contributions grew 68 percent in the first three years of their existence. The number of contributors grew from 1.21 million in 1975 to 1.95 million in 1977, contributing in the latter year a total of $2.4 billion. This amount represented 3.6 percent of personal saving during 1977, and probably a substantially larger amount by 1979.

SIRAs will thus serve a dual purpose: (1) they will correct the inequities imposed on retirement security by unanticipated inflation; and (2) SIRAs will encourage additional long-term saving that will foster much-needed capital formation.

TABLE 1

RETIREMENT SECURITY COVERAGE
1950 - 1977

Year	Total Paid(a) Employment (Millions)	Private Pension Plans: Number(b) Covered (Millions)	Private Pension Plans: % of Employment	Social Security: Number Covered (Millions)	Social Security: % of Employment	Government Pension Plans(c): Number Covered (Millions)	Government Pension Plans(c): % of Employment
1950	60.0	9.8	16	38.7	65	6.0	10
1955	64.5	15.4	24	55.0	85	7.2	11
1960	67.5	21.2	31	59.4	88	8.1	12
1965	73.6	25.4	35	65.6	89	9.6	13
1970	80.6	30.2	37	72.1	89	11.0	12
1975	86.2	38.5	45	77.6	90	12.8	15
1976	89.5	40.9	46	80.7	90	13.3	15
1977	92.6	43.6	47	83.4	90	13.6	15

Sources: United States Department of Commerce, Bureau of the Census, Current Population Survey, Series P-20, Life Insurance Fact Book, various editions; Social Security Bulletin, Statistical Supplement, 1975; and unpublished data from American Council of Life Insurance.

(a) Includes members of Armed Forces and all employed labor force participants over age 16.
(b) 1976, 1977 figures are estimates.
(c) Includes Federal Civilian Employment (primarily Civil Service), Railroad Retirement, State and and Local Government Employment.
(d) "Number Covered" includes unemployed, but non-retired individuals who are covered by various private pension plans.

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TABLE 2
AVERAGE PER CAPITA PRIVATE PENSION PLAN BENEFITS,
IN CURRENT AND CONSTANT (1979) DOLLARS

Year	Annuitants (Thousands)	Total Benefits (Millions)	Average Annual Per Capta Benefits	Average Real Per Capita Benefits (1972 $)
1950	450	$ 370	$ 822	$ 1,443.28
1951	540	450	833	1,354.96
1952	650	520	800	1,272.26
1953	750	620	826	1,303.51
1954	880	710	807	1,269.03
1955	980	850	867	1,366.93
1956	1,090	1,000	917	1,442.47
1957	1,240	1,140	919	1,38[illegible].95
1958	1,400	1,290	921	1,348.43
1959	1,590	1,540	968	1,402.94
1960	1,780	1,720	966	1,379.26
1961	1,910	1,970	1,031	1,456.44
1962	2,100	2,330	1,109	1,548.49
1963	2,280	2,590	1,136	1,566.59
1964	2,490	2,990	1,200	1,633.35
1965	2,750	3,520	1,280	1,715.02
1966	3,110	4,190	1,347	1,752.38
1967	3,415	4,790	1,403	1,775.50
1968	3,770	5,530	1,466	1,780.74
1969	4,181	6,449	1,542	1,796.70
1970	4,726	7,360	1,557	1,441.01
1971	5,211	8,600	1,650	1,722.01
1972	5,460	10,015	1,834	1,834.00
1973	6,095	11,235	1,843	1,741.97
1974(a)	6,600	12,500	1,894	1,632.48
1975	7,000	13,300	1,900	1,494.30
1976	7,600	13,700	1,803	1,347.94
1977	8,100	14,100	1,741	1,229.43

Sources: Life Insurance Fact Book, various editions, and unpublished data from American Council of Life Insurance.

(a) Figures from 1974-1977 are estimates.

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TABLE 3

REAL REPLACEMENT RATES AFTER 5, 10, 15 AND 20 YEARS OF RETIREMENT WITH ALTERNATIVE RATES OF INFLATION

Years in Retirement	Real Value of Retirement Income Based on Initial 100% Replacement Rate			
	No Inflation	3% Inflation	5% Inflation	10% Inflation
0	100 %	100 %	100 %	100 %
5	100	86	78	62
10	100	74	61	39
15	100	64	48	24
20	100	55	38	15

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TABLE 4

REAL AVERAGE PER CAPITA BENEFITS UNDER VARIOUS RETIREMENT SECURITY PROGRAMS
(1972 $)

			Government-Administered Pension Plans				
Year	Private Pension Plans	Social Security	Railroad Retirement	Federal Civilian Employees	State and Local Government	Private Pension Plus Social Security	State/Local Pension Plus Social Security
1972	$1,834	$1,470	$1,471	$3,223	$2,871	$3,304	$4,341
1973	1,753	1,628	2,474	3,684	3,171	3,381	4,799
1974	1,632	1,630	2,406	3,923	3,163	3,262	4,793
1975	1,497	1,642	2,515	4,467	3,046	3,139	4,688
1976	1,354	1,722	2,611	4,254	3,129	3,076	4,851
1977	1,230	1,752	2,598	4,297	2,763	2,982	4,515

Sources: Life Insurance Fact Book, various editions; Social Security Bulletin, various issues and unpublished data from the American Council of Life Insurance.

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TABLE 5

SOURCES OF NET NATIONAL SAVING

	1946-55	1956-65	1966-75	1976-78	1946-78
Net National Saving Rate	8.3%	7.0%	6.5%	4.5%	7.0%
Percent of Net National Saving					
Personal Saving	60.0	67.4	87.0	103.7	74.4
Corporate Saving	35.4	41.5	33.7	33.3	36.5
Government Saving	4.7	(8.5)	(21.1)	(37.0)	(13.8)
Personal Saving Rate	5.8	5.9	7.1	5.3	6.2

Source: U. S. Department of Commerce, Bureau of Economic Analysis, "National Income and Product Accounts" as found in Survey of Current Business, various editions.

TABLE 6

NET NATIONAL CAPITAL FORMATION AS A PERCENT OF NET NATIONAL PRODUCT

Period	Rate (%)	Period	Rate (%)
1869 - 1878	12.5	1946 - 1955	8.9
1879 - 1888	12.1	1956 - 1965	7.3
1889 - 1898	13.2	1966 - 1975	6.8
1899 - 1908	12.9	1976 - 1978	4.7
1909 - 1918	10.4	1869 - 1928	11.9
1919 - 1928	10.1	1946 - 1978	6.0

Sources: Martin Feldstein, "National Saving in the United States" in Capital for Productivity and Jobs, 1977; and United States Department of Commerce, Bureau of Economic Analysis, Survey of Current Business, various issues.

TABLE 7
IRA AND KEOGH CONTRIBUTIONS
1974 - 1977

YEAR	IRA # Returns (Millions)	IRA Amount Of Contributions (Millions)	KEOGH # Retuns (Millions)	KEOGH Amount of Contributions (Millions)
1974	N.A.	$ N.A.	0.50	$ 1,235
1975	1.21	1,436	0.60	1,604
1976	1.64	1,968	N.A.	N.A.
1977	1.95	2,409	0.57	1,827

Source: Internal Revenue Service
N.A. - Not Available

RN/339

Statement
of the
National Association of Mutual Savings Banks
on
Tax Incentives for Savings
Before the
Committee on Finance
United States Senate
July 29, 1980

Summary of Principal Points

1. Legislation to provide tax incentives for individual savings is vitally needed to stimulate our nation's perilously low personal saving rate. This will encourage increased investment and productivity growth in the economy, and thereby contribute importantly to the long-run battle against inflation.

2. This can best be achieved by extending the Individual Retirement Account program. Accordingly, we strongly urge that allowable contributions be increased and that coverage be expanded to taxpayers not now eligible for IRAs. The result would be a broadly-based, long-term, tax deferral provision available generally to all individual taxpayers.

3. Such an IRA-type tax deferral provision would have a continuing economic impact over the long-run, and would tend to stimulate new saving, rather than rewarding past saving. It would be ideally suited to the objective of increased long-run noninflationary economic growth. The tax deferral feature would permit the Treasury to recover part of its initial revenue losses, even aside from the increased tax revenues resulting from more rapid real economic growth.

4. Support for some form of tax relief is mounting, largely because of the impact of inflation, recession and the scheduled rise in social security taxes. This current situation provides a golden opportunity to tailor tax relief to the longer-run need to encourage saving, capital formation and real economic growth.

Statement
of the
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Mr. Chairman and members of the Committee, my name is Charles A. Pearce. I am Chairman of the Committee on Federal Legislation of the National Association of Mutual Savings Banks and President of the Quincy Savings Bank in Massachusetts. The National Association represents the nation's 464 mutual savings banks, located in 17 states. Savings banks are mutual institutions without stockholders. Their assets total $167 billion, two-thirds of which is represented by mortgage investments.

I appreciate the opportunity to present the views of the mutual savings bank industry. My statement will concentrate on the critically important need for increased tax incentives for individual savings.

Summary of Savings Bank Industry Position

Legislation to provide tax incentives for savings is vitally needed on many grounds. Such action would help correct the anti-saver bias persisting in our tax laws. It would stimulate our nation's perilously low personal saving rate. As a result, it would encourage increased investment and productivity growth in the economy, and thereby contribute importantly to the long-run battle against inflation.

Tax incentives for saving should, therefore, be a major element in any tax reduction package adopted by the Congress in the current environment. Inflation continues to be one of the most serious threats confronting our nation. Tax reduction legislation should, therefore, be framed with a view to providing major stimulus to saving, capital formation and real economic growth. Otherwise, a major reduction in taxation at this time could greatly aggravate our already serious inflation problem.

Our industry has long supported savings tax incentives. In line with this position, we strongly supported the $200-$400 exclusion for interest and dividends which was enacted earlier this year. We urge that this provision be made permanent. The $200-$400 exclusion is a useful first step in addressing the need for equity for the small saver. But it remains only a first step, which should be followed by additional tax action to encourage increased saving and capital formation.

This can best be achieved, we believe, by extending the Individual Retirement Account program. Thus, we strongly support an increase in allowable contributions and an expansion of coverage to taxpayers not now eligible for IRAs. The result would be a broadly-based, long-term, tax deferral provision available generally to all individual taxpayers.

Such a tax deferral incentive would have a continuing economic impact over the long run, and would tend to stimulate new saving, rather than rewarding past saving. Therefore, it would be ideally suited to the objective of increased long-run non-inflationary economic growth. And the tax deferral feature would permit the Treasury to recover part of its initial revenue losses, even aside from the increased tax revenues resulting from more rapid real economic growth.

A long-term, tax deferral provision would clearly help individuals provide for their retirement needs. This could significantly relieve the mounting pressures on the social security system. In addition to retirement needs, the Congress might want to consider other basic thrift purposes which could also be served by such a long-term incentive. Later in this statement, we will offer more detailed suggestions for achieving this objective.

Need for Savings Tax Incentives

Before turning to our specific recommendations, however, it is appropriate to reemphasize the need for tax incentives for savers. This need is critical and is becoming increasingly recognized. It has been underscored in recent years by our nation's low personal saving rate, declining productivity growth and explosive inflation rate. It is underlined also by the "revolt of the small saver," beleaguered by inflation and by a tax system that discourages saving while favoring spending and borrowing. It is dramatized further by the recent experience of our nation's thrift institutions, which are just now emerging from a period of record disintermediation and unprecedented earnings pressures, resulting from inflation-induced increases in open-market interest rates.

With respect to the personal saving rate, the basic facts are well known. After averaging over 6 per cent of disposable income during most of the post-World War II period, personal saving has declined below that level during the past 4 years. In 1979, the savings rate sank to 4.5 per cent, a 30-year low. And in the second quarter of 1980, the saving rate was still only 4.7 per cent, even after a sharp, recession-induced cut-back in consumer spending.

This record contrasts sharply with that of other Western nations, many of which have provided tax incentives for saving. In 1977, the latest year for which United Nations data are available, the saving rate was 25 per cent in Japan, 17 per cent in Belgium, 13 per cent in France, 13 per cent in West Germany, 11 per cent in the United Kingdom, and 11 per cent in Sweden.

With respect to productivity, our nation's record is equally dismal. From 1947 to 1967, productivity in the private business sector increased at an average annual rate of 3.2 per cent. During the past decade, however, productivity grew less than half as fast -- at a rate of 1.4 per cent a year. In 1979, productivity actually declined and this reduction continued into the first quarter of 1980.

The declining trends in the personal saving rate and in productivity gains have obviously contributed to the inflation problem plaguing our nation. These trends will not easily be reversed without tax incentives for increased saving and capital formation. Since the household sector in recent years has accounted for 63 to 80 per cent of total gross saving in the nation, specific incentives for personal saving are essential to an effective anti-inflation effort and to promote strong long-term economic growth.

In this regard, individual savers are caught in a vicious circle of rapid inflation that erodes the real value of their savings while pushing their incomes into higher tax brackets. And after siphoning off part of their incomes at steeply rising marginal rates, the tax system reduces further the return on funds that taxpayers manage to set aside in savings.

A tax incentive would be the most direct and practical means of improving real after-tax returns to savers and stimulating increased saving. Indeed, it is the only feasible means in most cases, given the weakened earnings positions of thrift institutions. Reflecting the rise in deposit interest costs, bottom-line income positions of savings banks have been seriously impaired. Thus, net income in the first quarter of 1980 was 40 per cent below a year earlier. Numerous individual institutions, moreover, will be operating in the red for at least part of 1980.

Even with increased deposit interest rates, it should be noted, thrift institutions suffered large-scale disintermediation in 1979 and early 1980. This brought mortgage lending to a virtual stand-still and contributed greatly to the serious recession in housing which is only now beginning to moderate. A tax incentive would be the best means of assuring an adequate supply of funds for housing in future high interest rate periods.

This would be particularly true if the incentive were designed to encourage long-term saving, in a manner similar to the IRA/Keogh programs. These retirement savings have been one of the few stable elements in the savings bank deposit structure. In 1979, for example, IRA/Keogh balances at savings banks increased by an estimated $600 million, excluding interest, contrasting with a net loss of $7.5 billion in other savings and time deposits in the same period. Retirement and other long-term savings are particularly appropriate for mortgage lending and would help to redress the borrow-short, lend-long imbalance in the thrift institution structure.

The Budgetary Impact of a Savings Tax Incentive

A major concern regarding tax incentives for savings, of course, is the impact on federal tax revenues. This is an important point at a time when the federal budgetary deficit is increasing greatly. Over the longer run, however, an increased level of private saving and capital formation would provide more than offsetting economic benefits to the nation, particularly in its anti-inflation impact. Increased private saving, for example, would help offset new inflationary pressures that might result from a major increase in defense spending. To the extent that more savings are channeled to the depressed housing sector, furthermore, the need for costly federal subsidy programs would be reduced.

Increased real economic growth, moreover, would generate increased tax revenues and thus help offset any initial revenue loss. And, of course, the tax deferral route would ultimately permit the U. S. Treasury to regain much of its initial revenue losses.

In any event, major tax reduction legislation appears to be in prospect. Strong support for tax relief is being generated by the effect of inflation in pushing taxpayers into higher brackets, by the scheduled rise in social security taxes and by the impact of the current economic recession. This situation provides a golden opportunity to tailor tax relief to the critical longer-run need to promote noninflationary economic growth through increased private saving and capital formation.

Modification of Existing IRA Program

Individual Retirement Accounts are a major area of consideration in current efforts to provide increased tax incentives for saving. Reflecting their widely recognized benefits, a number of proposals have been made to improve the IRA provisions of the Code. In general, these proposals seek to increase allowable contributions and liberalize eligibility rules.

IRAs are vitally important as a supplement to social security in building retirement income for many individuals. As indicated earlier, IRAs are also an important stabilizing force in the savings bank deposit structure, as well as being ideally suited to long-term mortgage lending. Accordingly, NAMSB has always supported needed modifications in the program.

Thus, we strongly support proposals to increase the maximum amount of deductible contributions to IRAs from $1,500 to $2,000 or a higher figure. Individuals utilizing IRAs should be able to set aside amounts more closely comparable to amounts currently permissible in other retirement plans. Increases in maximum deductions should also be permitted for so-called spousal IRAs.

We also support the extension of the IRA concept to individuals who are covered by corporate pension plans and consequently are not permitted to deduct contributions to IRAs. This would clearly provide another method of enabling individuals to supplement social security payments, as well as present pension benefits which are being eroded through rapid inflation.

We are gratified that Senator Bentsen has proposed legislation (S. 557) having the same general purpose sought by our industry. Furthermore, Senator Heinz has proposed legislation for rollover accounts (S. 1964) which has a broadly similar intent.

A Broadly-Based, Long-Term, Tax Deferral Provision

All of these changes point in one direction -- toward a more widely applicable tax deferral provision to permit and encourage individuals to undertake long-term savings for retirement purposes. Such a tax deferral provision would be available to all taxpayers, including those currently covered by corporate pension plans and hence presently ineligible for participation in IRAs. This would permit taxpayers to provide more adequately for their own retirement. It would also help protect the social security system from pressures which could eventually undermine its viability.

As discussed earlier, the tax deferral feature would permit the Treasury to regain part of the initial revenue loss. By encouraging individuals to set aside funds for lengthy periods of time, and by discouraging early withdrawls, such an incentive would tend to generate new saving that otherwise would not be undertaken. In addition to IRA/Keogh plans, there are other precedents for tax deferral such as Series E savings bonds and IRS-approved profit-sharing or "defined contribution" plans.

In this regard, a major mutual fund organization recently began to offer variable annuities invested in money market fund shares, which accumulate income on a tax deferred basis until the annuity payout period begins. Similar programs may be introduced by other mutual fund organizations. This underscores the need for Congressional action on an IRA-type tax deferral provision which would be available to all taxpayers through a wide range of savings instruments, rather than on a narrow basis as permitted under present law.

Making tax-deferral available to all taxpayers has obvious merit as a means of stimulating retirement savings. In addition, the Congress might wish to consider the extension of the principle to a broader range of savings purposes in addition to retirement. NAMSB proposed such a provision during hearings conducted by the House Ways and Means Committee on January 30, 1980. As we testified at that time, the proposed provision could be structured essentially like an IRA except that:

1. All individuals would be eligible to establish such accounts.

2. Distributions would be taxable after a stated maturity (for example, 5 years) or upon retirement if earlier.

3. Distributions might be entirely nontaxable or taxable at capital gains rates, as well as free of penalties, if used to meet specified types of expenditures such as down payments on first-time home purchases or education expenses.

Concluding Comment

In conclusion, the savings bank industry strongly supports enactment of a long-term tax deferral provision to promote increased personal saving. Such an incentive is urgently needed in the long-run battle against inflation. It is needed to provide increased rewards to all savers, and a better deal for the "small saver" in particular. We hope that our comments will be useful to the Members of the Committee as you consider this critical issue.

The CHAIRMAN. Now we will call a panel consisting of Herbert B. Cohn, accompanied by Robert R. Nathan, on behalf of the Committee for Capital Formation Through Dividend Reinvestment; and Ms. Margaret Cox Sullivan from the Stockholders of America, Inc.

Mr. Cohn and Mr. Nathan, would you please proceed.

STATEMENT OF HERBERT B. COHN, ACCOMPANIED BY ROBERT R. NATHAN AND DONALD C. ALEXANDER, ESQ., ON BEHALF OF THE COMMITTEE FOR CAPITAL FORMATION THROUGH DIVIDEND REINVESTMENT

Mr. COHN. Mr. Chairman, my name is Herbert B. Cohn. I appear here today as chairman of the Committee for Capital Formation Through Dividend Reinvestment. The members of this committee are listed in an appendix to my formal statement.

Also appearing for our committee are Robert R. Nathan, our economic consultant, and Donald C. Alexander, our tax counsel.

I should like to request, Mr. Chairman, that the formal statements filed by Mr. Nathan and by me be incorporated in the record, and at this time Mr. Nathan and I will briefly summarize our views.

We support, Mr. Chairman, a carefully formulated and targeted tax cut of some $30 billion to take effect January 1, 1981. Such a tax cut should be designed to stimulate the economy, and to counter inflation. The major objective should be to encourage capital formation, savings, and investment, and increased productivity, and thereby to reduce unemployment.

This objective, we believe, can be materially advanced by including in any tax cut the dividend reinvestment proposal embodied in S. 1543, which would defer current taxes on dividends reinvested under qualified plans in new issue stock.

The dividend reinvestment proposal is now sponsored by 13 Senators. The counterpart proposal in the House now has 100 sponsors.

I would like to emphasize very briefly, Mr. Chairman, five points in support of our recommendation.

First, we believe the dividend reinvestment proposal is the most direct, most closely targeted, and most cost-effective proposal for encouraging new capital formation where it is most urgently needed.

It is the most direct because the reinvestment of dividends in new issue stock represents instantaneous formation of new capital. One can see it happen.

It is the most closely targeted because it represents a rifle shot which is 100-percent effective in providing new capital to capital intensive companies having an urgent need for such common stock capital to finance new facilities.

It is the most cost effective since it will provide a substantial increase in new capital formation, new capital investment, and stimulation of the economy, while involving a modest or nonexistent revenue loss.

Second, the proposal will be counterinflationary in helping to finance increased productive facilities, and in substituting capital formation for current consumption. It will also represent an important step in reducing the double-tax on dividend income by eliminating the tax at the stockholder level when dividends are reinvested under qualified plans.

Third, the dividend reinvestment proposal is complementary to, and in no way conflicts with, proposals to increase internal generation of capital through accelerated tax depreciation and other approaches to reducing taxes imposed on corporations.

But it is important to note that such a reduction of taxes will have little or no effect in capital formation for a company which must flowthrough tax savings into the price of its product, or which has little or no taxable income.

For the many such companies, which are primarily dependent on external financing through the continuing sale of securities, the dividend reinvestment proposal is the most direct, and most cost effective vehicle to encourage capital formation.

Fourth, at a modest or nonexistent loss in tax revenues, the dividend reinvestment proposal would provide very substantial new capital formation, and substantial help to our economy.

Dividend reinvestment plans for new issue stock are now providing close to $2 billion of common stock capital for an important segment of American industry, primarily dependent on external financing. Adoption of the legislation will double this figure, and this will provide some 50 percent of our total external common stock requirements.

Fifth, the record is clear that the very large majority of the participants in these plans who would benefit are the small stockholders. As shown in the chart attached as appendix B to my statement, an analysis of the participants in the general telephone plan indicates that over 84 percent of the stockholders participating in that plan hold less than 100 shares.

Thank you very much, Mr. Chairman for this opportunity to appear.

STATEMENT OF ROBERT R. NATHAN, ON BEHALF OF THE COMMITTEE FOR CAPITAL FORMATION THROUGH DIVIDEND REINVESTMENT

Mr. NATHAN. Mr. Chairman, my name is Robert Nathan, and I am here as a consultant to the Committee for Capital Formation Through Dividend Reinvestment. I want to speak about the dividend reinvestment plan, but also about the general tax picture. I will summarize my statement orally, knowing that the full statement is in the record.

First, Mr. Chairman, this country does have a very serious problem now with a deepening recession, with tremendous losses of production and jobs and real damage. The question is: Should there be a tax cut or not, and if so, why and how much, and what kind of a tax cut.

I would very much like to support what has been said concerning a sizable tax cut, which I believe, Mr. Chairman, can serve as an anti-inflation factor, not an aggravating force in terms of inflation.

I have grave doubts personally, Mr. Chairman, as to whether a recession is the answer to inflation, I think the costs of inflation in this country are very severe, and they are very broad. We will need a broad program to overcome inflation.

We have to go after the energy problem so that we are not continuously subject to OPEC price rises that affect inflation. We have to go after productivity in a very direct manner as well as through indirect channels. We must stimulate investment to get rid of our obsolete equipment and replace it with modern, efficient, expanded capacity to produce and compete effectively at home and abroad.

We must check carefully to be sure that we have maximum price competition in our economy, and that the marketplace functions well, because if it does not function well. A recession is totally wasteful.

We must review and check regulations for their inflationary impacts. We must review trade policies. We must consider the nature and composition of taxes—some are more inflationary than others.

These are the kinds of problems, Mr. Chairman, at which I think we have to take a hard look and not just plan another recession. Recession has failed twice in bringing a solution to the inflation problem.

It seems to me that there is no better time to attack the productivity and the investment problems than now because the recession is discouraging investment. What we need to do is to encourage investment. That is why I very strongly support a tax cut of about $30 billion, about half of which would relate directly to productivity and the stimulation of investment through this dividend reinvestment plan, accelerated depreciation, and stimulation of research and development.

As to the other half, as I develop in my written testimony, it would be highly desirable to focus on reducing the inflationary impact in the consumer price index, delaying social security tax increases so that we don't get the spiral effect that causes inflation to get worse rather than better.

Mr. CHAIRMAN. I think this dividend reinvestment plan is one of the most effective ways to stimulate investment, and especially to bring about investment in equity financing.

Unfortunately, in the last decade or two, too much of our capital formation in this country has taken on the form of debt financing, and this has had a precarious and serious effect on the financial structures of many, many American corporations, reducing their dividend coverage, downrating bonds, and seriously increasing the financial risks of many corporations.

As Mr. Cohn said, for certain categories like utilities, when regulatory commissions force a flowthrough of the benefits of accelerated depreciation it does not help investment at all. But the dividend reinvestment plan would. It would increase investment by billions, and the feedback in terms of increased gross national product would yield increased revenues which I am convinced, would within 3 years after such a bill were enacted yield more revenue rather than less, and there would not be any cost.

I don't know of any kind of a taxation plan that would give us a bigger bang for the buck, that would be more direct in its impact in stimulating investment than the dividend reinvestment plan.

Let me say, Mr. Chairman, that I believe it is tremendously important to look at this as an important democratic principle because the stock dividend is a decision of the corporation. I am in favor of stock dividends when corporations need to retain cash. But this dividend reinvestment plan requires a joint decision of the corporation and of the investor.

I think that we ought to give to direct reinvestment of dividends the same benefits that apply to stock dividends. I very strongly urge that it be given serious consideration because you will get more benefits in investment per dollar than from any other incentive.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you very much, sir.

Now let's hear from Ms. Margaret Cox Sullivan of Shareholders of America, Inc.

STATEMENT OF MARGARET COX SULLIVAN, STOCKHOLDERS OF AMERICA, INC.

Ms. SULLIVAN. Mr. Chairman, I appreciate the opportunity to appear here on behalf of Stockholders of America to tell you what I have been hearing from our members across the country by phone, mail and personal contacts.

My name is Margaret Cox Sullivan, and I am president of this 8-year-old national, nonprofit, nonpartisan organization dedicated to representing the interests of stockholders of publicly held American corporations.

We are grateful the committee has arranged for these hearings for the consideration of tax cut legislation. Certainly our tax system needs a lot of consideration. Our remarks, and indeed our conclusions and recommendations are predicated on the findings in the 1980 Joint Economic report, a report which Senator Bentsen, the chairman, said signals the start of new era of economic thinking.

It recommends that one-half of the next tax cut be directed toward enhancing savings and investment. To be sure, it has a dark side—the decline of the country's economic fortune. But the bright side is that this trend can be reversed.

The past has been targeted primarily to the demand side of the economy, whereas the 1980 report recommends policies designed to increase the productivity, the supply side of the economy, and this must be done. The United States now ranks seventh in productivity, in capital investment, and economic growth, and has the lowest investment rate of any industrialized nation in the world, with the period of capital recovery one of the longest.

Therefore, it is crucial that we restructure our tax laws to allow corporations to generate capital internally, to attract new investments to supply capital in the market place. We must do this now. We no longer have the luxury of time, because time is a factor, in our judgment.

Stockholders of America continues to support enactment of the Capital Cost Recovery Act of 1979, S. 1435, as it is written, with the 10-5-3 liberalized depreciation formula. It has been studied and sponsored by the 54 bipartisan members of the Senate.

It is not just another tax proposal, but it is a carefully worked out answer to our Nation's problems of declining investment and productivity.

Further the Capital Cost Recovery Act would increase the cash available for either corporate retention or paying dividends, and dividends are important to stockholders.

The success and strength of our free enterprise system comes from this large diversified ownership base. Although there are still 25 million stockholders who currently own stock in 11,000 publicly owned corporations, the number reveals a sharp decline of 18 percent.

The number slid from 1970 to 1975 from 32 million, but we do have indications now that individual investors are coming back to the market, and we feel that this is due to the lowering of the tax on capital gains by the Revenue Act of 1978, and this is good.

Historically, it has been the individual investors, the stockholders, the little guys, who have been the main source of equity capital. Their role is vital. The markets will not work without them. They must be attracted back, and tax incentives are needed to attract them.

Therefore, Stockholders of America continues to support enactment of S. 1543, a bill which would exempt dividend payments from the stockholder's individual Federal icome tax when dividends are reinvested in original issue stock under the corporation's qualified dividend reinvestment plan. It is a very simple technique.

Stock purchased in this manner would be treated similarly to stock dividends, and subject to capital gains tax when sold. The stock must be kept a year to qualify. The individual stockholder would be able to exclude only up to $1,500 per year on his or her dividend income.

We would like also, though, to support Senator Cranston's recently introduced capital reinvestment incentive bill, which would reduce the effective tax rate on capital gains from 28 to 21 percent, which we feel is only another step in the right direction.

Yesterday, Senator Schweiker introduced a venture in Equity Capital Revitalization Act of 1980, S. 2983, which warrants attention.

It is our conclusion that the tax cut legislation should be enacted as soon as possible. The enabling legislation should include the Capital Cost Recovery Act of 1979, the tax exempt status for reinvested dividends, and the Capital Cost Investment Incentive Act of 1980, plus a 10 percent across-the-board reduction of individual income tax to take effect in 1981.

We heartily agree with the Joint Economic Committee that the Federal Government must put its own financial house in order, and that does require a steady reduction in the ratio of Government spending to the gross national product, and a full accounting of the command over resources now exercised by the Federal Government as the report says.

We feel as taxpayers we are paying for more government than we want, and more than we need, and as a Nation more than we can afford.

The Federal Government is trying to do more than its resources will permit. It is trying to do many things that it cannot do very well, and endeavoring some things that should not be done at all, in our opinion.

Thank you.

Mr. CHAIRMAN. Thank you very much.

[The prepared statements of the preceding panel follow:]

STATEMENT OF HERBERT B. COHN, CHAIRMAN
COMMITTEE FOR CAPITAL FORMATION THROUGH DIVIDEND REINVESTMENT
IN SUPPORT OF THE DIVIDEND REINVESTMENT
PROPOSAL IN S. 1543
BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE
JULY 29, 1980

SUMMARY SHEET

A. Our Position - We support a carefully formulated and targeted tax cut of from $20-30 billion to take effect January 1, 1981. Such a tax cut can and should be designed both to stimulate the economy and to counter inflation. The major objective should be to encourage capital formation, savings and investment and increased productivity. This objective can be materially advanced by including the dividend reinvestment proposal, embodied in S. 1543, which would defer current taxes on dividends reinvested under qualified plans in new issue stock.

The dividend reinvestment proposal, while providing tax relief at the individual taxpayer level, will encourage substantial savings and investment, reduce inflationary pressures by encouraging capital formation and restraining consumption and will generate substantial new common stock capital for a segment of business which is heavily capital intensive and dependent for the major part of its capital needs on external financing.

The proposal is complementary to -- and in no way conflicts with -- proposals to increase internal generation of capital through accelerated tax depreciation and other approaches to reducing taxes imposed on corporations. But such a reduction of taxes will have little or no effect in capital formation for a company which must flow through tax savings in the price of its product or which has little or no taxable income. For the many such companies which are primarily dependent on external financing, the dividend reinvestment proposal is the most direct and most cost-effective approach to encouraging capital formation, savings and investment. And it would achieve these objectives with a relatively modest or non-existent revenue loss.

B. Economic Impact - Adoption of the proposal in S. 1543 would, in 1979 dollars and in the third full year after its adoption:

1. Increase dividend reinvestment to about $2.5 billion;

2. Increase national output by approximately $2.7 billion annually;

3. Increase business fixed investment by about $1.0 billion annually;

4. Add about 50,000 jobs per year; and

5. Involve a net revenue loss of some $350 million in the first complete year of operation, a wash in the second year, and an annual net revenue gain of $600 million in the third year and thereafter.

C. Furthering National Objectives - Adoption of this proposal would further important national policies in at least six respects. It would -

1. Provide, on a highly cost-effective and rifle-shot basis, substantial, direct and immediate help in the formation of new capital where it is most urgently needed.

2. Be counter-inflationary in substituting capital formation for current consumption.

3. Reduce the double tax on dividend income by eliminating the tax at the stockholder level when dividends are reinvested.

4. Encourage thrift and providing for supplemental retirement income.

5. Be more equitable in treating receipt of stock under a qualified dividend reinvestment plan as the equivalent of a conventional stock dividend.

6. Help in financing essentially needed energy facilities.

STATEMENT OF HERBERT B. COHN, CHAIRMAN
COMMITTEE FOR CAPITAL FORMATION THROUGH DIVIDEND REINVESTMENT
IN SUPPORT OF THE DIVIDEND REINVESTMENT
PROPOSAL IN S. 1543
BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE
JULY 29, 1980

My name is Herbert B. Cohn. I am associated with the law firm of Morgan, Lewis & Bockius in Washington, D. C. I appear here today as Chairman of the Committee for Capital Formation Through Dividend Reinvestment.1/ Accompanying me are Robert R. Nathan, Chairman of Robert R. Nathan Associates, Inc., our economic consultants, and Donald C. Alexander of the law firm of Morgan, Lewis & Bockius, our tax counsel.

We support a carefully formulated and targeted tax cut to take effect January 1, 1981. We are convinced that such a tax cut can be designed both to stimulate the economy and to counter inflation. The major objective of such legislation should be to encourage capital formation, savings and investment and increased productivity.

This objective can be materially advanced by including in the tax cut legislation the dividend reinvestment proposal embodied in S. 1543, originally introduced by Senators Nelson and Bentsen and subsequently co-sponsored by Senators Packwood and Wallop of the Finance Committee and Senators Schmitt, Tower, Hollings, Leahy, Armstrong, Helms, Thurmond, Domenici and

1/ The members of this Committee consist of the 49 companies listed in Appendix A.

Humphrey.[2/] This proposal, while providing tax relief at the individual taxpayer level, will encourage substantial savings and investment and the formation of new common stock capital for a segment of industry which is heavily capital intensive and dependent for the major part of its capital needs on external financing.

The proposal is complementary to -- and in no way conflicts with -- proposals to increase internal generation of capital through accelerated tax depreciation and other approaches to reducing the taxes imposed on corporations. These latter proposals will create new capital for companies which depend primarily on internal generation of cash and which can realize and retain the tax savings. But they will have little or no effect on capital formation for those companies which are required to flow through any reduction in taxes in the price of their product or whose financial condition is such that they have little or no taxable income. And many of these companies, representing a very important segment of American industry, are heavily dependent for their capital requirements on external financing.

For companies which are primarily dependent on external financing, the dividend reinvestment proposal is, we believe, the most direct and most cost-effective approach to encouraging capital formation, savings and investment which has been proposed. It is the most direct because it encourages increased

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2/ S. 1543 was the subject of hearings on October 31, 1979 before the Senate Finance Subcommittee on Taxation and Debt Management Generally.

The House counterpart of S. 1543 is H.R. 654, originally introduced by Congressman Pickle, which now has a total of 94 sponsors. Section 201 of H.R. 7015, introduced by Chairman Ullman of the House Ways and Means Committee, includes similar provisions. These bills were the subject of hearings in January, 1980 before the House Ways and Means Committee.

reinvestment of dividends in new issue stock which represents the instantaneous formation of new capital. It is the most cost-effective because it is a rifle-shot targeted for virtual 100% effectiveness in providing such new capital where it is urgently needed and it involves a net revenue loss which is either relatively modest or non-existent. Moreover, it achieves these objectives through a tax reduction at the individual taxpayer level rather than through a reduction in corporate taxes.

The Provisions of the Dividend Reinvestment Proposal - In essence, the proposal is to encourage materially increased reinvestment of dividends in new issue stock and materially increased capital formation by deferring current taxes on dividends which are reinvested (with an annual limitation of $1,500 for an individual taxpayer and $3,000 for a joint return) under qualified dividend reinvestment plans.

A qualified dividend reinvestment plan is defined as a plan which does, in fact, provide for reinvestment of a cash dividend in new common stock.3/ The stock received on reinvestment of such dividend would be regarded, for tax purposes, as essentially the equivalent of a conventional stock dividend,

3/ It had been suggested that a corporation having no need for new common stock capital might buy in its existing common stock and then adopt a dividend reinvestment plan for an equivalent amount. This would be contrary to the primary objective of the proposal to stimulate new capital formation and new capital investment; and the bills include provisions to prevent it. Such provisions would establish a presumption (rebuttable on a showing of a proper business purpose) that the tax benefit would not be available where a corporation purchased its own common stock within a specified period before or after the issuance of stock under a dividend reinvestment plan.

which is, of course, not now subject to any current income tax.[4/]

Economic Impact and Revenue Loss Estimates - In 1978 our Committee retained the firm of Robert R. Nathan Associates to carry out a study of the economic impact of a similar proposal (which did not contain any dollar limitations) introduced in the 95th Congress. In its Report, the Nathan firm concluded that adoption of that proposal would greatly increase dividend reinvestment, provide a major stimulus to the economy, and "certainly seems to be in the national interest."[5/]

4/ It had been suggested that the proposal could be circumvented by stockholders who, while not desiring to increase their investment in the corporation, would reinvest their dividends and then immediately sell an equivalent number of shares in the marketplace. To minimize any such motivation, the bills provide that (a) the basis of stock received under the dividend reinvestment plan would be zero and the holding period would commence on the date of its issuance, and (b) sales after the record date for the dividend and within one year after receipt of stock under a dividend reinvestment plan would be deemed to include the stock so received within the preceding year.

5/ The Report concludes that adoption of that proposal, by the third year of operation, would:

1. Increase dividend reinvestment by more than 500% to some $6 billion;
2. Increase national output on the order of $10 billion annually;
3. Stimulate business fixed investment by close to $3.5 billion annually; and
4. Add the equivalent of 200,000 jobs per year.

The full text of the Nathan Report is included in the January 1980 hearings before the House Ways and Means Committee on "Tax Incentives for Savings", at pp. 150-263. If desired, copies of the Report will be furnished to the Committee's staff.

The Report noted that if the proposed tax treatment were limited to only a specified amount per taxpayer, there would be a related reduction in all quantitative effects -- i.e. in all costs and all benefits. (See Nathan Report, p. viii, n. 1).

The Nathan firm later analyzed the economic effects of a similar proposal with a $1,500/$3,000 annual cap (which is included in S. 1543 and the counterpart bills pending in the House) and concluded that adoption of such a proposal would, in 1979 dollars and in the third full year after its adoption:

1. Increase dividend reinvestment to about $2.5 billion;
2. Increase national output by approximately $2.7 billion annually;
3. Increase business fixed investment by about $1.0 billion annually; and
4. Add about 50,000 jobs per year.

Addressing itself to the effect on tax revenue losses -- and after giving consideration to forecasted increases in both plans and participation, and to their economic effects -- the Nathan firm estimates that, in 1979 dollars, adoption of the proposal in S. 1543 would result in a net revenue loss of some $350 million in the first complete year of operation, a wash in the second year, and an annual net revenue <u>gain</u> approaching $600 million in the third year and thereafter.

We understand that the Staff of the Joint Committee on Taxation has estimated that adoption of the proposal would result in gross revenue loss in receipts for the first fiscal year, running from January 1 to September 30, of $240 million.

65-969 0 - 80 - 14 (pt.3)

We further understand that the estimates of the Joint Committee Staff increase in succeeding years but are in no case more than $1.1 billion per year and that such figures do not take into account (as the Nathan Report does) any "feedback" by reason of increased capital formation and economic growth.

Current Participation in Dividend Reinvestment Plans for New Issue Stock. About 175 companies now have dividend reinvestment plans for new issue stock. These companies vary in size, geographical location, type of business and otherwise. In general, they are, however, alike in the following respects:

First, they are capital-intensive; they cannot obtain all the capital they require through internal generation of cash; they must place substantial reliance on external financing; and they have a continual need to obtain additional common stock capital to finance their business.

Second, they find it increasingly difficult and expensive to attract the necessary capital through large public offerings in the marketplace.

Third, they have found that dividend reinvestment plans, under which their stockholders have the option of automatically investing cash dividends in additional new issue stock of the company, can be a most effective vehicle for obtaining new common stock capital they require.

About 2 million stockholders now participate in such plans. Surveys have shown that the large majority of participants are the smaller stockholders.[6/] The average holdings of the participating stockholders are less than the average of all stockholders and are generally in the range of 150 to 200 shares. It is estimated that in 1979 dividend reinvestment plans for new issue stock produced new common stock capital in the amount of some $1-1/4 billion.

The Benefits of the Proposal - Under existing tax law, federal income tax is imposed currently on the value of the stock received by a stockholder who opts to participate in a dividend reinvestment plan and to take stock instead of cash. It is clear that this discourages participation by those stockholders who may be pressed to use the cash dividends to pay the current tax. It is equally clear that deferral of the current tax would greatly encourage increased participation. The extent of such increased participation can, of course, only be a matter of opinion. But, as has been indicated, the Nathan Report estimated that adoption of the original proposal, without limitation of the tax benefit per taxpayer, would increase the reinvestment of dividends into new issue common stock by more than 500% to some $6 billion; and the Nathan firm has more recently estimated that adoption of the proposal in S. 1543 (which includes the $1,500 - $3,000 annual cap) would more than double participation.

Such increased capital formation would obviously be of major help in assisting capital-intensive companies to obtain the common stock capital which is essential to finance their needs and to provide a cushion for required debt and preferred stock

6/ See, for example, the statistics on participation in the plan of General Telephone & Electronics Corporation set forth in footnote 7, below, and in Appendix B.

financing. It would provide an alternative (at least in part) for the periodic need to sell large blocks of additional common stock in the marketplace -- with the associated market pressure which frequently leads to market prices well below book value and continued dilution exerting further pressure to depress market prices.

Adoption of the proposal would also help larger numbers of stockholders, who do not at the time need the cash dividend, to participate in a simple, convenient and economical way to invest relatively small amounts which might otherwise be dissipated; and to obtain the advantages associated with a periodic savings plan, the principles of "dollar averaging", and the compounding effect, to assist in building an investment to provide larger cash dividends when the stockholder has need for such income.

From the broader perspective of the national interest -- we believe that adoption of the proposal, and the resulting increased participation in dividend reinvestment plans for new issue stock, would further important and desirable national policies in at least six respects:

1. Capital Formation: It would provide, on a highly cost-effective basis, substantial, direct and immediate help in the formation of new capital -- a most important national objective. It is difficult to envisage any clearer or more direct way in which capital formation takes place than through a dividend reinvestment plan for new issue stock -- where the reinvested dividends are immediately converted into new common stock capital.

The tax incentive to increase such capital formation is, in this case, a rifle-shot which is fully and directly effective. And, as has been indicated, the dividend reinvestment plans have their greatest appeal and, in general, have been adopted only by the most capital-intensive companies having the greatest need for new capital. Accordingly, under these plans, capital formation, and capital investment to increase productivity and provide jobs, is taking place where it is urgently needed.

2. Helping to Reduce Consumer Demand and Counter Inflation. The majority of participants in dividend reinvestment plans are the smaller stockholders. Encouraging increased participation in such plans increases the reinvestment of cash dividends into productive capital facilities and substitutes capital formation for current consumption. In helping to increase new productive facilities and decrease consumer demand, the proposal would, therefore, also help in the effort to counter inflation.

3. Eliminating or Reducing the Double Tax on Dividend Income. Elimination -- in whole or in part -- of the double tax on corporate dividends also has wide support as a desirable national objective. The proposal would represent a step in this direction in eliminating the current tax imposed at the stockholder level when the dividends are reinvested in the corporation. There would appear to be particular logic for taking this step and eliminating the second tax under these circumstances -- since the stockholder is not receiving the cash dividend and since the cash is, instead, being plowed back into the corporation where, if invested profitably, it would lead to additional taxable earnings at the corporate level.

4. Encouraging Individual Savings to Provide Supplemental Income for Retirement. Many -- and probably a large majority of participants in dividend reinvestment plans -- have elected to participate during a period in which they do not require the cash dividends in order to be able to look forward to larger cash dividends at a later time when such income is needed as a supplement to social security and pension income. The proposal would materially encourage thrift and assist participants in providing for their own supplemental retirement income. In this respect, the dividend reinvestment proposal is analogous to the Keogh and IRA programs which represent similar desirable national objectives and which have been encouraged by similar favorable tax treatment.

5. Fairness and Equity for the Participating Stockholder as Compared with the Recipient of the Conventional Stock Dividend. Many companies have the option available to reduce or eliminate cash dividends and declare alternative or supplemental stock dividends. In such cases, the recipient of the stock dividend pays no current tax. But companies whose stock has historically been purchased on a yield basis cannot, as a practical matter, reduce their cash dividend and substitute a conventional stock dividend. At the same time, there are many stockholders of such companies who, while they wish to remain as investors in such companies, would prefer, at least during their working years, to take the equivalent of a stock dividend rather than cash. In the context of the practical realities, it would seem to be

fairer and more equitable to permit the stockholder also to have the option of stock dividends and to treat his receipt of stock under a qualified dividend reinvestment plan for new issue stock as the equivalent, for tax purposes, of a conventional stock dividend.

6. Assisting in the Financing of Essential Energy Facilities and in Dealing with our Energy Problem. An essential need in reducing our dependence on imported oil is to provide new facilities for the production of increased domestic energy supply. Limitations on financing capability represent a real and significant obstacle to providing such new facilities. A large number of companies engaged in energy supply require continuing infusions of new common stock capital and have adopted and are using dividend reinvestment plans as a vehicle to obtain at least a part of the common stock capital they require. Increased participation in such plans would produce additional common stock capital and help materially in financing essentially needed energy facilities.

The proposal to defer current taxes on dividends reinvested in new issue stock has wide support from stockholders and from a large number of capital intensive companies which must obtain their common stock capital requirements primarily through the continuing sale of common stock. It is also supported by a number of associations, representing industry and stockholders, including:

American Bankers Association

American Council for Capital Formation

American Gas Association

American Society of Corporate Secretaries

Business Round Table

Edison Electric Institute

Stockholders of America

United States Chamber of Commerce

United States Independent Telephone Association

In what we believe to be the only testimony before the Senate Finance Subcommittee which was critical of the proposal in S. 1543, a representative of the Treasury Department argued that the major beneficiaries of this proposal would be the high bracket investors and that the low bracket investors would generally choose to receive cash dividends. We believe this argument is of doubtful relevance and that its basic premise is contrary to the facts.

First, and most important, the argument in no way negatives the primary objective or the effectiveness of the proposal as a means of encouraging increased capital formation. Indeed, to the extent that there is any basis for the argument, it reinforces the proposal as a vehicle for capital formation.

Second, the factual premise is in error. The evidence to date is that the smaller investors are very much interested in dividend reinvestment and represent the large majority of present and potential participants in dividend reinvestment plans.[7/] And, as to the larger investors, the best advice we have from those most knowledgeable about their investment decisions is that the rather limited incentive in this proposal is not, in general, likely to change their current preference for the alternatives of tax exempt bonds or companies with low dividend payouts and high growth potential.

Treasury Secretary Miller, in his testimony at the opening of these hearings, recommended that a tax reduction program not be enacted prior to the national election but he then went on to suggest criteria which he believed should be used in the formulation of such a program. He emphasized, principally, that tax incentives should be concentrated on capital expansion to increase capital investment and productivity; should not contribute to inflation by increasing demand pressures; and should be consistent with fiscal discipline. The dividend reinvestment proposal embodied in S. 1543 would make a substantial contribution to in-

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7/ Testimony submitted on behalf of the United States Independent Telephone Association before the Senate Finance Subcommittee included a chart analyzing the participants in the General Telephone & Electronics Corporation dividend reinvestment plan. That chart, a copy of which is attached hereto as Appendix B, shows that 79,484, or over 84%, of the total 94,350 participants in the plan were the holders of less than 100 shares each; and that 88,904, or over 94%, of the total participants were the holders of less than 200 shares each. It further shows that 29.5% of all holders of less than 50 shares, and 16.2% of all holders of 51-100 shares, participate in the plan.

creased capital formation, capital investment and productivity; would be counter-inflationary; and would do so with a new revenue loss which, ovet a three-year period, would be either relatively modest or nonexistent. We submit that the dividend reinvestment proposal merits inclusion in any tax cut legislation.

APPENDIX A

COMMITTEE FOR CAPITAL FORMATION THROUGH DIVIDEND REINVESTMENT

Allegheny Power System, Inc.
Amax, Inc.
American Electric Power Co.
American Telephone & Telegraph Co.
Baltimore Gas and Electric Company
Brooklyn Union Gas Co.
Central & Southwest Corp.
Central Illinois Light Company
Cleveland Electric Illuminating Company
Commonwealth Edison Co.
Columbus and Southern Ohio Electric Co.
Continental Telephone Corp.
Dayton Power and Light Company
Delmarva Power & Light Company
Duke Power Company
Empire District Electric Company
General Telephone & Electronics Corp.
Gulf States Utilities Co.
Houston Industries, Inc.
Illinois Power Company
Inco Limited
Iowa Electric Light and Power Company
Iowa Resources Inc.
Kansas City Power & Light Company
Kansas-Nebraska Natural Gas Company, Inc.
Long Island Lighting Company
Manufacturers Hanover Corp.
Mercantile Texas Corporation
Minnesota Power & Light Co.
New England Gas and Electric Association
Northeast Utilities
Orange and Rockland Utilities, Inc.
Otter Tail Power Company
Pacific Power & Light Company
Pennsylvania Power & Light Company
Philadelphia Electric Co.
Portland General Electric Company
Public Service Company of Colorado
Public Service Company of New Hampshire
Public Service Electric & Gas Company
Puget Sound Power & Light Co.
Rochester Gas & Electric Corp.
Sierra Pacific Power Company
Texasgulf Inc.
United States Steel Corporation
Virginia Electric & Power Company
Washington Gas Light Co.
Wisconsin Electric Power Company
Wisconsin Power & Light Co.

APPENDIX B

GTE DIVIDEND REINVESTMENT PLAN SHAREHOLDER PARTICIPATION

Shareholders		Plan Participation	
Shares Held	Registered Shareholders	Participants	Percent Participation
1-50	210,538	62,069	29.5%
51-100	107,456	17,415	16.2
101-200	67,399	9,420	14.0
201-500	52,198	4,338	8.3
501-1,000	12,850	900	7.0
1,001-over	7,376	208	2.8
Total	457,817	94,350	20.6%

SUMMARY OF POINTS INCLUDED IN STATEMENT OF ROBERT R. NATHAN ON TAX REDUCTION LEGISLATION BEFORE THE SENATE COMMITTEE ON FINANCE, JULY 29, 1980

The present recession is in large part the result of measures designed to counter inflation. Since excess demand appears not to be a major cause of the inflation, tight monetary, fiscal and other recessionary policies will not work unless they are carried to extremes few would advocate. Any anti-inflation benefits attributable to the recession are likely to be transient.

To overcome some of the root causes of the inflation, enactment of tax shifts or tax reductions during this session of the Congress would be appropriate even if the economy were not in recession. Tax changes designed to improve productivity, to stimulate new investment, and to lessen tax impacts on the Consumer Price Index (CPI) are all anti-inflationary and needed. At this time such changes could moderate the depth and duration of the recession.

A tax reduction of about $30 billion in the next calendar year seems necessary and not excessive. Approximately half should be designed to stimulate productivity. The remainder should go to individuals to relieve the impact of scheduled payroll tax increases, reduce inflation's effect on the Consumer Price Index, and ameliorate similar pressures on the wage-price spiral.

Examples of actions to aid individuals and reduce tax impacts on the CPI include (1) delay of the scheduled January 1, 1981 and perhaps 1982 increases in social security payroll taxes, transferring a portion of the costs of hospital insurance and indexed benefit increases to general revenues, if necessary, (2) encourage state and local governments to reduce sales and selective excise taxes by providing a general revenue sharing incentive without changing total revenue sharing outlays, and (3) providing income tax rate relief in a manner compatible with inducing restraint or moderation in prices and in labor-management wage (including fringe) settlements.

Highly important are inducements to business designed to improve productivity through modernization and expansion of plant and equipment. Such inducements should also help reinvigorate our domestic and international competitiveness, promote greater energy independence and foster innovative research and development.

Accelerated depreciation allowances could help achieve these objectives. But they would provide limited or no assistance to many firms in certain key sectors of the economy. The dividend reinvestment plan (DRP) proposal in S.1543, H.R. 654, H.R. 5665, and H.R. 7015 would provide the needed help to such firms, mainly regulated utilities with precarious debt-to-equity ratios, currently unprofitable firms investing in risky new energy or other ventures, and firms that must rely too heavily on external financing for their capital investment.

The DRP provision is targeted for firms that will actually use the reinvested dividends to provide additional capital formation. It will improve productivity. It will be anti-recessionary, adding about 50,000 jobs per year. After taking account of its economic "feedback," its revenue loss will be relatively small, about $350 million in the first complete year, no loss in the second year, and a revenue gain of $600 million in each succeeding year. It is a constructive and entirely feasible program whose benefits will far exceed its costs.

STATEMENT OF ROBERT R. NATHAN ON TAX REDUCTION LEGISLATION BEFORE THE SENATE COMMITTEE ON FINANCE, JULY 29, 1980

Mr. Chairman and Members of the Committee:

I am Robert R. Nathan, Chairman of the Board of Robert R. Nathan Associates, Inc. (RRNA), an economic consulting firm located at 1200 18th Street, N.W. in Washington, D.C., 20036. I appear today on behalf of the Committee for Capital Formation Through Dividend Reinvestment[1]. For more than two years our firm has worked with that Committee, studying and advising on the economic and revenue impacts of the kind of dividend reinvestment tax proposals embodied in S.1543, H.R. 654, Section 202 of H.R. 5665, and Section 201 of H.R. 7015.

I appreciate the opportunity also to offer broader comments and suggestions of my own. The U.S. economy is faced with two critical and interrelated problems -- inflation and recession. The short-term economic outlook is not encouraging. True, the precipitous declines in employment, automobile production, housing construction, industrial production, and retail sales are not likely to fall for long at the rates of the past two or three months. If they did continue at such rates we would have 10 to 12 percent unemployment by the end of the year and in some industries

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1. A list of the business firm members of this Committee is appended to Mr. Herbert Cohn's testimony in this hearing.

production would be at depression rather than recession levels. However, without early enactment of appropriate tax legislation economic recovery will be delayed, and we will continue to be plagued with the problems of unemployment and underlying inflation.

I do not mean to imply that a prolonged recession will not have an effect on inflation, because, to a degree, it will slow the pace of price increases and encourage wage-price spiral moderation. But it will not attack the root causes of the inflation. As a consequence, even the anti-inflation benefits attributable to the recession are likely to be transient. The roots of the present inflation would be more susceptible to corrective action during a period of rising economic activity. The tax reduction issue now under consideration should be designed as an anti-inflationary force, even though it would also serve as an anti-recession weapon at this time.

The current recession is inextricably related to the nation's critical inflation problem. The present recession cannot be attributed to normal business cycle phenomena. There were few if any discernible, serious cyclical distortions that precipitated the current slide. Rather, the recession was in large part the result of measures taken to counter inflation. Restrictive monetary and fiscal policies may in retrospect prove to have been an "overkill" bringing on the steepest, near free-fall decline in economic activity since the Great Depression. I refer especially to the big and blunt credit pincers applied on October 6, 1979 and March 14, 1980, and to the strong restrictive thrust in fiscal policy announced in late March 1980. The March actions came after the economy had already started downward and undoubtedly exacerbated the severity of the recession.

Inflation will likely continue to be with us for many years to come because we have not attacked its basic causes. Present policy appears designed to fight inflation with recession, and may well be a no-win game over time. Economists commonly agree that excess aggregate demand is inflationary. But there are serious doubts whether the disastrous double-digit inflations of 1973-74 and 1979-80 were mostly attributable to excess demand. From the first quarter recession trough of 1975 to the first quarter 1980 recovery peak, unemployment never fell below 5.7 percent. If excess demand was not the major cause and the economy was not overheated, then overcooling and other recessionary policies will not work unless they are carried to extreme depths and durations that few would advocate.

In my judgment, enactment of anti-inflationary tax shifts or reductions during this session of Congress would be appropriate and desirable even if the economy were not in recession. Tax changes designed to improve productivity, to stimulate new investment, and to lessen tax impacts on the Consumer Price Index are all anti-inflationary and needed.

It became evident early in the decade of the 1970s that the rate of growth of productivity in our economy was slackening relative to historical standards. The reasons for this distressing phenomenon were not and still are not entirely clear. In 1974 and again in 1979 and currently, productivity, measured as the output per hour of all persons in the private sector, actually declined. The need to encourage modernization and expansion of our nation's productive capacity, to discard obsolescent facilities, to overcome domestic energy bottlenecks, and to achieve much greater energy efficiency is urgent. Such investment would

65-969 O - 80 - 15 (pt.3)

not only attack inflation in the right way and the right place, but is now compatible with reasonable recovery objectives as well, and will result in sound, solid economic growth. Additionally, we need to hold down or roll back or compensate for scheduled increases in some taxes, such as social security taxes, which directly tend to increase production costs, push up the Consumer Price Index (CPI), evoke demands for higher take-home pay, and further aggravate the inflation spiral.

Given these circumstances, an early tax reduction in the order of annual magnitude of about $30 billion seems necessary and not excessive. To properly attack the problems mentioned, approximately half of the reduction should be designed to stimulate productivity and the remaining half should go to individuals to relieve the impact of scheduled payroll tax increases, reduce inflation's effect on the cost of living, and ameliorate similar pressures on the wage-price spiral.

With respect to tax relief for individuals and an easing of tax impacts on the CPI, I recommend that the Congress consider several measures. First, the payroll tax increases for social security scheduled for January 1, 1981 and perhaps 1982 should be delayed. If essential for the sound financing of the system, a portion of the costs of hospital insurance and inflation-indexed benefit increases could be paid from general revenues. Second, because excise and sales taxes directly impact the CPI and cost-of-living adjustments, the Federal program of general revenue sharing should be designed to provide an incentive for State and local governments to hold down sales taxes and perhaps selective excise taxes as well. Third, income tax rate relief should be granted in a manner compatible with inducing restraint or moderation in prices and in wage and worker-fringe negotiations. I recognize that objections have been raised to past suggestions along these lines, but serious attention must be given to the need to fight inflation on all fronts.

We must also bear in mind that there are several specific inflation-reducing objectives that can be helped by a tax cut offering inducement for business investment. We desperately need improvements in productivity and efficiency in the fight against inflation. Low productivity and high unit costs of production arising from use of obsolete plant and equipment tend to be aggravated by a recession. Our tax policies and programs must be designed to activate the demand for investment in new plant and equipment.

I do not mean to imply that poor productivity has been the major cause of the present inflation, nor has the lag in business investment been the sole cause of our poor productivity performance. But elimination of obsolete equipment and expansion and modernization of productive capacity can and will contribute materially to improved productivity, to lower unit costs, and to slow the rate of inflation. Cooperative efforts by management and labor can also contribute to greater efficiency.

Unfortunately, expenditures for needed research and development to accelerate innovations and inventions are usually reduced during recessions because of anticipated low profitability. That often happens also during inflation because of high current costs and added uncertainty over future returns. Yet, well designed R&D programs yield discoveries that foster economic growth and help fight inflation by reducing unit costs of production. Tax incentives should support additional R&D of this nature.

Highly inflationary is our dependence on oil imports and seeming helplessness in the face of drastic OPEC price increases. This powerful inflationary factor will not be corrected by a recession. We must not continue to allow OPEC to affect seriously U.S. price levels and balance of payments. To achieve greater energy independence, we need tax changes to bring about greater energy conservation and greater domestic energy production and supply. We must speed investments in new energy efficient plant and equipment by relatively intensive industrial users of energy.

We need to reinvigorate our domestic and international competitiveness. We must find ways to make the marketplace function more efficiently in the United States. We must be more competitive with Japan, Germany, and other strong trade expansionist economies. It will take more than tax policies alone to make such progress, but tax policies that help the steel industry, to cite just one example, to build and install adequate, modern capacity will do more to help our economy than protectionist measures. Improved competition is required to help lower unit costs of production, thus aiding in the fight against inflation as well as against our trade deficits.

All these specific objectives, as well as the high priority overall goal of reducing the rate of inflation, can be facilitated by enactment of such tax provisions as accelerated depreciation and the dividend reinvestment plan being proposed. Accelerated depreciation of plant and equipment would result in shortening the duration of risk exposure and in higher immediate after-tax profits and greater retained earnings, thus providing business stronger motivation and internal funds for overcoming the lagging investment demand that has been a key ingredient in the slow growth in business outlays for plant and equipment. Higher investment will result in a stronger economy and, in turn, tend toward smaller or fewer federal deficits, making more funds available for private investment.

Some key sectors of the economy have large financing demands for expanded and modernized plant capacity but face difficulties in raising the necessary funds at reasonable costs, particularly the equity capital that is necessary to preserve sound financial structures. The regulated utility, transportation and communication sectors of the economy come immediately to mind as examples. Companies providing these services have encountered precarious capital structures. They have inordinately high debt to equity ratios, resulting in reductions in bond ratings, high interest rates, and low interest coverage ratios. Recurringly, these companies are faced with inexorable cost increases due to inflation and to environmental requirements, coupled with lagging rate relief by federal and state regulatory agencies.

Accelerated depreciation would be of only limited help to these firms wherever "flow-through" provisions of States prevail. Accelerated depreciation also would not be immediately helpful to firms investing in risky new energy ventures and those currently not profitable enough to pay substantial income taxes. On the other hand, the dividend reinvestment tax proposals (DRP) embodied in S.1543, H.R. 654, H.R. 5665, and H.R. 7015 would strongly encourage such equity investments in a direct and cost-effective manner.

The testimony of my colleague on this panel, Mr. Herbert B. Cohn, Chairman of the Committee for Capital Formation Through Dividend Reinvestment, describes the DRP proposal and its benefits in some detail and summarizes its economic effects. Basically, the dividend reinvestment provision would defer the current individual income tax on dividends reinvested in original issue stock. The stock received by shareholders in those companies having a qualified dividend reinvestment plan would be regarded, for tax purposes, as essentially the equivalent of a conventional stock dividend. The tax on such dividends would be delayed until the acquired shares are sold and the proceeds would then be subject to capital gains tax rates. I would emphasize that the tax benefits in the pending bills would be limited by establishing a "cap" on qualified dividends of $1,500 for a single return and $3,000 for a joint return.

Robert R. Nathan Associates have studied the economic impact of the dividend reinvestment provision. We have concluded that by its third year of operation such a provision, with the $1,500/$3,000 "cap", would about double the present dollar volume of corporation and individual investor participation in qualified reinvestment plans and would (in 1979 dollars):

1. Increase dividend reinvestment in new issue stock to about $2.5 billion annually;

2. Increase gross national product by approximately \$2.7 billion annually;

3. Increase business-fixed investment by about \$1 billion annually;

4. Add about 50,000 jobs per year;

5. Involve a net revenue loss of some \$350 million in the first complete year of operation, a wash in the second year, and a net revenue gain of \$600 million in the third year and each succeeding year. These estimates include the economic "feedback" of the proposal on Treasury revenues.

Enactment of such a fruitful dividend reinvestment provision would enhance and reinforce important constructive national economic policies. It would provide much needed assistance to firms that have to rely heavily on external financing of essential plant and equipment outlays, and for whom accelerated depreciation allowances would be of limited or no help. It would make more equity capital available at reasonable cost to firms with high debt to equity ratios, tending to improve their capital structures. It would facilitate the equity financing needed for new ventures, especially the more risky ventures in energy supply, efficient energy use (substitution and conservation), international competition, and innovative processes and products. It would encourage small investors to increase their equity in the nation's productive machinery. In these and other ways, it would encourage modernization and expansion of our productive capacity in essential industries and help improve our productivity.

In summary, the economy is in critical need of tax incentives for modernization of plant and equipment and tax reductions to relieve inflationary spiral pressures. Such tax measures enacted at the present time should encourage moderation in actions affected by the CPI and help stimulate increased capital formation, improve productivity, lower unit costs of production, and strengthen the competitiveness of U.S. goods and services in domestic and international markets. They will relieve inflationary pressure in both the short and long run. They will reduce unemployment and set the stage for sound, solid economic performance in the coming decade.

Stockholders of America, inc.

INVESTORS IN AMERICA

THE VOICE OF 25 MILLION

1625 EYE STREET, N.W. WASHINGTON, D. C. 20006 (202) 783-3430

STATEMENT BEFORE
THE SENATE COMMITTEE ON FINANCE
96TH CONGRESS

BY

MARGARET COX SULLIVAN
PRESIDENT
STOCKHOLDERS OF AMERICA, INC.
WASHINGTON DC

JULY 29, 1980

ON

TAX CUT PROPOSALS

A NATIONAL NON-PROFIT NON-PARTISAN ORGANIZATION
ESTABLISHED 1972

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I APPRECIATE THE OPPORTUNITY TO APPEAR BEFORE THIS DISTINGUISHED COMMITTEE ON BEHALF OF STOCKHOLDERS OF AMERICA, INC. TO TELL YOU WHAT I AM HEARING FROM OUR MEMBERS ACROSS THE COUNTRY BY PHONE, MAIL AND PERSONAL CONTACTS. MY NAME IS MARGARET COX SULLIVAN AND I AM PRESIDENT OF THIS EIGHT-YEAR-OLD NATIONAL NONPROFIT NONPARTISAN ORGANIZATION DEDICATED TO REPRESENTING THE INTERESTS OF STOCKHOLDERS OF PUBLICLY HELD AMERICAN CORPORATIONS.

WE ARE GRATEFUL THE COMMITTEE HAS ARRANGED THESE HEARINGS FOR THE CONSIDERATION OF TAX CUT LEGISLATION. CERTAINLY OUR TAX SYSTEM NEEDS A LOT OF CONSIDERATION.

IN THE INTRODUCTION TO THE JOINT ECONOMIC COMMITTEE 1980 REPORT, CHAIRMAN SENATOR LLOYD BENTSEN SAID, "THE 1980 REPORT SIGNALS THE START OF A NEW ERA OF ECONOMIC THINKING." THE RANKING MINORITY MEMBER CONGRESSMAN CLARENCE J. BROWN SAID, "IT (THE REPORT) IS A CLARION CALL TO GET THIS COUNTRY MOVING AGAIN." THE MAJORITY AND MINORITY MEMBERS OF THE JOINT ECONOMIC COMMITTEE HAVE RISEN ABOVE POLITICAL PARTISANSHIP IN THIS ELECTION YEAR AND HAVE ISSUES A UNIFIED REPORT.

THE COMMITTEE RECOMMENDS THAT ONE HALF OF THE NEXT TAX CUT BE DIRECTED TOWARD ENHANCING SAVING AND INVESTMENT. THE REPORT IS A VERY POLISHED, THOUGHTFUL, INDEPTH DOCUMENT. TO BE SURE, IT HAS A DARK SIDE - THE DECLINE OF OUR COUNTRY'S ECONOMIC FORTUNES. BUT THE BRIGHT SIDE IS THAT THIS TREND CAN BE REVERSED.

THE PAST HAS BEEN TARGETED PRIMARILY TO THE DEMAND SIDE OF THE ECONOMY WHEREAS THE 1980 REPORT RECOMMENDS POLICIES DESIGNED TO INCREASE THE PRODUCTIVITY - THE SUPPLY SIDE OF THE ECONOMY. THIS MUST BE DONE. THE UNITED STATES NOW RANKS 7TH IN PRODUCTIVITY, CAPITAL INVESTMENT AND ECONOMIC GROWTH - AFTER JAPAN, WEST GERMANY, ITALY, FRANCE, CANADA AND UNITED KINGDOM. INCREDIBLE AS IT MAY SEEM THE UNITED STATES HAS THE LOWEST INVESTMENT RATE OF ANY INDUSTRIALIZED NATION IN THE WORLD. AND THE PERIOD OF CAPITAL RECOVERY IS ONE OF THE LONGEST. THEREFORE IT IS CRUCIAL WE RESTRUCTURE OUR TAX LAWS TO ALLOW CORPORATIONS TO GENERATE CAPITAL INTERNALLY AND ATTRACT NEW INVESTMENTS - TO SUPPLY CAPITAL - IN THE MARKET PLACE - WE MUST DO THIS NOW - WE NO LONGER HAVE THE LUXURY OF TIME.

BECAUSE TIME IS A FACTOR IN OUR JUDGEMENT, STOCKHOLDERS OF AMERICA CONTINUES TO SUPPORT ENACTMENT OF THE CAPITAL COST RECOVERY ACT OF 1979 (S. 1435), AS IT IS WRITTEN WITH ITS 10-5-3 LIBERALIZED DEPRECIATION FORMULA. IT HAS BEEN STUDIED AND SPONSORED BY 54 BI-PARTISAN MEMBERS OF THE SENATE. THE COMPANION BILL IN THE HOUSE (H.R. 4646) HAS 307 BI-PARTISAN MEMBERS SUPPORTING IT. (S. 1435) IS NOT JUST ANOTHER TAX PROPOSAL BUT IT IS A CAREFULLY WORKED OUT ANSWER TO OUR NATION'S PROBLEMS OF DECLINING INVESTMENT AND PRODUCTIVITY. IT WOULD PROVIDE A SYSTEM OF ACCELERATED CAPITAL RECOVERY FOR INVESTMENT IN PLANT AND EQUIPMENT, ENCOURAGE ECONOMIC GROWTH AND MODERNIZATION THROUGH INCREASED CAPITAL INVESTMENT AND EXPAND EMPLOYMENT OPPORTUNITIES.

This is imperative. We have allowed our once great American business machine to get rusty; much of our equipment has become obsolete. We have to realize that 67% of all metal working machinery in this country is more than 13 years old whereas in Japan the figure is only 30% and in Germany, 37%. This is typical of all our plant and equipment and shows why our long term production advantages are fading and why we are losing our position in the international market place.

Further, the Capital Cost Recovery Act would increase the cash available for either corporate retention or paying dividends. Dividends are certainly the incentive for stockholders to invest in and share in the ownership of companies. In some enterprises, they share ownership with less than one thousand others. And in certain companies, they share ownership with a million others. The success and strength of our free enterprise system come from this large diversified ownership base.

Although there are still 25 million stockholders who currently own stock in 11,000 publicly owned corporations (NYSE statistic) this number reveals a sharp decline of 18%. The number slid from 1970-75 from 32 million. 1975 was the last Census taken by the Exchange. Comparable figures from 1975-80 are not yet available. There are indications, however, that the individual investors are coming back into the market. We feel that this is due to the lowering of the tax on capital gains by the Revenue Act of 1978.

THIS IS GOOD. HOWEVER, WE MUST REALIZE, YEARS AGO IT WAS PREDICTED THAT WE WOULD NEED 50 MILLION STOCKHOLDERS BY 1980 TO TAKE CARE OF THE EXPANDING LABOR FORCE AND TO MEET CAPITAL NEEDS. HERE WE ARE HALF INTO 1980 WITH A LITTLE MORE THAN HALF THAT NUMBER. HISTORICALLY, IT HAS BEEN THE INDIVIDUAL INVESTORS, THE STOCKHOLDERS, THE LITTLE GUYS, WHO HAVE BEEN THE MAIN SOURCE OF EQUITY CAPITAL. THEY HAVE BEEN CALLED THE BACKBONE OF OUR CAPITAL MARKETS; THEIR ROLE IS VITAL. THEY ARE THE CAPITAL FORCE OF OUR COUNTRY. JUST AS THE MILLIONS OF WORKERS IN THE LABOR FORCE SUPPLY LABOR SERVICES, SO CAPITAL SERVICES ARE SUPPLIED BY THE CAPITAL FORCE - THE MILLIONS WHO INVEST IN THE AMERICAN BUSINESS SYSTEM. NOW WE HAVE TO GET THIS CAPICAL FORCE BACK INTO THE MARKET - PUT THEIR CAPITAL TO WORK. THIS CAPITAL FORCE MUST GROW. EMERGENCY STEPS MUST BE TAKEN TO ENCOURAGE AND ATTRACT.

OUR MARKETS WILL NOT WORK WITHOUT INDIVIDUAL INVESTORS; THEY MAKE THE MARKET. THE MILLIONS OF DIFFERING INDIVIDUAL DECISIONS MADE DAILY IN DIVERSIFIED MARKET TRANSACTIONS ARE NEEDED FOR LIQUIDITY, FOR A TRUE AUCTION, AND A MORE REALISTIC VALUE OF STOCKS. FURTHER, THE INDIVIDUAL HAS A DIFFERENT PATTERN OF INVESTING THAN THE LARGE FINANCIAL INSTITUTIONS. FUND MANAGERS, EITHER BECAUSE OF REGULATIONS OR FIDUCIARY RESPONSIBILITIES, INVEST PRIMARILY IN THE WELL-ESTABLISHED COMPANIES AND FOR THE MOST PART IN A FAVORED FEW. THE INDIVIDUAL, IN HIS OWN FRAME OF INTEREST, AND JUDGEMENT, WITH HIS OWN CAPITAL MAY MAKE INVESTMENTS IN THE SMALLER, OFTEN MORE VENTURESOME - HIGH RISK COMPANIES - SOMETIMES REGIONAL ONES.

THESE INVESTORS MUST BE ATTRACTED BACK. TAX INCENTIVES ARE NEEDED TO ATTRACT THEM. THEREFORE SOA CONTINUES TO SUPPORT ENACTMENT OF (S. 1543), A BILL WHICH WOULD EXEMPT DIVIDEND PAYMENTS FROM THE STOCKHOLDER'S INDIVIDUAL FEDERAL INCOME TAX WHEN DIVIDENDS ARE REINVESTED IN ORIGINAL ISSUE STOCK UNDER A CORPORATION'S QUALIFIED DIVIDEND REINVESTMENT PLAN.

(S. 1543) PROPOSED A VERY SIMPLE TECHNIQUE. STOCK PURCHASED IN THIS MANNER WOULD BE TREATED SIMILARLY TO STOCK DIVIDENDS AND SUBJECT TO CAPITAL GAINS TAX WHEN SOLD. STOCK MUST BE KEPT AT LEAST A YEAR TO QUALIFY UNDER THIS LEGISLATION. THE INDIVIDUAL STOCKHOLDER WOULD BE ABLE TO EXCLUDE ONLY UP TO $1,500 PER YEAR OF HIS/HER DIVIDEND INCOME, $3,000 FOR THOSE FILING JOINTLY.

ACCORDING TO A RECENT WALL STREET JOURNAL ARTICLE, IT IS ESTIMATED THAT SOME 20% OF THE CAPITAL RAISED LAST YEAR WAS RAISED THROUGH THE PRESENT TYPE DIVIDEND REINVESTMENT PLAN TECHNIQUE. CERTAINLY WITH THIS ADDITIONAL TAX INCENTIVE THE AMOUNTS WOULD GREATLY INCREASE - AND THE NUMBER OF COMPANIES ESTABLISHING SUCH A PLAN WOULD GROW. ACCORDING TO OUR BEST RESEARCH, THERE ARE NOW APPROXMATELY ONE THOUSAND COMPANIES OFFERING A REINVESTMENT DIVIDEND PLAN BUT ONLY ABOUT 175 COMPANIES WITH THE ORIGINAL ISSUE APPROACH.

WHILE (S.1543) WILL PROVIDE CONSIDERABLE, DIRECT AND IMMEDIATE HELP IN THE FORMATION OF NEW CAPITAL BY LIMITING THE TAX EXEMPT STATUS TO REINVEST IN ORIGIAL ISSUE STOCK AND, FURTHER IT IS A STEP TOWARD THE REDUCTION OF THE DOUBLE TAX ON DIVIDENDS.

THIS OF COURSE IS A GOOD STEP, BUT IT MUST NOT BE OVERLOOKED THAT THE DOUBLE TAX ON DIVIDENDS IS UNFAIR AND UNJUST. FURTHER LEGISLATION SHOULD BE CONSIDERED TO ELIMINATE THIS INEQUITY.

IN CONSIDERING A COMPLETE RESTRUCTURING OF OUR TAX SYSTEM AS APPARENTLY ENVISIONED BY THE CONGRESS, CAREFUL CONSIDERATION SHOULD ~~BE GIVEN TO THE TREATMENT~~ OF CAPITAL. ANY TAX ON CAPITAL IS INDICATIVE OF A BASIC MISCONCEPTION OF ITS FUNCTION IN A FREE ENTERPRISE SYSTEM. CAPITAL IS THE FUNDAMENTAL FOUNDATION OF THE SUPPLY SIDE OF OUR ECONOMY. IT IS THE BASIS FOR THE PRODUCTION OF ALL GOODS AND SERVICES. THEREFORE TO DEDUCT FROM IT ANNUALLY, IN THE FORM OF TAXATION IS TO DIMINISH OUR NATIONAL PRODUCTIVITY BASE. THERE SHOULD BE NO TAX ON CAPITAL GAINS. TO CONFIRM THIS POINT OUR PRINCIPAL INTERNATIONAL COMPETITORS HAVE NEVER TAXED CAPITAL AT ALL.

WHEN SENATOR CRANSTON RECENTLY INTRODUCED HIS BILL, THE CAPITAL INVESTMENT INCENTIVE ACT OF 1980, (S. 2923) WHICH WOULD REDUCE THE EFFECTIVE TAX RATE ON CAPITAL GAINS FROM 28% TO 21% HE INCLUDED THESE REMARKS ON THE FLOOR OF THE SENATE.

> "... OUR TAX LAWS HAVE TURNED INVESTMENT INCENTIVES UPSIDE DOWN. BY IMPOSING HIGH TAX RATES ON PRODUCTIVE CAPITAL INVESTMENTS WE HAVE TOLD INVESTORS TO PUT THEIR MONEY INTO ECONOMICALLY VALUELESS AND WASTEFUL TAX SHELTERS."

THIS BILL IS A GOOD STEP IN THE RIGHT DIRECTION.

Our concluding remarks and indeed our conclusions and recommendations are predicated on the findings in the 1980 Joint Economic Report. We are grateful this work has been so thoughtfully done and the economic model of Dr. Otto Eckstein of Data Resources is in being.

It is our conclusion that the tax cut legislation should be enacted as soon as possible. That the enabling legislation should include the Capital Cost Recovery Act of 1979, the tax exempt status for reinvested dividends and the Capital Investment Incentive Act of 1980. Plus a 10% across the board reduction of individual income tax to take effect in 1981.

We heartily agree with the Joint Economic Committee, "... that the Federal Government must put its own financial house in order. That requires a steady reduction of the ratio of government spending to the gross national product and a full accounting of the command over resources now exercised by the Federal Government."

As taxpayers we are paying for more government than we want, more than we need, and as a nation more than we can afford. The Federal Government is trying to do more than its resources will permit; it is trying to do many things that it cannot do very well; and endeavoring to do some things that it should not do at all - in our opinion.

Thank you.

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The CHAIRMAN. I am going to recess this hearing until 2 o'clock.

[Whereupon, at 12:20 p.m., the hearing recessed, to reconvene at 2 p.m., the same day.]

AFTER RECESS

Senator BENTSEN. It is 2 o'clock, and this hearing will come to order.

Our first witness is Mr. Herbert Dwight of the American Electronics Association. Is he here?

VOICE. Mr. Chairman, Mr. Dwight is down the hall.

Senator BENTSEN. All right, then we will hear first from Mr. John Nesheim, Semiconductor Industry Association.

If you will come up, we will start with you.

STATEMENT OF JOHN NEISHEIM, SEMICONDUCTOR INDUSTRY ASSOCIATION

Mr. NEISHEIM. Mr. Chairman, you are aware of some of the challenges to the semiconductor world. You have been to Japan. You have traveled, seen and heard testimony by L. G. Sevenmoss, and other of our colleagues.

Today, as treasurer of National Semiconductor of Santa Clara, I represent the industry association that has 42 U.S. manufacturers.

We would like to talk to you today about some of the problems that we are facing in international competition that are presented to us that can, in fact, be dealt with in part by the tax legislation that is being considered.

The sense of urgency, Mr. Senator, that we are concerned with is that the necessary steps in this tax legislation enable us to redress some of the inequities in the competitive environment with which this industry is faced around the world.

We ask that unique qualities of this particular industry be taken into account in considering proposals to accelerate depreciation, and encouraging research and development.

The comparative advantage in high technology is that it is really a U.S. first. We control it. We want to continue controlling it. We think that it is critical. We help fight inflation. The prices come down 20 to 30 percent annually.

We help revitalize basic industries with new applications of semiconductors. We end up being able to take these chips and apply them throughout the world to be able to provide us with the kind of improvement in trade balance and maintenance of strong defense that we believe is so critical.

We think that our world leadership right now is facing a real challenge from the competition overseas that is receiving real support from the local governments who are creating an economic environment really designed to foster, nuture and grow those semiconductor companies.

The first source of the competition challenge is in the tax incentives and subsidies. We measured that over $2 billion is spent on direct subsidies alone currently around the world, and this is not taking into account other incentives through tax proposals.

Second, there are basic structural differences. We have found in the case of Japan that when we asked the Chase Manhattan Bank to address the structural differences that they are able to borrow 5 to 10 times as much debt as we, and they have half the return on their investment, and they still are able to raise capital without regard to the financial performance right through economic downturn cycles.

As a result, the Japanese have a true competitive edge because their cost of capital is lower, and we have a hard time raising that kind of money. The result is that the United States is being challenged to take on its leadership and maintain it by environments that are created by the foreign governments.

We believe that a properly designed tax cut really can be of major help. It is not really the total solution, but it really can help.

We are proposing two areas to be focused on. The first is that we would like to urge Congress that enactment of an R. & D. tax credit, S. 2906 sponsored by Senators Danforth and Bradley, take place. That will provide an excellent stimulus for additional research. As a corrollary a tax credit should be created for setting aside corporate funds for university research. The basic research is ~~nil in the United States~~ currently.

Second, we support the concept ~~of depreciation reform~~ as in 10-5-3, and other proposals, but we urge you to refine them to provide more significant benefits for short-lived equipment. In my company alone, 97 percent of my equipment has a life of 5 years or less, and they only receive two-thirds of the investment tax credit presently under the current law.

Under 10-5-3 the proposal of useful life to 5 years could actually hurt us if it is mandatory. Optionality is really necessary to avoid a problem of impinging on the industry.

We urge that if you are going to adopt 10-5-3, or some similar proposal that you take into account such things as 3-year lives, and full investment tax credit, or some proposal similar to what the Japanese use which is a 25-percent additional depreciation in the first year alone for short-lived equipment.

Besides an R. & D. tax credit and modifications to depreciation reform proposals, our association supports a number of other bills which are outlined in more detail in the written statement which we submitted.

But our real concern is that if a productivity oriented tax decrease is really going to take place, the benefits have to be accorded to an industry like this, which has high growth, short-lived equipment, and is really on the forefront of keeping America competitive for the remainder of this century.

Thank you.

Senator BENTSEN. There should be some reward for those who are patient and wait. Would you like another 5 minutes?

Mr. NESHEIM. The amount of challenge, I think, is manifest in the rapidity with which the Japanese have learned, the Europeans have not forgotten, and increasingly southeastern Asian countries are quickly learning. The industry is enabling us to do things we never could before.

We get more productive in steel and chemical industries by controlling the manufacturing processes with semiconductor built computers, and we end up being able to make automobiles much more energy efficient, meeting the pollution standards of the Government as well.

We are able to provide the growth in jobs for people that almost otherwise would be on welfare. We employ hundreds of thousands of people in this industry, and the related computer industry, people that we train from day one as a part of our daily business.

We have a real challenge on our hands to be able to reinvest money because we don't have that much. This year I could have honored 50 percent more capital expenditures than I was able to because I was unable to raise that kind of money for our industry.

Then when you face a recession like the one we are going through now, and you examine what you are going to do to create production capacity, you say to yourself, "How am I possibly going to be able to cope, when without regard to financial performance the competition internationally raises that capital."

We are currently facing a number of major investment decisions on new factories in the United States, and we would hope that the tax legislation would quickly be resolved to reduce the uncertainty in our investment decisionmaking. We would like to go ahead and make those commitments, take those risks, and be able to create those jobs as fast as we possibly can.

Those are the primary concerns. We are ready to go. We have got the ideas, and the innovations. We need the cash flow. Three-quarters of my fresh new capital comes from the aftertax retained earnings that are reinvested in my company. That is very typical for the semiconductor industry.

Thank you.

Senator BENTSEN. I would ask Mr. Dwight, if he would go ahead and testify. Mr. Dwight is president of Spectraphysics. Then we will return for questions.

If you would go ahead, sir.

STATEMENT OF HERBERT M. DWIGHT, AMERICAN ELECTRONICS ASSOCIATION

Mr. DWIGHT. Mr. Chairman, and members of this distinguished committee. I am Herbert Dwight. I am president of Spectraphysics, a $100 million high technology company, and a pioneer in the laser business.

Senator BENTSEN. Does the $100 million mean sales?

Mr. DWIGHT. In sales.

I am appearing also on behalf of the American Electronics Association, a trade association representing over 1,400 high technology companies.

We strongly favor passage now of a tax bill containing supply side tax incentives that will stimulate, rather than inflate the economy. We believe that a properly designed tax bill will stimulate long-term growth in jobs, in investment, in productivity, in exports, and in tax revenue.

Specifically, we are here to demonstrate the opportunity to make major improvements in the tax treatment of stock options, research and development, and capital gains.

I personally feel so strongly about stock options because I have witnessed firsthand the motivational power that they can generate in a company. In the early stages of Spectraphysics, we issued restricted stock options to every new employee because we saw the tremendous difference between how an employee behaves when he is an owner of the enterprise, and how he behaves when he is not.

Because a stock option has value only when the stock price increases with the success of the company, options give employees a powerful incentive to find ways to expand the business and operate it more efficiently.

Senate bill 2239, cosponsored by Senators Packwood and Nelson, would restore deferred tax to stock options without costing the Treasury a dime. In fact, it would actually make money for the Treasury.

Currently nonqualified options are virtually useless as incentives in most companies because of their ominous tax treatment. For example, adverse tax treatment of nonqualified options cause employees in my company to argue for cash incentives in lieu of stock options.

Cash incentives are inflationary because their costs must be recovered through price increases. Whereas stock options are anti-inflationary because they encourage productivity.

Promoting stock options before Congress is a very frustrating endeavor because the minimal, albeit positive, effects on the Treasury make it difficult to get Congress attention. In fact, even the administration has chosen not to oppose this bill.

Stock options have my attention because at Spectraphysics I have seen employees with restricted stock options put forth that extra effort that created 2,000 jobs in 10 years.

Mr. Chairman, we also strongly recommend enactment of two complementary bills which would stimulate research and development, allowing our innovative growth industries to remain competitive while revitalizing our less competitive industries. These bills are Senate bills 2906, the Research and Development Act of 1980 sponsored by Senators Danforth and Bradley, and 2355, the Research Revitalization Act of 1980, sponsored by Senator Tsongas.

Our innovative industries contribute more of our exports. They create most of the new jobs in this country. Much of the economic growth, and the means for the goods and services to be produced that allow more efficient production.

Despite these benefits, there are seemingly endless statistics that show innovation is declining in the United States, while increasing in the major countries with whom we compete internationally. We believe that it is extremely dangerous to ignore these trends. Our competitive future is directly related to our ability to innovate and to create new products.

I can personally relate to this cause and effect relationship by virtue of the dynamics in my own company where over two-thirds of the sales and three-quarters of our profits derive from new products introduced within the past 36-month period.

The Danforth and Bradley bill provides a 25-percent tax credit for new incremental research and development. By applying only to incremental R. & D. it minimizes the effect on the Treasury, and serves as an incentive for increased research and development.

Mr. Chairman, in 1978 our association appeared before this committee seeking capital gains tax relief to increase the risk capital available for financing innovative companies. We presented hard statistical data to provide that new economic activity more than compensates for the short-term loss to the Treasury.

For example, we showed that each $100 of equity invested in the youngest of surveyed companies resulted in an annuity of $70 in export trade per year, $33 of R. & D. per year, and $35 of Federal, State, and local taxes per year.

It is now clear that reducing capital gains taxes has increased equity values. It has increased the availability of risk capital, and the number of initial stock offerings for young companies.

Mr. Chairman, we now urge your efforts to enact the Cranston bill, Senate bill 2923, which calls for a further reduction in capital gains to 21 percent. The results from the initial reduction in capital gains taxes have been spectacular. We will be passing up a real opportunity for further benefits if Senate bill 2923 is not written into law.

With each passing day, the news abounds with evidence that this Nation is losing its competitive edge. The balanced tax measures I have prescribed will increase our competitiveness, and help reduce inflation. We hope that you will act now to help us become more competitive.

Thank you.

Senator BENTSEN. Am I a cosponsor of the stock option bill?

Mr. DWIGHT. Yes, you are, and we thank you.

Senator BENTSEN. One of my deep concerns about American management today is the change in American management today is the change in American mamagement that is taking place for a number of reasons. I am generalizing. It is not true of all. But we have had a professionalism develop in American management, and a move away from the entrepreneurial manager by the stake and the ownership of these companies.

You have had a portability develop in American management. American management today is dedicating less and less to the funds of the company for research and development, particularly basic research and development. For some of them, their outlook is as short term as a politican's next election.

They will not do the long-term thing because that is something their successors are going to get the credit for. They are compensated on how much they increased earnings over last year, and that is where they get their bonus. That is the way they measure. Maybe that helps get them hired by a competing company.

So we don't have the long-term effort and identification with companies to the extent that we used to have it. I think that a stock option helps that way. The fellow then really has a stake in the long-term efforts of that company, and we have lost some of that, and we have to restore it.

That was taken out in 1969, when they repealed the deferred taxation of stock.

Mr. DWIGHT. Really, 1976 was the death knell. It began in 1964, but the process was completed in 1976, when the qualified stock option was eliminated.

Senator BENTSEN. There was some of that before. I know that in the 1970 election, the gentleman who had sponsored the cutting back lost.

Mr. DWIGHT. The stock option was affected mainly by the Tax Revision Acts of 1964, 1969, and 1976.

Senator BENTSEN. The act of 1969 is the one that I was thinking of.

So I feel very strongly that it would help increasing the productivity of our companies.

I certainly agree with you, Mr. Nesheim, concerning refining 10-5-3. I am one of the original cosponsors of 10-5-3, but as we get into it we see some inequities.

You talk about lowering the cost of capital it does not necessarily happen just because you can borrow higher amounts. That is what you, in effect, inferred. It is not necessarily true, and it depends on the rate that you can borrow. They have a much lower ratio of equity, and that is traditional in the Japanese industry, the way banks look at the situation, and the way the Government looks at it.

But your problem has been also in getting equity capital, has it?

Mr. NEISHEIM. Yes, the primary source for American industry has been equity capital, and the lack of incentive for the investor has become very evident. For the past 10 years we have seen that internally. We put in as much as we can to get ownership internally for stock purchase plans for employees that typically don't know what equity is. They have their retiring plan vested in company stock almost exclusively.

We believe that people who identify with the company make better workers, and that is our primary objective. It is one of our corporate goals written in our annual report this year.

We are concerned about the long term. We want to be around. We think that there is a future. We are just starting to embark on the future, and we want to be able to participate and raise capital in that important equity market in the long term. The business risk aspect of equity is the thing that we thought hardest about.

If you end up as a Government causing through leadership, or poor leadership, a set of business conditions that increase the risk to investors, then you increase the cost. I think that we have had some of that for the past 10 years or so, whether it is economic leadership or policy, or business, or trade. Those things increase cost, and that adds to the high rate of return that I have to get to match that cost, and it makes my job even more difficult.

Senator BENTSEN. I am very supportive of those things that are necessary to increase research. I get a little concerned about identification and categorization, whether you can end up with a bunch of lawsuits with the IRS as you try to get it done.

Mr. NESHEIM. That is one of the major strengths of the Danforth bill, is in the fact that in the bill we have adopted a definition of research and development which has withstood the test of time by virtue of the fact that it is identical to the definition of the financial accounting standards. So much of that grayness, if you will, has been removed, although obviously there is grayness in any aspect of tax legislation, but much of that has been addressed in the Danforth bill.

Mr. DWIGHT. There are some forces that are counterbalancing there to keep people from pumping everything in the kitchen into R. & D. We are battling an allocation of R. & D. to overseas income, if you will, constantly. Therefore, there is a pressure to put as little as possible into R. & D. as a category.

The cost is very significant, and that is an aspect of the research and development taxation that we feel ought to be reexamined as part of this legislative process as well.

Senator BENTSEN. How has the recession affected your industry?

Mr. NESHEIM. We are now seeing softness, and our backlogs are coming down steadily month after month. We have yet to go off the cliff as we did in 1974, and we think that this is because of better management of inventories on our part as well as our customers. We are watching very closely—it is starting to hit—our pricing reflects the demand meeting supply. Yet, we know that when the recession is over, we are going to need much more capacity, and just have got to have the ability to invest in that now.

Senator BENTSEN. Senator Danforth?

Senator DANFORTH. Mr. Chairman, you have asked the question that I wanted to ask with respect to whether or not research and development can be sufficiently defined so as not to just open a door allowing everything to be put under that heading. I take it that the view of each of you is no.

I think that your answers were clear enough as far as I am concerned. Unless you have further embellishment on it, it satisfied me.

The second question that I would like to put on the same subject of research and development is: would a tax credit for R. & D. do any good, or would it turn out to be simply rewarding a business for what it was going to do otherwise?

Mr. DWIGHT. My response to that would be that we regard decisions that we make in the research and development area as being the most important decisions that we make as managers in our companies. I think that that is probably true of any high technology company. We call it the spoke of the wheel because everything in the company rotates around that.

We go through great caution to insure that the money that we spend in research and development is going to pay off, and we have very high standards of return. In our company, we have a standard of 40 percent pretax return on investment before we will make an investment. So that means that not withstanding all of the——

Senator BENTSEN. The first year, or over how many years?

Mr. DWIGHT. Typically over a product life of 6 to 7 years in our case.

Notwithstanding the fact that we are taking great pains to examine our R. & D. expenditures, there are a good many that fall in what might be called a marginal area, where the returns would still be very high, and which this bill would do a great deal to foster because they are in an area of marginality that could not otherwise be justified. But with the tax benefits that could be derived from a bill of this sort, it would stimulate a company like ours to make a much higher percentage of research and development expenditures.

Mr. NESHEIM. We have each year a request for funds that I can only honor two-thirds of. This has been our experience over our life. This year I could have honored 50 percent more capital requests than I have. Each year, for the past 10 years, we have bet the company's entire net worth on R. & D. and new projects. That is the kind of growth potential that is there currently.

The second advantage is that when tax reform reduces the cost of tax, it increases the number of projects available, because with the reduced costs I am able to take a longer term view. I can look at 10, and even 15 years out. That will help a great deal.

You are right. We have a lot of pressure to push in the short term, but we also see where semiconductors can be in the year 2000. We have engineers clamoring for money every day for a new way to do things. The manufacturing processes by which we make these are almost as important as the basic idea because the processes are very involved high technology processes involving changes to equipment.

Our engineers work with his engineers on model No. 1, and within 2 years that is modified several times, and you have a new evolution of manufacturing equipment that is going on, and that process itself is very long term, and it means huge investments in the way you make things. It also will chew up large amounts of capital.

Finally, the technology is a driving force. We are entering the equivalent of crossing the line into supersonic speed with this VLSI world. Electrons now really have to be manufactured exremely carefull, but the power that comes out of them is enormous, and that is a major capital investment for us. It takes cash flow.

Senator DANFORTH. You don't view this as the sort of idea which is a gimmick?

Mr. NESHEIM. Which idea?

Senator DANFORTH. The tax credit?

Mr. NESHEIM. No. We have seen what it can do in other countries. We have seen applications where cash applied to research has, in fact, immediately stimulated new product development. We know that that is the case in our own company.

Senator DANFORTH. I mean as far as using it for cash flows?

Mr. NESHEIM. No. We think that it provides an incentive to do the right thing. When you tax something, you get less of it, in our opinion. If you reduce the tax on research, you are going to get more of it.

Mr. DWIGHT. I would never minimize the power of an incentive. It drives the industry in this country. I think that an incentive of this type would do a great deal in stimulating the research and development investments that are made in this country.

~~One of the tremendous contrasts~~ between perspectives of U.S. industry and the Japanese industry is that ~~of term. The Japanese~~ tend to be much longer term oriented. It is interesting to note that they have a 20 percent tax credit written into their law for incremental R. & D. So they represent our competion, and yet——

Senator DANFORTH. They have a 20 percent tax credit for R. & D.?

Mr. DWIGHT. That is my understanding, yes.

Senator DANFORTH. It seems to me the number one sticking point on this concept—as you know, I am all for it—is the question of definition. The definition of ordinary and necessary business expense is something that took years and years to evolve. Is it your opinion that a definition which follows the standards of the Financial Accounting Standards Board's principle No. 2, is adequate?

Mr. DWIGHT. That is necessary, but not sufficient. The regulations in general are complicated in their execution. But we distinguish between new oil and old oil, and we make other much more difficult distinctions that the distinction between R. & D., and capitalized expenses, if you will.

As Mr. Nesheim has suggested there are reasons why written into the tax code why we would choose to minimize R. & D. expense as relates to the amount of expense that gets allocated against overseas taxes, and so. There are reasons why management would choose to keep research and development expenses at a minimum, as well as trying to maximize them. There is a balanced activity within the code.

Mr. NESHEIM. I don't think the problems of definition are any greater or any less than is present with a large number of the issues with which we cope on a daily basis.

Senator BENTSEN. How old is your company, Mr. Dwight?

Mr. DWIGHT. Our company was founded in 1961, so we are in our 19th year.

Senator BENTSEN. You are meeting your projections of 40-percent pretax earning on investments?

Mr. DWIGHT. We exceed our projections in some cases, and we fall short in others. On balance, in meeting that criterion, we fall slightly short of that.

Senator BENTSEN. When you say that you didn't fund some 50 percent of what was asked by engineers for additional research investment, I understand that. That is easy. But how many of them were good, and what kind of projections do you have on return for them? How many met your criterion and what was it?

Mr. NESHEIM. We go through an annual planning cycle that has four stages. The final stage is what we end up calling the wish list.

Senator BENTSEN. We have one of theose before this committee, too. [Laughter.]

Mr. NESHEIM. We have gone through by that time three iterations in which we have screened out impossible ideas that we did not think fruitful. We have gone through two screening processes on a very quantified basis, and we are down to the hard, short strokes.

At that point time, in the most recent year I had a request for $300 million worth of new investments, and I could not honor more than $220 million given the financial criteria that my creditors and investors have cited for me. Those are real. If I could invest in those, I could get a good return with a good chance of that in a real business risk environment. It is not a complete first start laundry list.

The real wish list, the so-called pie in the sky, is probably close to double the $300 million. Our biggest problem often is that the reality of implementing many of those ideas, we don't have the skilled people to employ. That is one reason we were concerned about getting more energy going at the university level.

Our numbers have shown that the United States has been graduating a very constant number of electrical engineers for the past 10 years, about 14,000 annually. I believe the Japanese graduated

19,000 last year. So proportionate to their population and country, they are really growing rapidly.

We have to get engineers back out of our universities.

Senator BENTSEN. National Semiconductors is a pretty good size company, isn't it?

Mr. NESHEIM. Yes. Our annual sales are now in excess of $1 billion. In 1967, when we were founded with this management, we were $7 million in sales.

Senator BENTSEN. You have had your ups and downs in that company.

Mr. NESHEIM. We have had an unbroken growth record in the sales area, but when it has come to head-on competition in some particular area, such as the consumer area where pricing can be very ruthless, it is a real challenge, and this has happened in economic cycles.

If I could just make one final closing point. I think technology for America is very like oil. It is an opportunity for us and it is a resource. If we invest in it wisely, we will be free, as free as we could have been if we had invested wisely in alternative energy sources for the past 50 years.

If we don't, we will be as dependent upon imported technology, and have the consequences that we are currently having under oil. We, in the electronics world truly believe that. It has happened before in history. I was reading last month about what happened when the Phillistines got control of the iron technology, and the Israelis had to go and sharpen all their implements in front of the Phillistines, and in the end the Phillistines dominated the Israeli culture because of it. It was only because of one leader who asked for help from the lord that they overcame it with a flash flood.

We have the tools, and I think we have got the smarts. If we can get a consistent policy going that will make sense out of all the resources from a soverieign marketlace to the realities of multilateral trade agreements, we can get what we need to stay healthy. We don't want to come cup in hand like Chrysler and the others. We don't want to have to come here in that condition.

We are committed to it. We think that the competition this time took on the wrong industry.

Senator DANFORTH. What is the Tsongas bill that was mentioned in somebody's testimony?

Mr. DWIGHT. The Tsongas bill is a bill that would provide a tax credit for grants to colleges and universities for research. The benefits would be to provide more funds to the universities, and also stimulate the number of graduating technications from those universities.

So it is a mechanism to create a greater amount of basic research in the country.

Senator DANFORTH. If there were a proposal in the tax law that would have the advantage of increasing the basic research at colleges and universities, would that filter down to you?

Mr. NESHEIM. Funded research at Stanford which was patented by a professor who sold the patent to Japan has come back within 3 years in the form of machinery for photography, in the form of competitive technology that is driving American manufacturing out of the business. It happens fast in this technology world.

We already have tiny programs going with universities, and we know what has happened there. Professors and their students get a chance to work real time on practical problems. You get people. You get new ideas, and it happens quickly. Semiconductors is an example of that. We work closely with professors at our universities, small amounts of dollars, and quickly applied some ideas that were rather exciting, and bingo you have a semiconductor that can speak foreign languarges with accents complete.

Mr. DWIGHT. Stimulating basic research is one of these things that is desirable, but not sufficient because basic research by the large is in the public domain. What is accessible to industry in the United States is also accessible in industry in the U.S.S.R. and Japan.

People who are doing basic research in universities get their motivation and their recognition out of the public dissemination of what they do. That is good. It fuels the world economy. But we also have to pay attention to the commercialization of those ideas, and the overwhelming share of commercialization takes place in industry. For that matter in smaller business than it does in the universities.

Senator BENTSEN. Gentlemen, thank you very much. It was very helpful.

[The prepared statements of Messrs. Nesheim and Dwight follow:]

STATEMENT OF

JOHN NESHEIM
CORPORATE TREASURER

National Semiconductor Corporation

ON BEHALF OF THE
SEMICONDUCTOR INDUSTRY ASSOCIATION

SUMMARY

We need an American response to the foreign industrial challenge to U.S. high technology industries. The challenge referred to is a result of the ability of foreign semiconductor producers to obtain capital at a lower cost and to operate from relatively insulated markets. These advantages allow Japanese producers to acquire control of selected product markets in the United States and other countries through highly aggressive marketing strategies.

In the last few years, the competition has taken the form of selling high volumes of product at exceptionally low profit margins in specific product lines. This resulted in the domestic industry being deprived of the earnings necessary for sufficient levels of research and development and capital investment.

The competition ultimately may be difficult for U.S. firms to meet because it is based on a lower total cost of capital than that available in the United States. Moreover, the traditional trade remedies do not address inequalities in international competition which arise due to differing industrial structures.

There is a developing sense that the Government should not remain in a "neutral corner". The maintenance of the technological lead of the U.S. semiconductor industry is increasingly being clearly recognized as a strong national interest, both for our defense and commercial interests. Success in this endeavor will require expansion of capacity and increased research and development efforts.

Future expansion of capacity is the critical requirement for the industry. The principal bottleneck to capacity growth has been identified as access to adequate financial resources. This disadvantage could be partially offset by changes in the U.S. tax system which would aid capital formation. Part of the solution must also be a carefully coordinated research and development program including funds for the universities for applied research activities. This would attract greater numbers of talented engineers into this key area of technology.

Our conclusion is that the Government and the industry have a mutual interest in working together to achieve a properly structured and coordinated set of domestic programs and international policies which will provide effective market incentives to strengthen the U.S. in this core technology.

SUMMARY STATEMENT

My name is John Nesheim and I am Corporate Treasurer of National Semiconductor Corporation of Santa Clara, California, the largest semiconductor manufacturer in Silicon Valley.

I appear today on behalf of the Semiconductor Industry Association, a trade association composed of 42 U.S. manufacturers of semiconductors. I have a more detailed written statement which I would like to submit for the record.

My purpose in testifying is to bring to your attention the importance of this tax cut to the semiconductor industry, an industry at the heart of America's high technology industries. Our willingness to assume risk, our innovativeness and our entrepreneurial drive have made the United States a world leader in the vital new area of semiconductor technology. But we face a major challenge in this decade from foreign governments intent upon creating economic environments for our competitors far more favorable than our free market system can provide. We urge you to take the necessary steps in this tax legislation to enable us to maintain America's technological leadership. All that we ask is that the unique qualities of this industry be taken into account in the proposals to accelerate depreciation and encourage research and development.

U.S. comparative advantage lies in high technology industries like semiconductors. Continuing American leadership in semiconductor technology is critical to the U.S. economy.

Semiconductor technology is shaping the world. Our industry produces the tiny silicon chip on which thousands of bits of information can be processed and stored. These chips form the heart of computers and other "programmed" appliances.

Semiconductors provide the keys to solving many of the most critical problems facing the United States - increasing employment and productivity, conserving energy, improving our trade balance, and maintaining a strong national defense.

To take one example, our national defense depends on semiconductor technology. From our foot soldiers to our ships and planes and missiles, semiconductors are used for navigation, detection and communications systems. Our ability to maintain a strong nuclear deterrent depends largely on our ability to develop "smart" missiles and sophisticated detection devices based on semiconductor technology.

Our world leadership faces a major challenge in this decade from foreign corporations supported by foreign government policies designed to provide a competitive edge over American industry.

The dimensions of this problem are highlighted in a document recently published under the auspices of Japan's Ministry of International Trade and Industry. The report concluded:

> "The United States is in a state of relative decline... .

America must stop and think about what MITI is saying. The United States cannot afford to allow this conclusion to be correct. We are not ready to abdicate our technological leadership.

The Japanese, and other countries, have no doubts about the appropriate policies to follow. They are providing government support in the form of subsidies and tax incentives to attract the capital needed in this high growth, highly capital intensive industry. As much as two billion dollars is being spent on this effort, much of it in the form of accelerated depreciation, investment reserves, and special treatment for R&D expenses.

But the advantages enjoyed by foreign competitors go beyond this. Structural differences between the U.S. and foreign economies give our competitors advantages in lower capital costs.

Our Japanese competitors operate in the environment of a capital market much more advantageous than that available to U.S. companies. The SIA commissioned a study by Chase Manhattan Bank to examine the importance of these differing markets on our industry. That study concluded that because the Japanese are able to obtain a much higher portion of their needed capital through low-cost borrowing, their cost of capital is almost half that of U.S. companies.

Such financial ratios would be unthinkable for U.S. semiconductor firms. Quoting the Chase study: "....leverage of this magnitude would not be available from conventional banking or [other] capital market sources in the U.S."

How are the Japanese companies able to achieve these extremely high ratios and what are their importance? The Chase investigation concludes that, "Japanese semiconductor companies are able to employ high-leverage ratios [debt-to-equity ratios] because of their affiliation with large industrial groups, Japanese lending practices, and a supportive government policy."

Capital is like any other cost. It must be reflected in the cost of goods sold. Lower capital costs give Japanese firms a substantial competitive edge.

The net effect of these types of foreign government programs and structural economic differences is clear. Foreign companies are threatening to displace the United States as the leader in semiconductor technology.

The state-of-the-art integrated circuit is now the 16K RAM (Random Access Memory). This chip can hold 16,000 bits of information. The Japanese began selling these 16K RAMs in the United States at twenty to thirty percent below the U.S. price, based on their protected market, government support and lower capital cost. As a result, by 1979 the Japanese had gained 42 percent of that market.

This type of competition has serious implications for the U.S. semiconductor industry. For U.S companies, large sales volumes are necessary to finance the supporting research required for the development of further integrated circuit products. Thus, if a large segment of the 16K RAM market is lost to foreign competition, the American semiconductor industry will suffer in all integrated circuit product lines. Without the cash flow from high volume products, U.S. firms will be hard pressed to remain technologically competitive.

This type of government supported competition has serious implications for the U.S. semiconductor industry.

We believe that a properly designed tax cut can be a major help in keeping U.S. firms competitive. In our view, such a tax cut can be best accomplished by the enactment of two proposals.

First, we urge that the Congress enact a tax credit for research and development expenditures. You have before you S.2906 proposed by Senators Danforth and Bradley. A high rate credit for incremental expenditures over an historical base, like that provided in S. 2906, will provide a substantial stimulus for additional research expenditures and will benefit most those companies which are most productive. As a corollary to this credit, a tax credit for setting aside corporate funds to be used in university research should be enacted.

Second, we support the concept of depreciation reform as reflected both in "10-5-3" and other proposals. We urge, however, that the Committee refine these proposals to provide more significant benefits for short-lived equipment.

Under present law, most of the equipment used to manufacture semiconductors has a useful life of five to six years for tax purposes and receives only a two-thirds investment credit.

Under the "10-5-3" proposal, these present useful lives for our equipment will not be significantly reduced. Indeed in those cases where the equipment is written off over a shorter period of time than five years because of technological obsolescence, "10-5-3" useful lives -- if made mandatory -- could actually lengthen the period of time over which such equipment must be depreciated.

We urge that if this Committee adopts "10-5-3" or a similar proposal, the useful life of equipment in our industry be set at three years and a full investment credit be permitted. Alternatively, if a five-year useful life is to be retained, we urge that some form of additional first-year depreciation, similar to the 25 percent additional depreciation permitted in Japan, be provided.

Besides an R&D tax credit and modifications to depreciation reform proposals, the Association supports a number of other proposals which others have discussed in more detail and which are included in our written statement. But at this point our industry has one vital concern: If a major productivity-oriented tax cut is to be enacted, its benefits must be shared by those industries such as ours that are on the forefront of the kinds of technological improvements that will make America's economy competitive for the remainder of the century.

STATEMENT

My name is John Nesheim, and I am Corporate Treasurer of the National Semiconductor Corporation of Santa Clara, California, which has annual sales of about $1 billion. We are the largest semiconductor manufacturer in Silicon Valley. We sell to a broad customer base, including computer and telecommunications customers. Our suppliers are also high-technology equipment manufacturers.

I appear today on behalf of the Semiconductor Industry Association, a trade association composed of 42 U.S. manufacturers of semiconductors.

I. Maintaining American Technological Leadership.

We are at a critical juncture in America's economic development. The tax cut you are considering could have a major impact on the problems plaguing the U.S. economy--the decline in productivity and innovation, high unemployment, the slow rate of growth and the deterioration in the competitive performance of U.S. firms in international trade. While others will address the critical questions of the size of a tax cut and the appropriate timing, my objective is to bring to your attention the importance of the shape of the tax cut to the U.S. semiconductor industry.

What you do as a result of this hearing will significantly affect the growth of America's high technology companies.

Semiconductor technology is shaping the world. Without maintaining our leadership in this technology, America will be as vulnerable as we are today because of our dependence upon oil imported from abroad.

The industry I represent is a research-intensive, high-technology industry. It exports top quality products around the world. It combines creativity, scientific knowledge and risk-taking entrepreneurial drive. We provide the core technology for the computer, telecommunications, and consumer electronics markets. The semiconductor industry produces the tiny silicon chip on which thousands of bits of information can be processed and stored. These chips form the heart of computers and other "programmed" machines and appliances.

There is virtually no new product today which is not affected by semiconductors. Semiconductors in teaching aids help the children of the 80s learn to spell and do mathematics. Your toast and morning breakfast are cooked in appliances that are controlled by semiconductors. The car you start up and drive to the office in the morning is monitored by semiconductors which enable it to significantly boost its miles per gallon while greatly reducing the cost of energy to drive it. The security systems which protect your offices are built with semiconductor systems. The air conditioning system of your office is made energy-efficient by computers and control systems built with semiconductors as building blocks. The dictating machine on your desk needs semiconductors to operate. The telephone which you use is controlled by billions of semiconductors in central stations and satellites around the world. The rockets which launch those satellites rely on the miniaturized power of semiconductors to perform their extraordinary function. Even the machine tools used to build missiles and aircraft are controlled by microprocessor chips of silicon semiconductors

Semiconductors provide the keys to solving some of the most critical problems facing America--how to reduce inflation, increase employment and productivity, conserve energy, improve our trade balance, and maintain a strong national defense.

Last year, our industry grew by a record rate of 36 percent. Even in this recessionary period we expect at least a 20 percent increase in sales to the $8.4 billion level. This type of growth signals new jobs for American workers. The industry itself employs over 100,000 people, with 250 factories located in 28 states.

Our customers range from AT&T and IBM to the smallest of venture capital companies, all of which rely on the semiconductor to build systems. For example, Bell Telephone and independent telecommunications companies employ millions of workers which represent huge employment pools that grow along with the applications that are created by the use of semiconductors. Even General Motors and other automobile manufacturers have semiconductor-related employment. And the number of people employed to write programming for use on semiconductor-based computers is awesome.

The productivity improvements which are possible through the employment of semiconductors are abundant and we are just beginning to realize the benefits.

Semiconductors help revitalize mature industries. Computer controls make manufacturers more efficient in producing steel and chemicals. Our technology enables textile machinery to help make the American worker more productive. Motor vehicles -- as well as these core industries -- increasingly rely on semiconductors to meet environmental and safety standards.

American workers are productive. We now offer them semiconductor-based tools to further increase their productivity. Peter Drucker has compared the impact of the semiconductor to that of the fractional horsepower engine. Look at the productivity gains made possible through hand tools and small engines and consider the possibilities when every work place and every household has its own computer system.

Semiconductor systems are crucial to energy conservation. The latest semiconductors reduce the consumption of power of a modern computer by 40 percent. A washing machine which uses semiconductors to replace electro-mechanical devices can save 25 percent of the power it formerly used. Soon, all automobiles will have semiconductor-controlled engine control systems to keep cars tuned, reduce fuel consumption, and meet pollution standards.

The semiconductor industry has been an international trader since its inception, designing products for world -- not just domestic -- markets. More than one third of our sales are overseas. Most of America's current and future export strength depends upon high technology products in which semiconductors are the essential components. Aircraft, computers, machine tools and telecommunications all rely upon the latest semiconductor technology to maintain their international competitiveness.

Our military strength relies on electronics. Radar and other telecommunication systems employ semiconductors as the eyes and ears of the military. Electronic systems fly aircraft, guide ships and launch missiles. Footsoldiers increase their effectiveness by using lasers, radar and other electronically controlled weapons. In all these applications, America's semiconductors provide our military with a decided advantage.

My point is simple: this is a critical industry. If America loses its technological lead in this industry, it will impair our ability to maintain world leadership in commerce and in defense capability.

The message we want to bring to this Committee is that in shaping the tax cut before you, this Committee is making a choice regarding the future of this industry and of all of our industries.

We face a major challenge in this decade from foreign competition in semiconductors, supported by foreign government policies designed to provide a competitive edge over American industry. We urge this Committee to consider an appropriate American response to this challenge. What we need are market incentives designed to promote research and development, reward innovation and assure access to capital for a high-growth, increasingly capital-intensive industry.

My plea is a dramatic one and is perhaps surprising, coming as it does from an industry which has accomplished so much in its short existence. However, our concern is for the future. We must look beyond the need for just the immediate stimulus of a tax cut, and address the need to preserve American technological leadership. This leadership position is currently the target of foreign government policies. What I am seeking from you today is only a first step--for the United States to provide a competitive environment for this industry more nearly equal to that provided our competitors.

To understand the policies which we need, you have to look at the basic ingredients which have made this industry unique.

II. Innovation and Capital

Over the past three decades, our industry has grown at an incredible pace. Numerous studies of the industry conclude that the factors behind this success have been a long term strategy incorporating risk-taking management, willingness to innovate, and adequate access to capital to support new ventures. We are world leaders in this technology because we are always seeking to try something new which has a longterm payoff.

This drive to continually advance the state-of-the-art technology is essential. Leading companies cannot afford to fail to support large research and development programs. Any company that fails to stay abreast of the state-of-the-art technology will begin to wither. Our industry's history is littered with the names of companies which failed to keep up with the breakneck pace of technological advancement. Our industry spends more than double the U.S. average on research and development--7 cents of every dollar of sales. In the extremely competitive semiconductor industry, maintaining that required level of R&D is becoming increasingly difficult. I will say more about why shortly.

Another cost our industry must bear is a very high rate of equipment obsolescence due to the rapid turnover of technology. We develop a new generation of manufacturing techniques every three to five years. This is a fact of life in our industry. The Department of Commerce estimated our rate of equipment obsolescence to be more than twice the all-manufacturing average.

The requirement to perform R&D and the rapid obsolescence of our facilities are two factors which must be kept in mind to understand what we are facing in the 1980s. Demand for semiconductor devices has been nearly explosive. Thus, we must expect that, by the time the recession has run its course, we will need to have put in place significant additions to our capacity to accommodate that demand. It is always difficult to raise capital during a recession in the United States. And this incremental capacity will be some of the most expensive ever put in place. The reason is simply that we are now entering an exciting new era of complex devices--far more powerful than anything we have ever produced commercially before. What this increased complexity means for our industry is a quantum increase in capital costs for a given amount of capacity. Our industry expects a two-fold increase in the costs associated with installing our basic production unit--called a wafer fabrication facility.

In summary, the needs for capital that this industry is experiencing are large and are growing larger. In order to survive, a semiconductor company must innovate and invest for the future. The industry must support very high levels of research and development. Yet the new facilities will be obsolete in just a few years. And, if we are to produce the latest generation of devices, then a company must invest in new equipment which costs two times as much as the last facility which was installed.

III. The Challenge of Unequal International Competition

Our industry is being confronted with a new challenge--one that threatens our ability to continue to maintain our high levels of investment in semiconductor technology. The challenge to our companies comes from the actions of foreign governments.

Governments around the world are lining up behind their national semiconductor industries and are adopting national policies and programs designed to provide a special economic environment which provides benefits far beyond those created by free market forces. They are seeking to give their industries a competitive edge in the world market. What is disturbing about this challenge is not the competition itself, for this industry has thrived on competition. What is disturbing is the fact that we may not ultimately be able to compete unless the gap is narrowed between the deliberately supportive economic environment provided abroad and that existing in this country.

This challenge can be used as an opportunity for America to learn from Europe, Japan and other countries.

For an important insight into the way others view us, and perhaps more importantly how they view themselves, let me read to you some selected passages from a document recently published through the auspices of Japan's Ministry of International Trade and Industry (MITI) entitled "The Vision of MITI Policies in the 1980s." The document represents the considered judgments of a broad consortium of Japanese business, labor, academic and government officials. It says:

> "The United States is in a state of relative decline...."

Let me pause a moment and consider that statement.

> "The United States is in a state of relative decline -- politically and economically -- the world is further transitioning toward a multi-faceted and multi-polar structure with a resultant intensification of instability."

This is not a hostile statement. It is made by the Japanese government agency most responsible for that country's economic success, built as it was to a large extent, on an emulation of what is best in American industry.

But America must stop and think about what MITI is saying. The United States cannot afford to allow this conclusion to be correct. We cannot abdicate our technological leadership.

The Japanese Government has no doubts about the appropriate policies that it must follow:

> "Economic security will be achieved through technological innovation; government action will be required because of the demand for large amounts of money.
>
> "Japan has heretofore, borrowed, applied and improved upon imported technologies. In the 1980s, it must switch over to 'forward engineering' by increasing budgets for R&D consistent with a 'long-term vision for technological development', which identifies priorities, . . . "

In the past, the Japanese have backed these policy statements with money and we have every reason to think they will continue. Over the last four years the Japanese Government spent $250 million on the well publicized Very Large Scale Integration (VLSI) program. In addition, according to a Joint Tax Committee staff report, the Japanese provide accelerated depreciation through a "special initial depreciation" for certain machinery using data processing equipment. Under this method, an extra 25 percent of acquisition costs may be deducted during the year when the assets are first placed in use. The Japanese also provide a special tax credit for any corporation which increases its research and experimental expenses and training costs of programmers and system engineers for electronic computers.

The Japanese are not alone in recognizing the importance of this and other semiconductor based industries and taking steps to protect and foster them. A wide variety of subsidies and tax incentives are being offered in other countries to promote development of high technology industries.

Several recent studies have catalogued some of the steps other countries are taking because these countries recognize that this industry is an important national resource. (Tables attached)

The attached table summarizes the results of a survey conducted by Rockwell International on the foreign government assistance for commercial ventures in semiconductors, computers and communications. As much as $2 billion is being spent on this effort and when you see that kind of money being spent, you can be sure that the governments are focusing other policies to favor this industry. The Department of Commerce and the General Accounting Office have catalogued some of the fiscal incentives provided by foreign governments to this industry in the form of accelerated depreciation, investment reserves, special depreciation and deduction for R&D, and tax credits.

The presence of these formal government programs targeting our industry would be challenge enough. But, compounding the situation are advantages accorded our foreign competitors by virtue of differences between the economic systems of the United States and foreign countries, in particular the nature of the respective capital markets. For example, while U.S. firms must generate adequate rates of return for their investors, our principal Japanese competitors do not. American capital markets demand that the price that U.S. firms must pay for capital be exceeded by returns that American companies generate from its use. Firms that fail to meet this criterion will find capital more difficult to raise, and available only at much higher cost. Our competitors are apparently not constrained by such market factors to the same degree.

To examine this issue in detail, the Chase Manhattan Bank undertook a study for the Semiconductor Industry Association comparing the United States and Japanese semiconductor industries. The results show how the Japanese capital market gives their companies significant advantages in access to low cost capital.

What motivated initiation of the Chase study was the desire to understand how the Japanese companies could obtain extremely high proportions of debt capital and how that affected their cost of capital. Data suggested that companies with so much debt would be very risky to finance. For every dollar of equity they invested, the Japanese companies borrowed large amounts of money from banks. It was observed that while American semiconductor companies had debt-to-equity ratios (leverage) of less than 25 percent on average, four of the Japanese semiconductor firms maintained debt-to-equity ratios of 150 to 230 percent. Such financial ratios would be unthinkable for U.S. semiconductor firms. Quoting the Chase study: "....leverage of this magnitude would not be available from conventional banking or [other] capital market sources in the U.S."

How are the Japanese companies able to achieve these extremely high ratios and what are their importance? The Chase investigation concludes that, "Japanese semiconductor companies are able to employ high-leverage ratios [debt-to-equity ratios] because of their affiliation with large industrial groups, Japanese lending practices, and a supportive government policy."

Chase concludes that largely as a result of the higher debt-to-equity ratios employed by Japanese companies, their cost of capital is significantly lower than that of U.S. semiconductor companies. Chase found that for U.S. companies the cost of capital was 17.5 percent; by contrast, the cost of capital for Japanese companies was 9.3 percent--a 50 percent difference.

Capital is like any other input to a company, its costs must be reflected in the cost of the goods sold. Lower capital costs give Japanese firms a substantial competitive edge.

But there is an additional advantage Japanese firms obtain from the way their economic system functions. As discussed earlier, efficient capital markets require that the cost of capital be covered by the return the user of the captial earns. But Chase found that Japanese semiconductor companies have earned rates of return which have fallen short of their already lower cost of capital. That is, while their cost of capital was about 9.3 percent, they were only earning a 7.5 percent return.

A U.S. company consistently performing in this manner would be cut off from further access to capital when the risk becomes too great for bankers and shareholders. By contrast, the Japanese financial system responds differently. It continues to fuel growth with fresh capital without regard for financial performance or the state of the general economy. The low rate of return is acceptable. With lower prices, the Japanese manufacturers can then gain world market share.

The net effect of these foreign government programs and basic structural differences is clear. Foreign competition is seeking to displace the United States as the leader in semiconductor technology. And this strategy is beginning to pay off. The state-of-the-art integrated circuit is now the 16K RAM (random access memory). This chip can hold 16 thousand bits of information. In 1978, the Japanese began volume sales of the 16K RAM in the United States at 20 to 30 percent below the U.S. price, based upon their protected market, governmental support, and lower capital costs. By 1979, the Japanese had gained 42 percent of the market.

The Japanese incursion in the 16K RAM market has a serious implication for the U.S. semiconductor industry. Volume sales are necessary to finance the supporting research required for the development of new integrated circuit products. Recovery of high R&D expenses is possible only with volume. If the 16K RAM market is further eroded, or the successive 64K RAM market is lost to Japanese competition, the American semiconductor industry would suffer not only in RAMs, but in other state-of-the-art integrated circuit product lines. Without the cash flow from the high-volume products, the U.S. firms will be hard pressed to remain competitive technologically. The United States will then become dependent on foreign producers of state-of-the-art circuits.

To meet the challenge of the next generation of semiconductors -- the 64K RAM and related chips -- the U.S. semiconductor industry must raise and invest large amounts of capital during the current recession. That will be difficult when earnings growth slows or declines, while our cost of capital remains high. In the 1974-1975 recession, we were unable to invest adequate capital and lost a large share of the 16K RAM market to our foreign competition.

65-969 O - 80 - 18 (pt.3)

IV. Proposed Tax Cuts and the Future of the American Semiconductor Industry

Three quarters of the fresh capital of American semiconductor companies comes from the reinvestment of after-tax earnings. Nondiversified U.S. semiconductor companies typically pay little or no dividends. Thus, a sizable tax reduction will generate new capital which can be quickly reinvested in new semiconductor technology. As an industry, we are still well below our innovative research and development potential. In my company, for example, the requests for new capital investments this year were 50 percent greater than we could finance.

For this reason, the tax cut decisions which this Committee will make will play a major role in determining the ability of the semiconductor industry to meet its international competition. If Congress would provide us the kinds of incentives through the tax system that other countries provide in a variety of ways for their semiconductor companies, we would overcome much of our growing competitive disadvantages as we seek to retain the U.S. lead in semiconductor technology. More needs to be done -- especially in capital formation and trade policy -- and tax reform is needed promptly in this aggressive, fast moving industry.

Depreciation Reform. Let me first direct attention to the types of incentives provided in proposals for depreciation reform. The Semiconductor Industry Association supports the concept of depreciation reform such as is reflected in the

"10-5-3" proposal. The Association urges, however, that any such proposal, if adopted by this Committee, be amended to provide more significant benefits to short-lived equipment.

Under present law, most of the equipment used to manufacture semiconductors has a tax-useful life of five to six years and receives only two-thirds of the full investment tax credit. In many instances, this equipment becomes technologically obsolete before the end of its useful life; in such cases the remainder of the equipment cost is deducted in the last year of its shortened use but part of the investment tax credit taken must be recaptured.

Under most suggested depreciation reform proposals the depreciable useful life and investment credit received by equipment in our industry substantially changed. For example, under the "10-5-3" proposal, the useful life of equipment used to manufacture semiconductors would remain at 5 years. Indeed, in those cases where the equipment is presently written off over a shorter period of time because of technological obsolescence, "10-5-3" useful lives -- if mandatory -- would actually lengthen the period of time over which such equipment must be depreciated. The primary benefit to the semiconductor industry from the "10-5-3" proposal results from the increase in the investment credit, from six and two-thirds percent to a full ten percent (for equipment having a five-year or six-year useful life which is not replaced at an earlier date because of technical obsolescence). Such an investment credit increase would be a helpful -- but not a substantial -- benefit to the companies in our industry; it would reduce the after-tax cost of purchasing new equipment by slightly over six percent on a present-value basis.

As the above figures indicate, "10-5-3", like most suggested depreciation proposals, would not provide substantial benefits to the semiconductor industry. This results essentially from two factors. First, as indicated above, the equipment utilized in the industry has a short useful life, as a result of the rapid pace of semiconductor technological development. Second, the companies undertake relatively large research and development expenditures in relation to their capital expenditures. Thus, in comparison to industries such as the primary metals industry and public utilities, in which a high proportion of investment goes for capital equipment with useful lives of 12 to 15 years and up under present law, the benefits of present depreciation reform proposals to the semiconductor industry and other electronic industries like it are relatively small.

This is not to say that depreciation reform such as "10-5-3" is not desirable. We believe it is. It would be of major benefit to many segments of the United States economy, including many of our customers and suppliers. However, we urge that in considering a productivity-oriented tax cut, this Committee consider ways that these and other proposals can be refined so as not to exclude industries like semiconductors.

For example, if this Committee decides to adopt "10-5-3" we urge that three changes be made. First, the useful lives set out in the "10-5-3" proposal should be made optional rather than mandatory. This change is essential in order to prevent the proposal from actually increasing over present law the useful lives of equipment which becomes technologically obsolete less than five years after being placed in service. It would indeed be the ultimate irony if Congress enacted a productivity-related depreciation reform package which, compared to present law, actually increases the taxes paid by companies engaged in technological innovation which benefits so many core industries.

Second, we urge that, if some form of "10-5-3" is to be adopted, either the useful life for non-transportation equipment presently depreciated over five or fewer years be reduced to 3 years or some form of additional first-year depreciation, similar to that used by the Japanese, be provided for such equipment. If, for example, additional depreciation were provided equal to 25 percent of the equipment cost -- as the Japanese provide for similar taxpayers -- the additional depreciation combined with "10-5-3" would reduce the after-tax cost of capital equipment by 13 percent on a present-value basis. The proposal would thus provide a substantial incentive to new capital investment.

The final modification we suggest would be to replace the so-called "half-year convention" in "10-5-3" with what might be called a "full-year convention." The half-year convention was proposed in "10-5-3" as a simplifying convention which, in effect, assumes that all equipment actually placed in service at different times during a taxable year is placed in service at the end of the sixth month of the year. Thus, under that convention one-half of a full year's depreciation is allowed in the first year for all assets regardless of when actually placed in service during that year. It would be a substantial improvement, and would be a further simplification if for depreciation purposes the legislation assumed that all equipment was placed in service at the beginning of the taxable year. In this way all taxpayers purchasing equipment would be able to take advantage of the full first-year benefit of the depreciation reform proposals. Moreover, the proposal would be of particular benefit to short-lived assets. Since these assets have, by definition, a larger portion of total depreciation taken in the first year, this change from the half-year convention would tend to balance the benefits from an overall depreciation reform proposal between short-lived and longer-lived assets.

Research Incentives. Any tax cut which is intended to make a substantial contribution to increased productivity in U.S. industry must provide incentives for more than the purchase of new plants and equipment. In most high technology industries, including the semiconductor industry, research and development expenditures are as important, if not more important, than capital goods expenditures. Economic studies have consistently shown that today's improvements in productivity are linked in substantial part to the research and development efforts undertaken in earlier years by U.S. industry and by the U.S. academic community. Thus, a balanced tax cut aimed at stimulating productivity increases should include new incentives for research and development in the United States.

S.2906, introduced by Senators Danforth and Bradley, provides just such an incentive. The bill would provide a 25 percent tax credit for research and development expenditures in excess of the taxpayer's average annual level of expenditures over the past three years.

We believe that S.2906 is a very important step in the right direction. In our view, such a credit should be adopted by this Committee. The credit is provided at a relatively high rate but is taken against expenditures in excess of some historic base. Thus, because it is a credit that rewards effort beyond prior levels of expenditures, it would both stimulate companies into undertaking additional research and would reward most those companies whose efforts and overall operations are growing. The credit would maximize productivity returns to the U.S. economy per dollar of tax cost to the Federal government. We strongly urge that the credit as set out in S.2906 be adopted by this Committee.

As a corollary to a tax credit for corporate research, we strongly support a credit for university research, such as that set out in H.R. 6632, introduced by Mr. Vanik. That bill would provide a tax credit for corporations that set aside funds in a reserve to fund U.S. university research. Such research, and the training of qualified scientists and engineers that can accompany it, is imperative if the United States is to remain at the forefront of semiconductor technology.

Other Proposals. There are other proposals which we believe should be before this Committee, although they are somewhat less central to the efforts of our industry than those discussed above.

First, we should like to say a word about capital gains taxation. The Revenue Act of 1978 took a major step in reducing capital gains tax rates to a maximum of 28 percent. This step was taken in part to encourage investment in new and growing companies, including many of the companies in the semiconductor industry. We believe the 1978 legislation has been a success and has in fact encouraged additional investment in our industry; but we also believe that further increases in investment could be obtained through additional reductions in capital gains taxation. For example, a reduction in the capital gains tax rate to a maximum of 21 percent, such as is provided by S.2923, introduced by Senator Cranston, would provide a substantially increased incentive for investment in smaller companies in risky but growing industries like the semiconductor industry. Moreover, such a reduction in capital gains rates would tend to counteract the increase in inflation since even the 1978 act, which has resulted in the taxation of substantial illusory capital gains. Thus, its adoption makes sense in today's economy and will provide further incentives to capital investment in productivity-gaining industries.

In addition, we are concerned about the IRS regulations that force us to allocate a major portion of our U.S. research and development expenses to our foreign operations. These regulations can have the effect of denying us any U.S. tax benefit from the allocated expenses. They are inconsistent with a U.S. policy of encouraging research in high technology industries in the United States. We urge that this committee consider overruling those regulations or at least requiring that a larger portion of total expenditures for research conducted in the United States be attributed to U.S. source income.

Finally, we believe that Congress should consider proposals to encourage capital investment and risk-taking by employees and investors in expanding industries by reinstating qualified stock options and permitting capital gains from equity investments to be reinvested tax free. We also urge this Committee to eliminate or reduce substantially the burden of U.S. taxation on the earned income of Americans working abroad.

V. Conclusion

There is much more which I would like to comment on, but cannot for lack of time and for concern that we lose the primary focus on the real heart of this problem. The actions of government shape the future for private industry.

Our proposed tax reforms will be of great help. Taken together with a supportive trade policy, they can provide a real boost in America to growth industries like ours which have been targeted by foreign governments.

We have yet to deal with those awesome debt-to-equity ratios of our chief competitors, but we are confident that we can find an innovative American solution to that challenge as well.

As a country, we must begin to take a longer-term view. Your decisions will shape the financial health of one of the last American industries to remain a world leader by virtually all measures. We need to create a supportive economic environment which will get us the equivalency and capital formation which we need to stay healthy. We are counting on your wholehearted support.

GOVERNMENT INITIATIVES & FINANCIAL SUPPORT FOR COMMERCIAL VENTURES INTO SEMICONDUCTORS, COMPUTERS & COMMUNICATIONS

COUNTRY	MAIN RECIPIENT	STATE SUPPORT	TERM
ECC	Semiconductor Infrastructure	$ million	
	four year Computer Program		
	Peripherals	$150 million	4 years
	Applications		
	EDP R&D program Low-Cost and Grants		1979-1983
Germany	EDP and Telecommunications	$ million	
	BMFT R&D Grants	$ 35 million	per year
	VLSI Development (Siemens, AEG-Telefunken Valvo)	$300 million	2 yrs 1980+
Italy	SGS-ATES, et al	$135 million	4 years
	ST Gobain Pont a Musson	$ 50 million	
	Ministry of Industry to	$120 to $200 million	5 years
France	Thompson CSF-SSC		
	Radiotechnique Compelec	$ 25 million	
	Matra	$ 38 million	5 years
UK	UK Total $621M		
	NEB to Insac (Software Consoritium)	$ 40 million	3 years
	NEB to Inmos LTD.	$ 50 million	spent
	NEB to Inmos Guaranteed Bank	$100 million	By 1981
	Loan	$ 60 million	
	NEB to NEXOS (Office Equip)	$ 10 million	
	NEB to Plessey (Loan)	$ 40 million	
	DOI to MISP (Microelectronic Industry support program)	$127 million	4 years
	DOI to map (uP Applications Project)	$127 million	2 years
	E-Beam Fab Techniques	$1.8 million	
	DoED & science, Classroom		
	NCC - Awareness Program	$ 20 million	
	(Software TRNG)	$ 75 million	5 years
	Microelectrons in Education	$ 9 million	3 years

GOVERNMENT INITIATIVES & FINANCIAL SUPPORT FOR COMMERCIAL VENTURES INTO SEMICONDUCTORS, COMPUTERS & COMMUNICATIONS (CONT'D)

COUNTRY	MAIN RECIPIENT	STATE SUPPORT	TERM
Japan	VLSI Subsidy (Loan)	$250 million	4 years
	Computer Cooperative Applications Support	$100 million	
Korea	Total State Funds for Semiconductors For Electronics: $270M	$180 million	6 years programs
	Total World Bank Loans For Semiconductors For electronics: $ 90M	$ 60 million	15 yr loans

Source: Rockwell International
Terry Wong
June 19, 1980

Comparison of Semiconductor Companies' Rates of Return
With Their Cost of Capital

	Average Rate of Return on Total Capital (1977-1979)	Average Rate of Return on Operating Capital (1977-1979)	Cost of Capital (June 4, 1980)
Typical U.S. Companies	16.3%	18.1%	17.5%
Large U.S. Companies	15.0	16.8	15.2
Japanese Comapnies	7.5	n.a.	9.3

Source: Chase Financial Policy

Financial Instruments Designed to
Promote Industrial Research and Development

Country (1)	Grants or Premiums	Credit Facilities, Loans, Advances: Direct: At Commercial Rates	Credit Facilities, Loans, Advances: Direct: At Reduced Rates	Credit Facilities, Loans, Advances: Indirect: Interest Subsidies (2)	Credit Facilities, Loans, Advances: Indirect: Guarantees	State Participation: Equity Participation (3)	State Participation: Joint Private-Government Research	Other
Argentina	•							•
Australia	•							
Austria	•		•	•	•			•
Belgium			•	•	•			
Brazil			•					•
Canada	•		•					
Denmark	•		•					
Finland	•		•				•	•
France	•		•		•			•
Germany (F.R.)	•		•		•			•
Greece								•
India								•
Ireland	•							
Israel	•		•				•	•
Italy	•		•					
Japan	•	•	•					
Korea			•					
Luxembourg	•							
Mexico								•
Netherlands	•	•	•					
New Zealand	•						•	•
Norway		•	•					
Portugal								•
S. Africa	•	•					•	
Spain	•	•						
Sweden	•	•	•					
Taiwan			•					
United Kingdom	•	•	•	•		•		

(1) A blank box denotes only absence of affirmative information with regard to specific heading.
(2) Including those cases where principal is provided by private sources.
(3) "Equity participation" refers to any public shareholding in the registered capital of a new company.

Source: United States Department of Commerce

1344

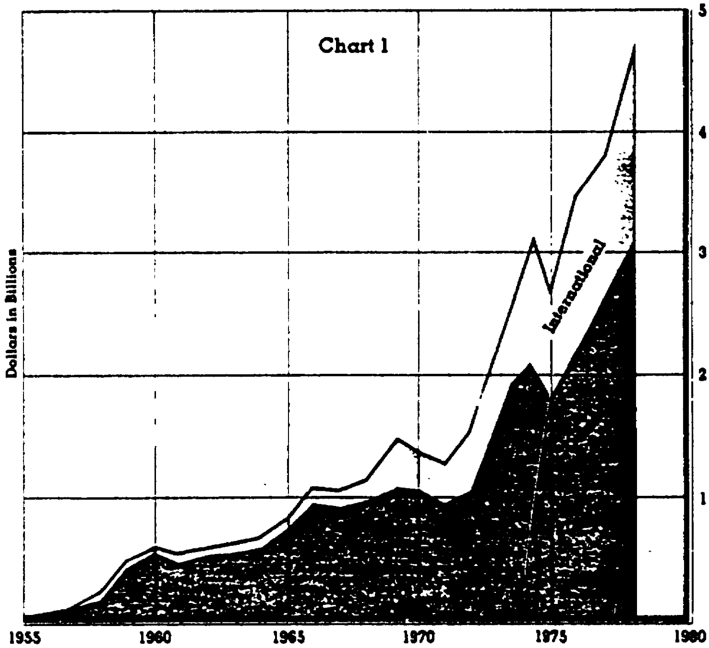
Fiscal Instruments Designed to Promote
Industrial Research and Development

Country (1)	R&D Capital Expenditures: Currently Deductible	R&D Capital Expenditures: Accelerated Depreciation	R&D Capital Expenditures: Investment Reserves	R&D Capital Expenditures: Tax Credits	R&D Capital Expenditures: Special Deductions or Exemptions	R&D Capital Expenditures: Other	Other Expenditures: Cur-rently Deduct-ible	Other Expenditures: Tax Credits	Other Expenditures: Special Deductions or Exemptions	Other Expenditures: Other
Argentina		•			•	•				•
Australia		•			•					
Austria		•	•	•			•		•	
Belgium		•			•	•	•			
Brazil		•			•	•	•			
Canada	•			•	•		•	•		•
Denmark			•			•	•	•		
Finland										
France		•			•	•	•		•	•
Germany (F.R.)		•	•		•	•			•	•
Greece					•					
India	•					•	•		•	•
Ireland							•		•	•
Israel	•	•								
Italy							• (2)			
Japan	•		•			•	•		•	•
Korea			•	•	•				•	•
Luxembourg							•			
Mexico									•	
Netherlands				•			•			
New Zealand	•	•					•			
Norway			•				•			•
Portugal										
S. Africa		•					•			
Spain	•									•
Sweden									•	•
Taiwan		•				•	•			•
United Kingdom	•	•		•						

(1) A blank box denotes only absence of affirmative information with regard to specific heading.
(2) 50% of current R&D expenditures may be deducted in the first year. The remaining 50 percent of R&D costs may be deducted in succeeding years.

Source: United States Department of Commerce

Worldwide Shipments
U.S. Based Semiconductor Companies
(Dollars in Billions)



Perspective

"Worldwide Shipments—U.S. Based Semiconductor Companies from 1954..." shows a compound annual growth rate of 15 percent from 1970 through 1978 while the international segment of the U.S. industry grew at a 19 percent rate and represented 36 percent of total worldwide shipments. Chart 2 tracks domestic shipments shown in Chart 1 by product category. As product lines grew, these data were added by EIA or SIA resulting in sharp steps not reflecting actual industry shipments. Examples are thyristors which were added in 1964, and optoelectronics added in 1971. MOS data, which was broken out in 1973, was reported as digital IC's (included in the bipolar column) in earlier years. All the Chart 2 data, whether EIA or SIA, are for domestic shipments (i.e., exports have been removed).

65-969 O - 80 - 19 (pt.3)

U.S. Based Semiconductor Companies
Domestic Shipments

Chart 2

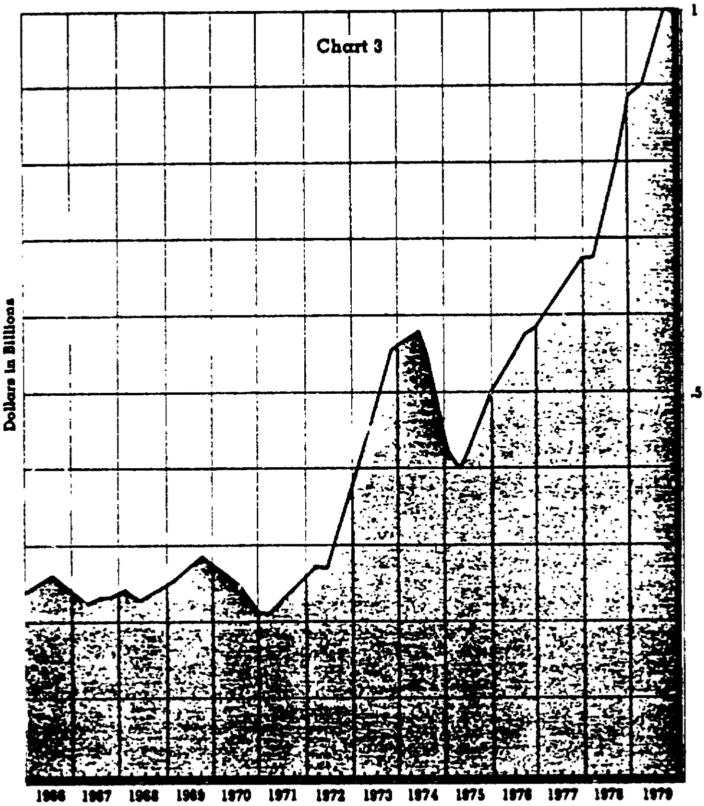
(Dollars in Millions)

	Transistors	Rectifiers & Diodes	Thyristors	Other	Opto	Total Discrete	Bipolar	MOS	Linear	Total I/C	Total Semiconductors
1954	5.1					5.1					5.1
1955	12.3					12.3					12.3
1956	37.4					37.4					37.4
1957	67.7	73.2		31.6		172.5					172.5
1958	109.7	95.4		20.4		225.5					225.5
1959	217.2	143.9		28.5		389.6					389.6
1960	293.6	203.1		24.9		521.6					521.6
1961	287.6	109.4		37.6		434.6					434.6
1962	278.1	180.7		49.7		508.5					508.5
1963	287.3	178.5		49.0		514.8					514.8
1964	311.7	216.6	26.2	35.2		589.7	34.7		6.0	40.7	630.4
1965	377.2	256.2	30.1	37.6		701.1	60.9		13.5	74.4	775.5
1966	443.1	315.8	46.0	48.9		853.8	107.7		28.3	136.	989.8
1967	370.5	271.9	46.3	48.9		737.6	161.6		40.7	202.3	939.9
1968	345.2	267.9	48.8	45.7		707.6	224.1		53.6	277.7	985.3
1969	368.3	313.0	52.7	48.0		782.0	294.6		64.2	358.8	1140.8
1970	296.4	261.5	47.0	41.7		646.6	295.8		68.9	364.7	1011.3
1971	267.3	171.3	43.5	36.3	36.0	554.4	298.1		78.8	376.9	931.3
1972	319.7	192.0	53.2	41.1	70.0	676.0	417.8		113.7	531.5	1207.5
1973	408.3	276.2	72.8	51.8	90.3	899.4	495.2	303.8	204.8	1003.8	1903.2
1974	408.5	292.9	75.4	53.9	91.4	922.1	528.9	432.8	237.8	1199.5	2121.6
1975	332.1	222.5	57.2	48.7	99.9	760.4	348.5	427.6	197.8	973.9	1734.3
1976	392.1	257.2	78.9	51.0	140.0	919.2	465.8	635.9	270.1	1371.8	2291.0
1977	389.6	257.4	99.4	47.6	94.2	888.2	558.1	777.3	349.0	1684.4	2572.6
1978	407.3	275.4	105.6	53.8	129.1	971.2	681.9	1045.3	424.3	2151.5	3122.7

Source: EIA Factory Shipments (1954—1972)
SIA Domestic Shipments U.S. Based Companies (1973—1978)

U.S. Domestic Semiconductor Shipments by Quarters

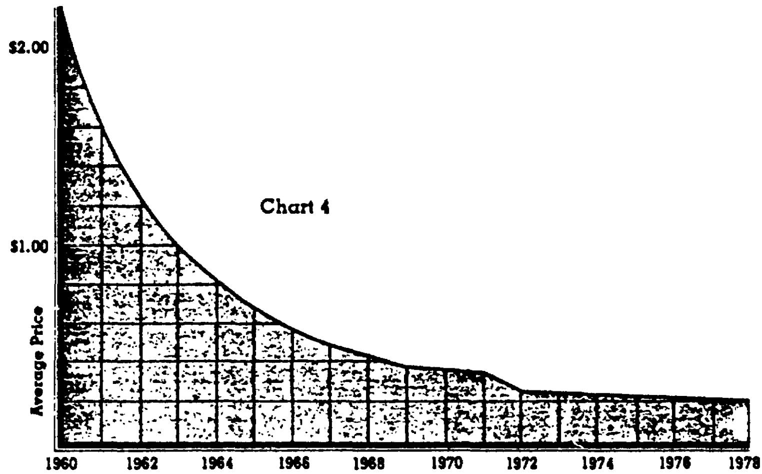
(Dollars in Billions)



Source: EIA, SIA, Company Estimates

Average Selling Price of Transistors 1960—1978

(In Dollars)



Perspective

Quarterly shipments to the U.S. domestic market, shown in Chart 3 provides a special perspective on semiconductor industry performance. From 1967 to mid 1971 the indus'ry was on a plateau. In mid 1971 a ba.ic new trend started and a long term gr.wth pattern initiated. Including the 1974/1975 recession, the compound annual growth rate from 1971 through 1978 has been 15 percent for the total industry. Similar data on integrated circuits shows a growth rate of 23 percent per year.

Semiconductor prices decline as volume and experience increases.

The rate of decline varies with the type of device, but price decline rates of 20 to 30 percent for each doubling of unit volume are typical for semiconductors. Chart 4 shows the average selling prices of all transistor product lines since 1960, and closely follows a 30 percent experience curve rate. The curve demonstrates the typical steep decline during the early low volume period and as the industry grows the curve shows slower price declines as the doubling of volume takes longer and longer time periods. In 1960, the average price of transistors was $2.36. By 1970 the price was $0.38 and by 1978 $0.20.

Source: SIA Annual Report

STATEMENT OF HERBERT M. DWIGHT, JR., CHAIRMAN AND PRESIDENT

SPECTRA-PHYSICS, INC.

ON BEHALF OF THE

AMERICAN ELECTRONICS ASSOCIATION

Before the Senate Committee on Finance

July 29, 1980

Summary of AEA's Recommendations

The American Electronics Association endorses and advocates enactment in 1980 of a tax reduction bill to be effective in 1981. The business portion of this bill should include:

- Restoration of deferred tax treatment of employee stock options (H.R.5060/S.2239)
- Tax credits for new R&D (S.2906 and H.R.6632/S.2355) and
- Lower capital gains taxes (S.2923).

These proposals would result in a balanced tax cut addressing human resources and incentives for both R&D and capital formation.

The Association also supports shorter depreciation periods for all capital investment (S.1435/H.R.4646).

AEA American Electronics Association
2600 El Camino Real Palo Alto, CA 94306

STATEMENT OF HERBERT M. DWIGHT, JR., CHAIRMAN AND PRESIDENT
SPECTRA-PHYSICS, INC.
ON BEHALF OF THE
AMERICAN ELECTRONICS ASSOCIATION
Before the Senate Committee on Finance
July 29, 1980

Mr. Chairman and Members of this distinguished Committee.

My name is Herbert M. Dwight, Jr. I am President, and Chairman of the Board and one of the founders of Spectra-Physics, Incorporated, based in Mountain View, California. Spectra-Physics is a world leader in the new and rapidly growing commercial laser industry. This year we will report sales in excess of $100 million -- almost half of it from exports -- and employ more than 2,300 people world-wide. The demand for our products has grown rapidly because they increase productivity for our customers, who include farmers, metal works, construction workers, supermarket operators, medical doctors, and chemists.

I am appearing before you this morning on behalf of the American Electronics Association. AEA is a trade association of more than 1,400 electronics companies in 43 states. Our members manufacture electronic components and systems or supply products and services in the information processing industries. While our member companies employ more than one million Americans and include some of the nation's largest companies, more than half of our member companies are small businesses currently employing fewer than 200 people.

We sincerely appreciate the opportunity to present our views concerning the important tax legislation now before you. Our Association's Government Affairs Committee recently summarized our support for the tax reduction bill:

> The American Electronics Association endorses and advocates enactment in 1980 of a tax reduction bill to be effective in 1981. The business portion of this bill should include restoration of deferred tax treatment of employee stock options H.R.5060/S.2239), tax credits for new R&D (S.2906 and H.R.6632/S.2355) and lower capital gains taxes (S.2923). The Association also supports shorter depreciation periods for all capital investment (H.R.4646). These proposals would result in a balanced tax-~~cut~~ addressing human resources and incentives for both R&D and capital formation.

We will briefly address each of these bills in this statement.

AEA'S PROPOSALS FOR 1981

I. S.2239/H.R.5060 Restoration of the Restricted Stock Option

Mr. Chairman, we urge this Committee to include S.2239 (which is co-sponsored by several members of this Committee), in its tax bill this year. We believe that the case for restoring the restricted stock option is unusually strong. S.2239 would:

- Promote productivity growth;
- Help small, growing companies attract talented employees;
- Eliminate the unfair tax treatment of the current (non-qualified) options; and
- Increase federal tax revenues.

I shall briefly describe each of these positive effects.

RESTRICTED STOCK OPTIONS WOULD PROMOTE PRODUCTIVITY GROWTH

Historically, the American industry has led the world in new technology, contributing significant export sales to this nation's trade balance and producing products which increase U.S. productivity. Regrettably, the United States today lags behind most industrialized nations in productivity growth. Major causes for this situation include inadequate savings and investment, lack of innovation incentives, and possibly a decline of motivation on the part of Americans at all levels of enterprise to make the kinds of effort and take the risks needed for American industry to keep pace with our competitors abroad. We are talking about a shortfall of "entrepreneurship" in American business, and specifically in the new technology industries which are traditionally the source of greatest growth.

Granting restricted stock options would provide employees an entrepreneurial stake in finding better ways to do the job. A stock option only has value to the employee if the price of the company's stock increases through growth in its sales and profits. Therefore, options give employees a powerful incentive to find ways to expand the company's business and conduct that business more efficiently. Business growth creates more new jobs; increased efficiency results in greater productivity.

Few employees have the financial resources needed to become significant shareholders in their companies, but restricted stock options can give them the opportunity to acquire sizeable investments without having to make an up-front cash outlay. Instead of cash, they invest their time, careers, and talents.

This attitudinal benefit derived from equity ownership can have a dramatic effect on a company's growth. Since 1972 the shareholders of Spectra-Physics have approved various plans reserving more than 20% of the company stock for employee options. In those years the company's sales have grown from $14 million annually to more than $100 million -- an increase largely attributable to the interest and dedication of our employees. About 15% of all our current employees have been granted stock options, and of our employees who have been with the company longer than three years, more than 30% have stock options.

RESTRICTED STOCK OPTIONS WOULD HELP SMALL, GROWING COMPANIES ATTRACT TALENTED EMPLOYEES.

Businesses of all sizes would benefit from restoring restricted stock options. We expect large companies which seek to foster employee ownership and improve their employees' motivation to welcome this change wholeheartedly. But the major benefits would flow to smaller businesses. Recognizing this fact, the White House Conference on Small Business, endorsed the restoration of favorable tax treatment of stock options as one of its key recommendations to promote innovation in small businesses.

Restricted stock options can substantially reduce the total cost of founding a new company. Considering the long lead time usually required for a new company to begin shipping its first product, it becomes apparent that any form of compensation which reduces the initial cash outlay during that period can be extremely valuable. That is precisely what restricted stock options accomplish. Employees who are granted options ultimately receive compensation in the form of increased stock value (if the venture is successful), but the company pays out no cash. Instead, the cost of compensation from restricted stock options is borne indirectly by the existing shareholders through mild dilution of their shares. The shareholders, in turn, benefit from the increased value of their shares that results from higher productivity of the company's employees.

Restricted stock options also give smaller, growing companies a means of attracting talented employees away from secure jobs in larger companies. Because the value of stock options depend on growth in value of the company's shares, the stock price of smaller companies can usually rise, on a percentage basis, far faster than that of established companies. Thus, options are proportionately more rewarding in small business than in larger companies. Smaller corporations can ill afford to pay the salaries necessary to compete with Fortune 500 companies for talented employees, but they can partially offset that disadvantage with stock options.

The initial employees in my own company came from established corporations such as IBM, Varian Associates, Texas Instruments and Hewlett-Packard. We used the "qualified" stock options (permissible in 1969 but later eliminated by Congress) to attract them. <u>Without such incentives we could not have attracted those key people</u>.

RESTRICTED STOCK OPTIONS WOULD ELIMINATE THE UNFAIR TAX TREATMENT OF CURRENT (NON-QUALIFIED) STOCK OPTIONS.

Restoring restricted stock options would create an attractive alternative to today's so-called "non-qualified" options, which are practically useless to many growing companies. Under present law, when an employee exercises non-qualified options, he must pay taxes -- at ordinary income rates -- on the "paper profit" between his option price and the price of the stock when he buys it.

Not only is taxation at ordinary income rates inconsistent with what other owners would pay on their capital appreciation, but in addition, the employee must pay the tax before he actually realizes any gain from selling the stock. It's analogous to taxing the appreciation on a homeowner's house before he sells it. Employees without reserves of funds find it extremely burdensome to buy the stock and also pay the tax on a "paper profit".

In some instances, today's law results in gross and unintended hardship. For example, if the value of the stock acquired by means of an option should decline sharply before the employee desires to sell it, the employee must not only take an actual loss on the stock, but he has also paid taxes at ordinary income rates on a "gain" he never realized. This is not just a theoretical possibility. It has happened often enough in recent years to destroy any usefulness employee stock options may have had for companies in volatile industries.

In one example with which I am familiar, four officers of a rapidly growing electronics company exercised non-qualified options. Because the options were non-qualified and the value of the stock had appreciated significantly during the option period, the exercise resulted in imputed taxable income of over $500,000 and aggregate taxes for the officers of approximately $200,00. The corporation received an off-setting deduction but the officers -- who had received no actual income -- were unable to sell their stock for at least six months because of the insider trading provisions of the Securities and Exchange Act. During the six-month waiting period, economic conditions changed and the stock declined in value to a point where no profit could be realized from the sale of the stock. The officers were stuck with large personal tax liabilities on a transaction that lost them money.

RESTRICTED OPTIONS WILL INCREASE FEDERAL TAX REVENUES

The final and most compelling reason S.2239 should be passed is that it will not cost the Treasury a dime. It will actually raise more revenue than the current demotivating tax treatment of stock options.

In 1976, Congress was told that phasing out the qualified stock option would increase Treasury revenue. As we now know, it has had the opposite effect. By depriving industry of an extremely useful form of incentive compensation that was not deductible from corporate taxes, the 1976 change forced companies to substitute other forms of compensation -- increased salary, as an example -- that are deductible. Greater deductions from the same taxable income has actually resulted in lower corporate tax payments to the Treasury.

Both cash compensation and non-qualified stock options generate employee taxes to the Treasury. However, these revenues are more than offset when the corporation deducts them as business expenses from its own taxable income. On the other hand, employee compensation in the form of restricted stock options would not be deductible to the corporation. Therefore, to the extent that these more attractive options replace cash and non-qualified options, corporate tax payments will increase.

A recent analysis of this bill performed by the public accounting firm of Price Waterhouse and Company confirms the positive revenue effect of this bill and indicates that, in most cases, the government is losing money under the current law.

The Joint Committee on Taxation has also examined the revenue impact of this bill. They estimate that after an initial adjustment period which should cost less than $10 million total, S.2239 would raise $15 million in Fiscal Year 1984 and $30 million in 1985. This is a net revenue gain of $35 million in six years.

We agree with the general conclusion of the Joint Committee's analysis, but we think its estimate of the positive revenue flow is much too low. Since many companies desiring to issue options would gladly subsitute restricted stock options for the less effective non-qualified options, we believe one good indication of the potential revenue to be gained from this bill is the amount of deductions companies now take for their non-qualified options.

In preparing to testify before this Committee, AEA contacted 10 of its member companies and asked them to report their non-qualified option deductions for the last five years to the public accounting firm of Coopers and Lybrand. Coopers and Lybrand informs us that between 1975 and 1979 these companies deducted more than $68 million due to the exercise of non-qualified options; at the current corporate tax rate of 46%, that represents over $31 million fewer tax dollars to the Treasury than these companies would have paid if these had been restricted stock options -- a loss which undoubtedly exceeds the personal income taxes paid on the "paper profit" by employees, having an average marginal rate of less than 46%. More importantly, the Treasury is deprived of $13.6 million of capital gains taxes the employees ultimately would have paid on the same transactions if restricted options had been used. Since there are thousands of other companies which would use restricted option programs if they were available, we think it is fair to expect that the positive net revenue flow to the Treasury will be far larger than the current official estimate for this bill.

Mr. Chairman, we are asking you to let us pay higher taxes. You may not hear this very often. But we are willing to -- even happy to -- because we believe restricted stock options are substantially more attactive to our employees than equivalent cash, non-qualified options or a combination thereof.

I should point out that passage of S.2239 will not require companies to pay higher taxes. Only those companies which, with the approval of shareholders, choose to adopt a restricted stock option plan would pay more.

II. S.2906 and H.R.6632/S.2355 Tax Credits to Stimulate Research and Development

Mr. Chairman, for the last year and a half, an American Electronics Association Task Force of senior industry leaders has been studying methods of promoting increased innovation. They have concluded that this nation must expand its R&D based markets, which have been targeted by our trading competitors. At the same time, we must stimulate more R&D to revitalize our less competitive industries. To do this, we strongly recommend enactment of two complementary bills which would facilitate major advances in these crucial areas at the lowest possible revenue cost to the Treasury. The bills are S2906, The Research and Development Act of 1980, sponsored by Senators Danforth and Bradley, and H.R.6632/S.2355, The Research Revitalization Act of 1980, sponsored by Congressman Vanik and Senator Tsongas. Here are the facts found by our task force which underly these recommendations:

THE FUNDAMENTAL IMPORTANCE OF R&D

Technological innovation in U.S. industry is crucial to this nation's ability to compete in world markets. Our most innovative industries -- high technology electronics, capital equipment, pharmaceuticals, and agriculture -- contribute the bulk of our exports. From 1960 to 1979, these R&D-intensive industries increased their export surplus from $5.9 billion to $47.5 billion. In contrast, during this same period our less innovative, non-R&D intensive manufacturing industries increased their trade deficit from near zero to $24.5 billion.

Innovation is as vital to our domestic economy and society, as it is to our exports. It is critical to real economic growth, increased employment, cheaper and better products, reduced inflation, and conservation of energy and raw materials. Innovation not only generates new products and services, but by stimulating productivity, allows existing products and services to be produced more efficiently. A study by Professor R. Solow of MIT concluded that between 1909 and 1949 approximately 80% of our GNP growth was due to technological change. Another study by Edward Denison shows that more than half the increased productivity in the United States results from technological innovation.

Perhaps a better way to portray the benefits of innovation is to compare the contribution of the R&D-intensive portions of our overall economy to the non-R&D-intensive sectors. In 1977, General Electric sponsored a study by Data Resources, Inc., which compared the average annual growth, productivity, prices and employment of high-technology industries to low-technology industries over the past three decades. The results speak for themselves:

Comparative Performance of High and Low Technology Industries
1950 - 1974

	High Technology	Low Technology
Compound growth rate	6.7%	2.3%
Productivity increases (per year)	4.0%	2.0%
Price increases (per year)	0.5%	3.0%
Employment growth (per year)	2.6%	0.3%

INDICATIONS OF DECLINING INNOVATION IN THE U.S.

Given the critical role innovation plays in the health and strength of our domestic and world economy, we are alarmed by clear signs that innovation is declining in the United States:

- R&D spending as a percent of GNP has declined by 27% in the last 15 years;
- Real growth in industrial R&D has slowed from an annual average of 6.5% in the 1960's to 1.6% from 1970 to 1975. R&D as a percentage of profits has declined steadily since 1976.
- Too much of industry's R&D has been diverted to "defensive" efforts required to comply with government regulations. Too much has been diverted to quicker payout, lower risk projects because of uncertainties caused by high inflation, high taxes and vacillating economic policies.

- The rate of productivity increases has deteriorated steadily from an annual average of 3.4% during 1948-1955 to a negative 0.4% in 1979;
- From 1960 to 1976, the U.S. world market share of manufactured goods declined from 18% to 11.8%.

INDICATIONS OF ADVANCING INNOVATION ABROAD

At the same time our innovation indicators are declining, it is evident that other industrialized countries whose firms compete with us in world markets are making great strides. The following table summarizes some comparative examples:

	Japan	West Germany	United States
Total R&D as a percentage of GNP from 1964 to 1976	1.5% to 1.9%	1.6% to 2.3%	3.0% to 2.3%*
Average annual rate of productivity improvement from 1960 to 1978	8.5%	5.4%	2.6%
Share of world exports from 1960 to 1977	4.0% to 8.0%	10.3% to 11.5%	18.0% to 11.8%

These gains have not been accidental. They were deliberately stimulated by the policies of our foreign competitors and trading partners. I shall briefly outline several examples of the incentives other countries use to foster R&D innovation.

The Japanese government targets certain high potential industries for development: automobile, steel and ship-building in the past -- computers and semiconductors today. Companies in these areas can receive R&D subsidies (repayable

* As a comparison of R&D efforts for commercial (i.e., non-defense and non-space) areas, these U.S. figures are deceptively high. For example, 36% of total U.S. spending for R&D in 1976 went to defense and space, whereas West Germany and Japan spent less than 9% and 3%, respectively, in these areas.

only if the program is successful), accelerated depreciation allowances, and long-term, low-interest loans. In addition, a 20% tax credit is granted for increases in R&D expenditures by all businesses. Companies that form joint research associations can immediately recover the cost of their investments in new machinery, equipment and facilities. Japan's Ministry of International Trade and Investment (MITI) has announced a goal to increase R&D spending from approximately 1.7% in 1979 to 3% of GNP by 1990.

The West German government provides low-interest loans for investments in R&D, a 7.5% tax-free cash grant for investment in R&D facilities and special accelerated depreciation allowances for R&D plant and equipment. In addition, in certain cases the income individuals receive for scientific activities is taxed at half the normal rate.

The French government provides highly favorable tax treatment to companies specifically formed to conduct R&D or apply innovative processes. In addition, special accelerated depreciation allowances are applicable to plant and equipment used for scientific or technical research. The sale of patent rights, technical and manufacturing processes and know-how are taxable at 15% as long-term capital gains.

The Canadian government allows a tax credit of at least 10% for R&D expenditures and a basic deduction for R&D expenditures,over the average of the previous 3 years' spending levels. The government also provides grants to companies that perform high-risk R&D in commercial technologies.

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Parenthetically, we may note that some of our major competitors provide additional assistance to certain of their industries by imposing significant barriers to entry of their domestic markets. While not directly applicable to this topic, those barriers add an additional dimension to the challenges confronting American industry today.

INCENTIVES FOR INCREASED RESEARCH & DEVELOPMENT

These trends are unmistakable and cannot be ignored. We believe the disparity between our R&D policies and those of our major competitors bodes ill for the future. Our nation's competitive future lies in our ability to innovate and produce new, improved, cheaper products and processes, be they textiles, steel, autos, chemicals or electronics.

S.2906 Danforth-Bradley

This bill would create:

- A 25% tax credit for increases in R&D spending over the average annual R&D outlays for the previous three years. It thereby targets the incentive on expanded R&D spending and minimizes the Treasury's revenue loss.
- A new statutory definition of R&D, adopting the Financial Accounting Standards Board (FASB) definition, long used by industry and accountants in non-tax areas. This definition is supported by an established body of learning, thereby eliminating many of the problems and uncertainties normally encountered in a new statutory definition.
- Special provisions for new companies because small start-up firms are frequently the most innovative. The billl allows them to calculate their first year tax credit using a base of 3 years of zero spending, the second year using seven years to insure they are not lost because of little or no tax liability in the first years.

We especially recommend the Danforth-Bradley solution to the problem of defining R&D. As the Treasury Department and others have correctly testified, simply adopting the present IRS Code Sec. 174 as a "definition" of R&D is inadequate. The present Code Section itself contains no definition of R&D but only provides rules for expensing or amortizing R&D expenditures. It is left to the Treasury's implementing regulations (Sec. 1.174-2) to define R&D. Treasury correctly contends its definitional regulation was not designed to adjudicate a tax credit. Changes would be required. This critical policy determination should not be made by the agency but by Congress. Amending Sec. 174 to add the time tested FASB definition to the Code itself -- as Sec. 2 of S.2906 does -- would answer this problem. This would give Treasury clear congressional policy guidance which, coupled with the benefit of years of interpretive experience with FASB rules, would greatly facilitate the promulgation of Treasury implementing regulations.

We believe the R&D tax credit approach is far preferable to and incalculably more practical than, more direct government involvement in industrial R&D. S.2906 would expand government's commitment to R&D, while allowing the marketplace to determine how R&D resources should be allocated.

H.R.6632/S.2355 Vanik-Tsongas

This bill would create a 25% tax credit for corporate funds contributed to colleges and universities for research . This would:

- Re-orient many academic programs and facilities away from wholesale federal sponsorship with its attendant administrative burdens, and toward the needs of industry in searching for productive innovation;

- Increase the supply of urgently needed technical graduates; and
- Allow a company, a group of companies in an industry or several industries to sponsor research.

Again, we believe the tax incentive approach of H.R.6632 is far preferable to increasing the federal government's direct role in identifying and funding research likely to lead to industrial innovation. This bill allows business and universities to allocate research funds where they would be most beneficial to the country, and avoids the entangling red tape and inefficiencies which have been the bane of federally financed R&D in our colleges and universities.

III. S.2923 Reduction of the Tax on Capital Gains to Stimulate Additional Risk Capital Investment

Mr. Chairman, we believe a strong case can be made for this bill in just two points:

- Risk capital investment rapidly generates jobs and other benefits to the economy;
- The 1978 capital gains tax reduction has been remarkably effective in increasing risk capital investment at minimal cost to the Treasury.

RISK CAPITAL GENERATES JOBS

In 1978, our Association appeared before this Committee seeking a solution to a serious problem facing our economy: the critical shortage of risk capital available to innovative young companies. To support our contentions, we offered the results of a major survey we had conducted of the capital formation experience of high technology industries.

The survey allowed us to document for the first time the damage that doubling the capital gains tax in 1969 had done to our companies' abilities to raise founding and growth capital. It also documented the continuing need that fast growing companies have for new infusions of risk capital as they expand.

But the greatest importance of the AEA survey was the ability it gave us to translate these abstractions about capital formation into politically meaningful statistics on job creation. We can now show that incentives to stimulate risk capital are direct incentives to create jobs.

We found that risk capital dependent young companies create jobs much faster than mature companies. In the AEA survey, the companies founded 10-20 years earlier had a 1976 employment growth rate <u>20-40 times greater</u> than the mature companies. Companies 5 to 10 years old spawned jobs nearly <u>55 times faster</u> than the mature companies. But most dramatic of all, the "start-up" companies founded in 1976 were generating new jobs <u>115 times faster</u> than the mature companies!

We also discovered that risk capital investment in these companies generates permanent streams of benefits to the economy far out of proportion to their size. We were able to show, for example, that in the youngest of the surveyed companies--those founded in 1976--for every $100 equity capital invested, they generated export sales of $70, spent $33 on R&D, paid $30 in federal income taxes ($15 corporate income tax and $15 personal income tax) and $5 in state and local taxes.

THE 1978 CAPITAL GAINS TAX CUT HAS BEEN REMARKABLY EFFECTIVE

In 1978 we contended that reducing the maximum tax on capital gains from approximately 49% would provide all these benefits and stimulate enough new economic activity to offset nearly all the revenue loss to the Treasury in the short run and generate a net revenue gain to Treasury after a few years.

We are among the many who are pleased by the very positive results from the 1978 capital gains reduction. Despite a major recession, it is now clear that reducing capital gains taxes made a major contribution to increased equity values, the availability of risk capital for growing companies, and the number of common stock offerings by new companies.

A table prepared recently by Oscar S. Pollock of Ingalls and Snyder summarizes this progress.

[illegible]

Mr. Chairman, we urge you to enact Senator Cranston's bill, S.2923, which would further reduce capital gains taxes to 21%. This unusually cost-effective job creation bill deserves a place in your tax package. The revenue impact of the 1978 capital gains tax reduction has been either positive or minimally negative. The beneficial economic fallout has been spectacular. S.2923 has similar potential benefits. Our economy will suffer a major lost opportunity if it is omitted.

SUMMARY OF AEA'S PRIORITIES

Restricted stock options, R&D tax credits and capital gains tax cuts are the urgent tax priorities for the electronics industry in the 96th Congress. We believe they form a well-balanced package that addresses human resources, innovation, and capital formation. These proposals would stimulate tremendous increases in productivity, innovation and jobs at a very modest revenue cost.

Accelerated Depreciation

Perhaps the most controversial business issue before this Committee today is accelerated depreciation, and specifically, the Capital Cost Recovery Act. Mr. Chairman, we support enactment of H.R.4646.

The Capital Cost Recovery Act would stimulate productivity by accelerating the return of capital invested in plant, equipment and vehicles. These funds can then be reinvested in newer and more productive facilities. Improved productivity, in turn, is essential to retaining our existing export markets and winning new ones.

Given the key role H.R.4646 could play in improving productivity, we find it ironic that Treasury has opposed it on grounds it could create excess demand. We also believe Treasury's estimates of the net revenue loss from H.R.4646 are overstated.

For example, Treasury spokesmen have told us they based their estimate of the tax benefit to the electronics industry on the impact the bill would have on companies which elect the Asset Depreciation Range (ADR) system. But, as the original Treasury statement on this bill concedes, "a very small percentage of small business tax payers have chosen to elect the ADR system." Few electronics companies use ADR's today. The system is too complicated, and the extremely short useful lives of much of the equipment used in our industry has often made case-by-case "facts and circumstances" determinations more attractive to our companies. Therefore, the revenue loss from this bill caused by the electronics industry would be only a fraction of Treasury's estimate.

The converse of minimal revenue loss from the electronics industry is that the bill provides comparatively little direct benefit for us either. We recognize that this bill will not benefit our specific industry as much as it might help others. But we also know that what is good for the economy as a whole is good for us -- both as businessmen and as citizens. If this bill passes, we would expect companies in every industry to be better able to adopt the best and most productive technology in their production processes and products. That is clearly good for the economy. Since some of the greatest strides in productivity have resulted from new uses of electronic technology, we believe H.R.4646 would both widen the market for our products and help our suppliers hold down their costs.

IMPORTANCE OF 10-YEAR REAL ESTATE WRITE-OFFS

As we have noted, the reason this bill provides comparatively little direct benefit to our industry is that many of our companies already depreciate their equipment in less than five years through individually negotiated "facts and circumstances" determinations by the IRS. A uniform and mandatory 5-year period for depreciating all equipment could actually raise taxes for our companies. Our companies would benefit most from the 10-5-3 bill in its treatment of real estate. Mr. Chairman, electronics companies purchase land to create facilities to manufacture products. We are owner-users, not land speculators. Ten-year depreciation for real estate would allow us to take a more aggressive posture toward the construction of new production facilities. We strongly urge you to retain this provision, and to temper the commendable zeal to limit land speculation profits so that it does not unduly restrain genuinely productive users and occupiers of real estate.

OPTIONALITY

A minor amendment to the capital cost recovery bill could solve both the problem we now have with mandatory five-year lives for equipment and the potential problem we would have if the ten-year real estate number is lengthened. We ask that whatever accelerated depreciation you pass be made optional.

It is important to understand that this amendment would not increase the revenue cost of the bill. Allowing existing arrangements to continue should be revenue neutral. Optionality would assure that this valuable reform actually accomplishes the good its sponsors intend without unforeseen harm to some industries.

Mr. Chairman, I again want to thank you for finding room for our testimony on your crowded docket. I would be happy to respond to whatever questions you may have.

[Whereupon, at 3:30 p.m., the committee adjourned, to reconvene at 10 a.m., Wednesday, July 30, 1980.]

TAX CUT PROPOSALS

WEDNESDAY, JULY 30, 1980

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

The committee met, pursuant to recess, at 10 a.m., in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr. presiding.

Present: Sentors Byrd, Nelson, Bentsen, Moynihan, Bradley, Dole, Packwood, and Roth.

Senator BYRD. The hour of 10 o'clock having arrived, the committee will come to order.

Senator Williams is scheduled as the first witness. Since he has not arrived yet, the Chair will recognize Mr. Lane Kirkland, president of the AFL-CIO.

Mr. Kirkland, the committee is pleased to have you today. Senator Long asked me to say to you that he so sorry that he is unable to be here. He wanted to be here. He has read your testimony, and on his behalf, after you conclude, I will put some questions along that line.

We are glad to have you, Mr. Kirkland. You may proceed as you wish.

STATEMENT OF LANE KIRKLAND, PRESIDENT, AFL-CIO, ACCOMPANIED BY RAY DENISON, DIRECTOR OF LEGISLATION, AND RUDY OSWALD, DIRECTOR OF RESEARCH

Mr. KIRKLAND. Thank you, Mr. Chairman.

I am Lane Kirkland, president of the AFL-CIO. With me today are, on my left, Ray Denison, the director of legislation of the AFL-CIO; and, on my right, Rudy Oswald, director of research of AFL-CIO.

The AFL-CIO believes that a tax cut now is inappropriate and economically unwise.

A nation beset with inflation and recession does not need a tax cut that will make inflation worse and will do little about getting unemployed Americans back to work. Rather, the Nation needs a program that will create jobs for the unemployed—and not tax breaks for those who already pay less than their fair share in taxes.

The link between a reduction in taxes—particularly a tax cut heavily weighted toward those with the highest incomes—and job creation is too imprecise, the lag in time too great. The Nation needs a program that will get the 8 million unemployed workers back to work as soon as possible.

America needs an economic stimulus program that is targeted to people and areas that need help the most. The Nation would be ill-served by enacting an economic abstraction that ignores the differences between dollars that generate jobs, build homes or enhance a skill and those that underwrite the playgrounds of the rich, corporate takeovers or flight of industry from hard-pressed urban areas.

The Nation does not need a tax cut that is politically motivated and has, at best, shaky grounding in economic fact. A tax cut program pushed through in the twilight hours of a legislative session, in the heat of a Presidential election and in response to campaign oratory would not be in the best interest of the country or taxpayers.

The AFL-CIO believes the Nation would gain far more benefit from programs that would create jobs, reduce unemployment and ease the burden on the unemployed and the poor. That is why we have called for, and today reiterate the need for: Expanded public service job opportunities; a local public works program, financed by the Federal Government and which can start up quickly that would rebuild public facilities ravaged by years of neglect; additional funds for low and moderate-income housing; Federal aid to maintain essential services in States and localities suffering high unemployment and resultant revenue loss; strengthened and extended unemployment insurance programs; maintenance of health care benefits and food stamps for the unemployed; establishment of special short-term mortgage relief and temporary housing programs for the unemployed.

Such a program would create jobs quickly and provide relief to those directly injured by the recession in a noninflationary manner.

We believe that targeted, specific programs are more effective than broad-scale, across-the-board efforts.

That is why, if Congress decides to go ahead with a tax cut bill, we believe that it would make sense this year—or as soon as the 97th Congress convenes—to nullify any adverse effects on jobs and purchasing power that would result from the 1981 increases in contributions to social security.

Employee and employer contribution rates will increase from 6.13 percent to 6.65 percent on January 1, and the wage base is scheduled to increase from $25,900 to $29,700. This increase, while necessary to maintain the financial integrity of the social security system, would deprive the economy of about $10 billion of worker and business purchasing power in fiscal 1981 and approximately $15 billion in the calendar year.

Legislation has been introduced—H.R. 7046 by Representative Gephardt, and S. 2920 by Senator Bradley—that would provide a refundable tax credit equal to 10 percent of the social security contributions of employees, employers and the self-employed.

As table 5 demonstrates, this type of tax cut would more than offset the scheduled increase for most wage earners, while not affecting the financial stability of the Social Security Trust Fund.

Such a tax cut would meet the standards of fairness, targeted relief to those who need it, and help in the fight against recession—standards we believe should be applied to every tax cut proposal.

The so-called Reagan-Kemp-Roth tax cut proposal does not meet the standards of fairness, equity or targeted relief. It is not the product of visionary economics. Rather, it is little more than the old "trickle down" economics wrapped in a new package for the fall campaign.

The tables based on Treasury and Joint Committee on Taxation data, which have been appended to our testimony, condemn the Reagan tax cut proposal as unbalanced and inequitable. It is evident from these figures that:

The Reagan proposal is a raid on the Federal Treasury. The 10 percent across-the-board cut in tax rates and the speedup in depreciation would cost $34.7 billion in 1981. By 1985 the cost more than triples to $117.1 billion.

The Reagan proposal primarily benefits the wealthiest in this society. Despite the appearance of equity by the phrase "across-the-board," this tax cut proposal has been designed to concentrate its impact in the highest tax brackets. The average worker in the private sector, according to the Bureau of Labor Statistics, earns about $12,000 a year. The proposed tax cut for a family of four supported by this worker would be $91 a year—or $1.77 a week. That is about the cost of a gallon of milk. At the same time, a family of four with a $100,000 income would receive about $2,190 a year.

The Reagan proposal would abandon the principle of taxation on ability to pay. About 15 million low-income taxpayers, who face higher social security taxes on January 1, would receive no benefit from the Reagan proposal. The 86 percent of all taxpayers who earn less than $30,000 a year would receive only about 50 percent of the tax reduction. At the same time, the wealthiest 3 percent of taxpayers would net about one-quarter of the benefit of the tax cut. Combined with the business tax reductions as a result of the proposed depreciation speedup, corporations and the wealthy would receive the bulk of the tax reduction.

The Reagan proposal is even counter to the Republican platform, which pledges that the family would receive priority tax consideration. But under the proposed Reagan tax cut individuals would, except for the $100,000 and more income bracket, receive substantially greater benefit than a family with two children.

The Reagan proposal would nearly halve corporate income taxes. By 1985, business would receive a corporate income tax cut of about 45 percent, compared with 10 percent for individuals.

The Reagan proposal would, by 1985, give the majority of its benefit to corporations. While 90 percent of the tax cut would go to individuals in the first year, that share shrinks constantly and by 1985 individuals would receive less than half of the tax cut.

The 10-5-3 depreciation speedup part of the plan, in addition to its huge revenue and equity costs, would replace the present system of tax depreciation—generally based on the cost and useful life of the asset—with an entirely new and dramatically accelerated system. This new method destroys any linkage between the actual cost of an asset and its actual useful life. Under the Reagan proposal, there would be only three classes of capital assets and the annual depreciation writeoff would be the same for all items within the class regardless of useful life.

Buildings and structural components would be written off in the 10 years. Presently, the average depreciation "life" of a building is

32.6 years. Machinery and equipment would be written off in 5 years—the present average is 10.2 years. And for autos and light duty trucks a 3-year writeoff would apply, compared with the current 3.5-year average.

The measure would also retain the double-dip in the present law which allows companies to ignore the 10-percent investment credit when calculating annual depreciation writeoffs. In other words, a company that buys a piece of equipment for $1,000 receives a $100 tax credit that cuts the actual cost of the equipmennt to $900. Nevertheless, the corporation can still write off the full $1,000—in effect deducting 111 percent of its cost.

Thus, under the 10–5–p–3 proposal, a company would be able to: One, write off more than the cost of the asset; two, do it in approximately half the normal time; and three, front load the deductions so much that 84 percent of the actual cost would be written off in only one-third of the actual lifetime of the equipment.

Our concern about the proposed tax cuts for business is greater than its cost or the fact that it is bad tax policy. In reality, the Reagan proposal amounts to a subsidy for the business community through the backdoor.

Technically, of course, depreciation speedups amount to a deferral of tax—and not an avoidance—since the deduction eventually runs out and taxes in later years are correspondingly higher. Thus, excess depreciation is an interest-free loan. However, since firms routinely and continually invest and reinvest, the loan is constantly recycled and never paid off. At current interest rates, money doubles in less than 7 years. Thus deferring taxes for 7 years is equivalent to paying no taxes at all, and represents a clear-cut and substantial subsidy to business.

We believe the Congresss should determine needs and impact before enacting such a subsidy through the tax code. For example, under the Reagan proposal industries using more capital relative to labor would receive the greatest tax subsidies. Firms that use plants and equipment with longer service lives would be given a greater advantage over those using short-lived plants and equipment.

The Treasury Department estimates that the tax break would be equivalent to about 20 percent of the investment of the communications industry. Yet, the three areas of the economy that are suffering the most from the current recession—primary metals, motor vehicles, and construction—would receive less benefit.

The primary metals industry would be able to finance about 15 percent of its investment from this tax cut proposal; motor vehicle only 8 percent and 4 percent for the construction industry. Wholesale and retail trade, along with other services, would receive lower benefits. Obviously, the benefits received from the tax break would have little or no relationship to the particular problems or needs of the industries or the economy.

In general, across-the-board business incentives are an ineffective and inefficient method of solving the types of economic problems the Nation confronts today. If tax policies can be tailored to meet those problems—within the framework of a coordinated national effort to bring about full employment and enhance this Nation's industrial base—we would be their most outspoken advocates.

Unfortunately, the track record of attempts to use general tax forgiveness to subsidize or encourage particular actions is poor. Needed revenue is dissipated through providing benefits to firms for doing what they would do anyway. The larger and more prosperous corporations that are least in need of aid get the lion's sharc of the benefits, and each new provision tends to devlop a life of its own.

The results often make the tax struture more complex. New constituencies for special privileges are generated, further eroding the tax base and loading more of the burden on those who are already paying more of their fair share.

Why, for example, should a company located in a center city with heavy unemployment be encouraged—through a tax incentive—to move elsewhere? Why not shape the incentive to induce the company to modernize its facilities and equipment and remain in the urban area.

Targeted tax incentives might apply to firms willing to invest in areas served by mass transit rather than far-away suburban parking lots. Such an incentive would make sense in terms of providing jobs for inner-city residents and public support for mass transit, which would help conserve energy.

Senator BYRD. Mr. Kirkland, you have already exceeded your time by 8 minutes.

Senator MOYNIHAN. Mr. Chairman, he was just getting to the good part.

Senator BYRD. Maybe you could tighten it up a little bit.

Mr. KIRKLAND. I will be perfectly happy, since you have the statement, to have it in the record, and I will respond to any questions you might have.

Senator BYRD. If you wish to comment briefly on the last two pages, why don't you go ahead.

Mr. KIRKLAND. We urge, sir, that any use of a tax device be targeted to specific objectives in mind, the objective enhancing and encouraging investment in areas of specific need, and inducing firms to do what they would not otherwise do, where it might be needed, and where it might be a critical factor in the decision in areas that are afflicted by substantial unemployment, and with a particular emphasis on the creation of employment opportunities in this country, rather than in Japan or elsewhere in the world.

The essence of what we propose and suggest is that the use of tax incentives ought not to be the exclusive reliance. The revival of the economy should be part of a broader program. We suggest the use of the instrument through a national entity that would be designed to spur industrial development, of certificates of necessity as only a part of a broader program.

This is essentially our position.

Senator BYRD. Thank you, Mr. Kirkland.

Let me ask you a question on behalf of Senator Long, and then he has several other questions which I would ask that you answer for the record, if you will.

[The following was subsequently supplied for the record:]

QUESTIONS SUBMITTED BY SENATOR LONG AND MR. KIRKLAND'S RESPONSES TO THEM

Mr. Kirkland, Senator Long is sorry that he is unable to be here today. He has read your testimony and requested that I ask you the following questions:

1. In your statement you oppose the 10-5-3 depreciation proposal. What kinds of measures, if any, would you support in order to increase American productivity and improve our competitive position?

2. You have also pointed out that it might be appropriate for us to use the stick as well as the carrot to help direct investment. How could this approach be employed to assist those industries which face serious financial problems?

3. In your statement you have urged us to consider the refundable tax credit proposed by, Senator Bradley that would equal 10 percent of the social security contributions of employees, employers and the self-employed. Would you also support changes in the tax rates, exemptions and the zero bracket amount designed to direct a similar tax cut to those affected by the social security tax increase?

4. In your testimony you have suggested the creation of a new tri-partite Industrialization Board to spur industrial development. The Board would have the discretion of determining the tax incentives appropriate for a particular industry or company on a case-by-case basis. This is an intriguing proposal. This type of proposal is in line with my thinking that we ought to bring together business, labor, and Government leaders to agree on specific goals and then to work together to achieve those goals. Do you think it would be productive for us to explore this concept on a broader basis as well as relating it to the specific case of a particular industry or company?

1. The slowdown in productivity in recent years is largely a result of recessions. Moreover, although the overall productivity measure does show a sharp slowdown, this is not true in basic manufacturing, where the slowdown in the 1970's has been more moderate. Also, because manufacturing—where productivity figures are relatively reliable—is accounting for a much smaller share of the economy, sectors such as services, where productivity is notoriously difficult to measure have a greater weight in the overall measure of productivity. As a result much of the "slowdown" in productivity may be exaggerated because of the inability to measure output in many sectors—made more difficult by inflation and the need to adjust for price increase.

There has also been an end to two historical transitions which had been contributing to productivity increases e.g. (1) The movement of millions of people from agricultural to industrial occupations and (2) the shift from small mom and pop retail stores to self-service supermarkets.

We therefore feel that the best way to meet productivity problems—real or perceived—would be through putting the economy firmly on a balanced course toward full employment—of workers and productive facilities. Federal government activities should include economic stimulation programs such as public service jobs, accelerated public works, energy and transportation programs and housing programs. Such specific programs would also alleviate inflationary pressures. The additional services and training provided by public service employment for example adds to the skill and productivity potential of the workforce as well as to the provision of needed public services. Public work programs can be targeted to provide the infrastructure for future industrial development. Without adequate sewers, water, and transportation facilities, goods cannot be produced efficiently. Energy conservation can also be speeded up by putting unemployed construction workers to work in weatherizing schools and hospitals as well as moving forward with the programs of weatherization for low-income individuals. Improving railroad, mass transit, highway and airport facilities would also lead to further energy conservation and productivity gains.

2. The point I was attempting to make in my recommendation to use sticks as well as carrots was primarily in the context of the huge amount of revenue that could be recouped by denying tax preferences in circumstances where the investment is not within the context of nationally determined goals. This, in turn would increase revenues and thereby provide more budgetary leeway to help firms that are in need. If Investment Credits, for example, were denied for activities that should not be encouraged, more funds would be available for assistance programs. And, of course, to that extent that existing tax preferences divert funds into nonproductive ventures, the entire economy suffers.

3. If a program could be designed that would have a similar effect on tax burdens, and federal revenues while having no adverse effect on the financial integrity of the Social Security System, suppose we could support it. We do however, feel that H.R. 7046 represents a simple easily understood and direct approach. At the same time it would make sense to apply the sample principle to workers not covered by Social Security—federal employees, those under the railroad retirement system and some state and local employees—through providing a tax credit equivalent to what they would receive if they were covered by the Social Security program.

4. Yes I do. But, I would like to emphasize that "exploring the concept on a broader basis" also means to me that tax "incentives" should be viewed as only one of a variety of actions that might be appropriate. I would not want the role of such a tri-partite board to be limited solely to determining and recommending tax incentives.

Senator BYRD. In your statement, you oppose the 10-5-3 depreciation proposal. What kinds of measures, if any, would you support in order to increase American productivity and improve our competitive position?

Mr. KIRKLAND. The question of productivity, sir, is a large one that I don't think is responsive to easy answers through the tax mechanism. There is an almost perfect correlation between the extent of industrial activity and the state of the economy, and trends in productivity.

Historically, every time we have hit a recession, productivity has dropped, and that, I believe, is the governing problem with relation to the general trend of productivity plus a number of other factors, such as the heavy shift to a service economy where productivity measurements are unreliable and dubious, and where policy conclusions drawn from those measurements are doubtful.

Senator BYRD. As I understand your answer, you don't advocate any tax program along the lines of encouraging greater productivity.

Mr. KIRKLAND. We certainly do not advocate an across-the-board blanket cut in corporate taxes through the depreciation speed-up device. There may well be, as we suggest in our statement, appropriate places in the interest of reviving the economy, reviving areas of the country that have high levels of unemployment, and the decline of industry, and the decline of competitiveness.

In those targeted areas, it may be appropriate as part of a general and broader program which would include facilities for making credit and resources available by other means. It might be appropriate in those cases. We suggest that the best approach in those instances would be by a more flexible, targeted approach which could be carried out through certificates of necessity in particular cases.

We also suggest that there should be governing what we regard as the appropriate objectives of national policy. Consideration of the impact on energy use is clearly one, and the access to mass transit rather than the encouragement of the development of plants and industrial parks on superhighways miles removed from the natural labor market, and from transit facilities.

We think that there should be strong consideration of where the products that are put in place, the equipment and so forth, is manufactured. Of course, beyond all that, there is a question as to whether this is a factor in encouraging, really encouraging or stimulating that investment, rather than a windfall tax break for investments that are made in the natural course of doing business anyway, and would have been made in the absence of such a program.

Senator BYRD. As you are aware, the Senate Democratic Conference had introduced a resolution with only three members of the conference, so far as I am aware, this Senator being one, who did not sign the resolution or endorse the resolution, which resolution mandates the Senate Finance Committee to bring in a tax reduction proposal.

I assume that you, number one, feel that this committee should not bring in a tax reduction proposal.

My other question is, do you think such a resolution was a wise resolution?

Mr. KIRKLAND. Well, sir, I would say not necessarily in both cases, and far be it from me to criticize the judgments of the Senate.

I think the presumption is against a likelihood of there being wise tax legislation produced under the pressures that exist at the current time, and under a forced draft situation.

Second, with all due respect, sir, we have been in some disagreement with the developments that have occurred in the Congress under the passing shifts of the tide of what appear to be the exigencies of the time such as the obsession with balancing the budget.

Senator BYRD. Well, you have won that fight. [Laughter.]

Mr. KIRKLAND. Senator, if you will excuse me, sir, we have not won a damn thing.

Senator BYRD. You have what you want. You have a $30 billion deficit which is going to be far greater than that by the time 1981 is over, and you are going to have a $61 billion deficit in this current year. So you ought to be pretty happy.

Mr. KIRKLAND. I think that this proves the point that we made. We argued against the proposition that you could hold the economy in a state of anesthesia and in a fixed position while you operated on the budget, and that one would have no relationship to the other.

It was our view, and it has been borne out by events, that the state of the economy has a far more profound influence on the actual facts with respect to Federal revenues and expenditures than do the paper accountings of the budget balancing process, or the alleged budget balancing process.

I believe that the way to revive and get the Nation's fiscal house in order is the revival of the economy, and the reduction of unemployment. We believe that that is most effectively done by targeted expenditure programs.

Senator BYRD. May I ask this question. Has the AFL-CIO ever at any time formally endorsed a balanced budget?

Mr. KIRKLAND. I don't think we have ever, nor do I expect we ever would formally endorse a balanced budget as the overriding objective of Government.

Senator BYRD. Have you ever done it under any conditions?

Mr. KIRKLAND. Yes, sir.

Senator BYRD. You have?

Mr. KIRKLAND. Yes, sir.

Senator BYRD. Could you tell us when that was?

Mr. KIRKLAND. We have and do today strongly advocate the balancing of budget, and the creation of a surplus by reviving the economy and putting people back to work. If we had a full employment economy, we would have a budget surplus today. We would regard that as a healthy thing.

Senator BYRD. Of course, we don't have full employment, and that is what this committee is struggling with to try to bring about some legislation that will help create jobs.

Mr. KIRKLAND. I understand the motive and the purpose, sir. We dispute the efficacy of the means that are proposed in what we analyzed here, the Reagan-Kemp-Roth approach.

Senator BYRD. Mr. Kirkland, you have been dealing with the Reagan-Kemp-Roth proposal, as you call it, and I think you are justified in calling it that. But I assume that you also oppose any Democratic initiative along that line.

Mr. KIRKLAND. We would oppose, sir——

Senator BYRD. So you are both against the Democratic Party, and the Republican Party. You are about like I am, I guess. [Laughter.]

Mr. KIRKLAND. I think that there might be some slight differences in nuance, sir. [Laughter.]

Senator BYRD. Senator Packwood.

Mr. KIRKLAND. We, I think, frankly and clearly state our preference in meeting the recession, the serious consequences on families, and workers, on the poor, and the distressed of this recession, this heavy unemployment we have, by targeted programs designed to address themselves to the particular areas of need, rather than by a blanket tax cut for business under the name of accelerated depreciation.

Otherwise, we think that it would put adverse pressure on the programs that we support, and that we favor in meeting these specific needs. If special concern is to be paid to any element of our society under the conditions that exist at the moment, it ought to be directed expressly at those who are really suffering the most from it.

I would add another point, sir. Depending, I assume, on how many books a company keeps, we still have with us the problem of inflation. The use of an accelerated depreciation device as the company keeps its books and makes its cost evaluations on the basis of this rate of depreciation, the consequence will be an inflation of costs which in an administered price, on the theory of cost push, is bound to lead to higher prices, which is in itself inflationary.

If you are using, for example, under the present price guidelines policy the profit margin approach, this will justify further increases in price without any change in circumstances, even under the guidelines.

Senator BYRD. Senator Packwood.

Senator PACKWOOD. Lane, we have had lots of testimony comparing the United States to other tax systems which we need to compete internationally, and then there will be some analogy made to Japan, or Germany, or France, that they are doing something better than we are.

Let me ask you this question, and you can put it to your economist if you want.

We tax about 32 percent of our gross national product in this country between Federal, State, and local taxes. Germany taxes around 42 percent, counting their Federal Republic and local taxes. Apart from Japan, which is incredibly low, the other major countries that we compete with tax higher than 42 percent. The Scandinavian countries tax above 50 percent.

The question that I want to ask you is this, if you read it the same way I do. It appears to me that while they are taxing more totally, those countries have less tax on capital, on savings, on investment, depreciation, and tax much more heavily on consumption, especially with the use of the value-added tax. On the average, the middle income taxpayers in those countries pay a larger proportion of their income in tax than they do in this country. Have your economic studies reached that same conclusion?

Mr. KIRKLAND. I think that that is correct, sir. I think they also pay far more in the way of social security taxes than we do, both employers and employees. Our is something like a half or a third, I think, of other industrial countries.

Senator PACKWOOD. I saw the story on social security the other day. As I recall, the Germans tax is either 10 percent, or 12 percent, or 16 percent. It is very high. Yet, they tax less on what business people like to refer to as the capital incentive side of investment. You say, yes, that seems to be true.

Is there any correlation between doing that—I don't want to put words in your mouth, but they just seem to shift their taxes onto consumption, and onto workers through value-added taxes and high social security taxes. Is there any correlation between their low levels, or relatively low levels of taxation on capital, savings, investment, and what-not, and their productivity, their lower rate of unemployment than ours, the better performance of their economy over the last 10 years than ours.

Mr. KIRKLAND. Sir, I would hesitate to draw broad analogies between the conditions that exist in a continental economy such as ours, and those of a country—in the case of West German, I think that it is about the size of your State, sir.

I think a great many problems are far more amenable to solution in those nice, tight little economies, than they are when we are dealing with a diverse continental economy where industry shifts and moves from one part of the country to the other, where we have the wide divergence of employment conditions, of the condition of industry from one part of the country to the other.

I would hesitate to make a judgment that attributes the differences in our economy and economic performance, certainly in the case of employment, to the tax structure. You might also point to a variety of other distinctions between our countries.

In the case of Japan, there is a close correlation between the decisions of Government and the decisions of industry. I doubt if they have much sympathy with the principles of the Antitrust Act in Japan. There are devices that are employed which, in our opinion, are virtually subsidies for exports. I would place the value-added tax in that category.

So I would hesitate to just embrace that notion, Senator.

Senator PACKWOOD. All I can conclude from your answer is this: Yes, indeed, they do appear to tax capital less, and investment less, whether that is a quid pro quo for lower unemployment and higher productivity, you are not sure.

Mr. KIRKLAND. Yes; that is right.

Rudy Oswald would like to comment on that, if he may.

Mr. OSWALD. Senator, most of the recent studies indicate that in spite of those tax differences, the actual level of productivity in this country is higher than practically all of the other developed countries.

Senator PACKWOOD. The level of productivity.

Mr. OSWALD. The level of productivity.

Senator PACKWOOD. The increase in productivity is last of those major countries.

Mr. OSWALD. That is because they started from a much lower base. Therefore, the rate of change is obviously able to be much higher. Obviously, a Germany that rebuilt completely after the war is in a different situation than the United States.

I think that our tax system has existed for a long time in terms of its heavy emphasis on corporate taxes as a method of raising taxes. In spite of that, over history, we have a much higher level of productivity than most of the other developed countries.

Senator PACKWOOD. Are you familiar with the figures in the Joint Economic Committee's report that if the trend continues as we are now going by 1985, in terms of total productivity of the major industrial nations, counting us as one, we will be fifth in terms of total productivity.

Mr. OSWALD. But that assumes that the others will continue to grow.

Senator PACKWOOD. Yes.

Mr. OSWALD. Affecting our productivity is the recession. Clearly the big drop that was reported for the second quarter of this year in terms of productivity is not related to capital investment. It is related to the recession.

The biggest drop in the 1970's, in manufacturing productivity, particularly, was the big drop that resulted from the 1975 recession. If we did not have that five point drop in productivity in the 1975 recession, the level of productivity in the 1970's in manufacturing would have been as good as it was in the 1960's.

Senator PACKWOOD. You are attributing, then, the whole last of the 1970's to that one recession, because during 1976, 1977, 1978, and 1979, before we hit the start of this recession, our increase in productivity in relation to other countries was still down. For 1977 and 1978 it was still last of the major, and in 1978 and 1979 it went actually down. You don't attribute that all to the 1974-75 recession, do you?

Mr. OSWALD. Part of the current decrease is the result of the slowing of growth in 1979, and the 1980 decrease is clearly related to the recession. The rates of growth in the other countries have also been slowing down in the 1970's. They have not been maintaining the rate of growth that they had in the early 1960's, or even in the earlier part of the 1970's.

Senator PACKWOOD. Let me ask you another question.

Mr. KIRKLAND. Let me add a point or two on this. I think there are a great many factors that enter into productivity and in management investment decisions. I suspect that possibly taxes are the least of them. I would think that it would be a very unwise company that would make an investment decision on the basis of the tax issue alone.

I would suspect that the basic incentives or reasons for decisions relate simply to: Is there a market for the product, and can you make money with it?

There are a number of factors affecting that which bear on productivity. I think over the long run the remarkable record of this country, in terms of productivity during periods when revenue derived from corporate taxes was just as high as related to other countries, was based in large part on the existence of mass markets which have been in many industries heavily impaired by foreign competition today.

The existence of relatively low cost money, and cheap and plentiful supplies of money relative to those other countries. I think, historically, the rates of interest and the availability of money in this country has been lower in the case of interest rates in the cost of money, and higher in terms of the availability of money. That is a factor.

It has always been a source of some surprise to me that management can get terribly exercised over minor variations in tax rates, or tax issues, and the impact of taxes on investment, and yet endure enormous increases in the cost of hiring money which seems to me to be a far more crucial decision than a decision as to whether or not to make a capital investment.

We have seen in the past few months interest rates soar to unbelievable levels, which I believe had a far more profound impact on investment and on growth than anything you might do in the tax area, and yet that seems to me a matter of relatively minor concern in the business community.

I do believe that there is an insatiable appetite for tax reductions in the business community under whatever label might be dreamed up. The object is, I suppose, a zero tax structure, whether you get there by accelerated depreciation, by investment tax credits—I don't know what next year's gadget will be, but the object is to reduce the taxes to nil.

That is a natural human aspiration, but to elaborate this theory of the correlation between investment performance and variations in the tax rate is, I believe, nonsense. The sources of productivity over history have been essentially, in my opinion, the state of the market, the existence of a large volume market which is based on relatively high incomes and purchasing power.

Second, the access to relatively inexpensive capital, and access to relatively inexpensive and plentiful energy. We are being heavily impacted and adversely affected by a radical change in access to energy and access to capital at reasonable cost. I think that those have a far heavier effect on investment decisions than do taxes. You don't pay the tax unless you make the money in the first place.

Senator PACKWOOD. Thank you.

Senator BYRD. Senator Moynihan.

Senator MOYNIHAN. Thank you, Mr. Chairman.

Mr. Kirkland, and Dr. Oswald, I was hoping that you would be able to get right through to the last page of your brief testimony because there you raise what I believe is a proposal that has been brought for the first time to this committee and is one which we want to attempt to pay very close attention.

You made the point that you have limited enthusiasm for an across-the-board cut in the depreciation rates, and you made the point of the impact that cutting the rate on structures from 32 years to 10 years might have in moving industry in part as a result of the tax code, but that such a move would have no basis in economic business decisions.

But you say that you would be for a new targeted program. This is an important statement from the American labor movement. You say—

> A new tripartite industrialization board should be established that would have policy responsibilities for spurring industrial development. This board should direct the activities of a financial institution that would have a fixed amount of money budgeted for the program. The amount and type of tax incentive or accelerated depreciation allowance granted to a particular industry or company would be determined on a case-by-case basis with some type of certificate of necessity.

This is a large idea, and it ought not to be passed over without comment. Would you tell us more of what you have in mind?

Mr. KIRKLAND. Yes, sir. I don't think that this is a particularly or necessarily original notion because it has been discussed in various quarters in terms of the national, widely current interest today in the so-called reindustrialization of the United States.

Senator MOYNIHAN. I suppose the AFL-CIO has always been under the impression that we are an industrial country. Maybe there are some people who have never been in a factory, and who think that it would be fun to see one. Therefore we ought to build one in order to see it.

Mr. KIRKLAND. We would like to keep it an industrial country. We are the biggest market in the world for steel, for autos, and for a variety of other products. I somehow cannot get too enthusiastic about the notion that we should get out of the business of serving the bulk of that market and turn it over to some other country as their particular specialty. I don't think that this is the way that the world works, or that it ought to work

This kind of an approach—we are not wedded to any particular aspect of it—is what we feel would make a major contribution to reviving this country.

I can go across the board and see many areas and many problems, bottlenecks, obstructions to the revival of this country that need to be overcome. I think that there will be relative scarcity of the resources in terms of the demand.

I have had it put to me by people who are in a position to know in the oil industry, for example, that to develop the resources that we have here, on which we will have to rely, in the face of diminishing quantities of petroleum, taking oil shale, for example, will require over the next 10 or 15 years upward of $700 to $800 billion worth of capital investment.

I think if we do undertake to do those things, and I think we should and must, we are going to have to make a sort of quantum jump in our thinking about how to mobilize capital, and how to channel it in the right direction.

Senator MOYNIHAN. You would see some role for a Government institution in that mobilization?

Mr. KIRKLAND. Yes.

Senator MOYNIHAN. Just to make a very rough analogy, the Reconstruction Finance Corporation did a good deal of that financing from about 1931 until 1944.

Mr. KIRKLAND. That parallel has not eluded us, sir.

Senator MOYNIHAN. My parallel has not eluded you.

My time is up, but I thank you very much. We would like to say that if you want to put more structure on that idea, and get it to this committee, I know that we would be very much interested in pursuing it, if we may.

Mr. KIRKLAND. There is another point in relation to it which I would like to make.

The greatest of capital accumulation or mobilization of growth formation, whatever you want to call it, in this country today is in the nature of social insurance funds, public and private. Those reserves of those funds are fed further by ERISA, by the legislation that requires full reserve funding, and are growing rather rapidly.

Senator MOYNIHAN. What was left of ERISA after we got done with it last night.

Mr. KIRKLAND. Right.

Senator MOYNIHAN. Those are workers' funds.

Mr. KIRKLAND. Yes.

Senator MOYNIHAN. Some say that their disposition is an appropriate role for the people whose money it is.

Mr. KIRKLAND. I would suggest the creation of such an entity could help channel and make it more feasible to direct some of those funds, as I think our members would like to, into projects and programs that would help to revive the industrial base of this country. This would offer one medium for doing that.

Senator MOYNIHAN. Thank you very much.

Senator BYRD. Senator Bradley.

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

Mr. Kirkland, I would like you to tell me if I am stating your proposition correctly. One of the major causes for the downturn of productivity in this country has been the idle capacity that our economic policy has created in industry. This idle capacity makes a businessman, when he looks at his plant and equipment and sees idle capacity, say: "Why do I want to invest in new plant and equipment?" It makes a worker, when he sees his fellow worker losing his job, not want to adjust to new technological developments in the processes of that particular industry.

This combination that is basically managed by government economic policy, the stop-go over the last 15 or 20 years, has been a major contributing factor to the downturn of productivity.

Mr. KIRKLAND. I would agree with that, sir.

Senator BRADLEY. What percent would you assess to the downturn of productivity that such stop-go policies represent?

Mr. KIRKLAND. Sir, I would not be in a position to put a number on it. I suppose you can gauge it by the past trends. I think there is a strong correlation between the level of economic activity and the level of growth of productivity.

If you go back to a time I recall, sir, and this is an interesting fact, back when the issue of revenue sharing was first being discussed and proposed during the latter years of the Johnson administration. The initiative was the idea of certain gentlemen who are now in the Brookings Institution.

The rationale for that proposal was the prospect that we would have a terrible problem confronting us very shortly, the projection of a mounting and rapidly growing Federal surplus stemming from the rate of growth that existed at that time projected into the future, and that revenue sharing was designed to help solve that grievous problem.

Now, what happened? That was only 10 or 12 years ago, what happened? There was no productivity problem then. We were in a period of rapid growth and productivity which was the envy of the world. We were approaching, at or near, what now would be regarded as close to full employment, and we had a very modest rate of inflation. We had in the last year, our last budget surplus after revenue sharing went into effect, including the cost of the Vietnam war.

I believe that if it was possible 10 or 12 years ago, I think that it is feasible today.

Senator BRADLEY. To reconstitute that growth?

Mr. KIRKLAND. Yes.

Senator BRADLEY. Could you tell me, if you think that we can increase productivity in this country and return our economy to an upward ascent on a growth path without increasing our share of the world markets?

Mr. KIRKLAND. I don't think that the share of the world markets in terms of the export impact is that crucial. It is still a relatively minor part of the total market. The base of our production has been the service of the domestic market by and large, and over history that is the base on which our productivity and our industrial system has grown. The export element of it is only 16 percent.

Senator BRADLEY. One in five jobs in the country is dependent on exports.

The point I am leading to is this. In 1945, we had an agreement, an informal agreement but nonetheless an agreement, among labor, industry, finance, and agriculture that it was in our interest to pursue open markets around the world. The Bretton Woods system was based on that precept. Another assumption was the United States was superior in technology, labor, and economic power.

We have gotten into a situation where we are seeing some tension, and the question that I am putting is. Is labor still committed to that system, or are we seeing tension now that will increase the pressures for protectionism? If so, what does that mean for the one-in-five in the country who are now employed in the export sector?

Finally, since the bell rang and I am still talking, I will add another aspect to my question. If we have this industrial board which had been suggested, what if that industrial board decides that there are some sectors of our economy that are just not competitive, and that we have to do what we can in order to expand our share of the world market by rewarding those sectors which can be more competitive?

Those are six questions which I would have preferred to ask sequentially, but that is life in the Finance Committee.

Mr. KIRKLAND. That is a pretty large order you have put on my plate, sir. I could discourse on that for a couple of hours.

The issue of trade policy is one where we have undergone a considerable evolution. I think that evolution has been a reflection of reality and changing reality. I think that it would be very nice, sir, and I would be all for it, if we had a world that worked according to the theory of comparative advantage in a classic sense. If we did, I think that we would probably still do quite well.

I don't think that that is the world that exists. I think we, still today among all the industrial nations of the world and development nations of the world, have the most open market. The object of most of the other nations of the world is to target that American market, which is still the greatest one in the world, in a wide variety of ingenious and extraordinary devices that have been developed far beyond any that had to be dealt with during the days of Bretton Woods in order to achieve that objective.

We have, for example, in the case of the automobile industry a situation where owing to circumstances that with the best of management could not have been too readily rejected, where the market in 1 year was a market for big cars because of the nature of our country and the nature of our highway system, and so forth, which does not make it too comfortable to traverse long distances in a small Fiat, made it prudent at the time, if you wanted to stay in business, to make and sell those cars.

With rather startling suddenness, that market did a 180 degree turn owing to the scarcity and rising price of gasoline, imposed not by the free market, sir, by a cartel that at Bretton Woods would not have been highly regarded as a instrument for determining the state of the world market and world production.

We have imposed social costs, which I believe in, and which we supported and advocated to you and industry, in the form of environmental and pollution controls which impose additional costs. Suddenly we have this industry in a state of acute vulnerability, and at that particular point our competitors target this market and move in like sharks. We have a basic industry in this country which faces the prospect of permanent loss of markets.

I don't think that I am prepared to say that that represents a long-run, natural, logical evolution of economic events, and we should writeoff that industry and concentrate on micro chips.

The same is true with the steel industry. You cannot take a slice of time at this particular moment and say that this is a declining industry. I cannot believe that the steel industry in this country is a permanently declining industry, and that it is incapable of correction by prudent approaches.

In fact, I think and I have heard evaluations of the situation, and projections of the future which maintained that within a few short years we will in all probability, on revival, be faced with a problem of undercapacity in our steel industry, and an enormous pressure of demand on our steel industry.

Things change, and you cannot project from one point on the chart what the future direction is or ought to be. I would negotiate a trade relationship of equity and reciprocity with any country. I don't think that is the way the world is, sir.

I certainly do not think that that is the way it is in our relations with Japan, and with much of the Common Market, not to mention the developing world where the structure of protectionist devices and enticements for industry to locate are extraordinary.

Senator BYRD. Senator Nelson.

Senator NELSON. Thank you, Mr. Chairman.

I regret that I was absent for the presentation of the testimony. I will defer any questions I have, and put them in writing as you indicated.

Senator BYRD. Yes.

Senator Roth.

Senator ROTH. I would like to welcome you, Mr. Kirkland, even though you are not an enthusiastic supporter of my legislation. Nevertheless, I think we have a joint interest in the problem of what has been called the reindustrialization of America.

One of my concerns currently is that under the current practices the people that are suffering the most really are the poor who don't have jobs, and the working people who are paying an increasing share of their income in the form of taxes because of inflation.

As I look down the road, what bothers me even more is that I see this country becoming increasingly less competitive in practically all forms of industry. We have large automobile plants at home, and we have seen what happened there. We also have some steel, and we have seen what has happened there.

What bothers me about your proposal, and I regret I was not here, as I understand what you are saying, we would create a tripartite board to hand out special tax incentives. By bothers me about that is that it would be very politicized.

Frankly, can you see such a board turning down any principal industry in our current situation, whether it were steel, or auto, or whatever it would be, saying that they should not get accelerated depreciation?

Mr. KIRKLAND. Yes, sir, I could.

Senator ROTH. You are more optimistic than I am, but I would say, sir, that any Senator or Congressman representing his constituency would feel compelled to try to protect the jobs of his area.

Actually, I am one who thinks that we have to do something to modernize our basic industries. I do not agree with those who think that we should be a service-oriented country. I think that as the leader of the free world we have to have a modern and competitive steel industry, a modern and competitive automobile industry. You name it, and I just don't think that we can afford to let them go down the drain.

Mr. KIRKLAND. I simply say, sir, political pressures are a fact of life, and they work in many diverse ways, many of them good.

Senator ROTH. Wouldn't be better off——

Mr. KIRKLAND. I don't think that the way to escape political pressure is just to yield to a universal political pressure and give it to everybody.

Senator ROTH. Of course, I am of another school, I will have to admit. I think the market itself works better. But I would be very concerned if we were taking this decisionmaking out of the private sector and putting it in a Government agency, which is in a sense what we would be doing.

That would be point number one. When you look at the complexities of industry, not only existing industry but hopefully future developments, it would seem to me to be very difficult taking that decisionmaking here to Washington.

Second, it does seem to me, whatever device you use, it is going to take tremendous quantities of capital formation to modernize or to develop the new industries. What bothers me—we have been holding hearings in the Joint Economic Committee—is that I have been told that Japan is outcompeting us in practically all areas, and by the end of the century Japan will have an economy as large as ours. They are spending as much today for equipment and plant as we are, although they are only half as large.

So it seems to me that we do have to promote savings to provide that capital formation, and that must come from all the working people. Do you disagree with that?

Mr. KIRKLAND. I would not so much disagree on the facts, as I obviously disagree on the inferences for how to approach it.

In terms of our capital investment—I could add this to the record, this is from Rudy Oswald's testimony to the House Ways and Means Committee on the panel the other day. It shows that the historical record of private fixed investment is a percentage of gross national product, and it shows that currently for the last 3 or 4 years we have been at an all time high since 1949. The current rate is about 10.8 as a percent of gross national product, and at no time since 1949 has it been higher.

Nonresidential producers durable equipment as a percent of gross national product——

Senator ROTH. Is that in current dollars, sir?

Mr. KIRKLAND. It is in current dollars, and in current GNP dollars as well.

Senator ROTH. I would just make, if I might, the observation, whatever we are doing, it seems to me to be inadequate. There seems to be very little argument among the economists that have appeared either before this committee or other committees that I have sat on——

Mr. KIRKLAND. I think that it is inadequate in certain areas, and in certain directions, and that is why we certainly would not preclude the use of this device in some targeted manner.

There was a very interesting and, I think, constructive article in the Wall Street Journal yesterday which highlighted something that had been brought to me in conversations, and elsewhere for some time back. We are looking forward to a situation where we have potentially an enormous prospect of being the world's leading exporter of coal.

There is a roadblock. There is an obstruction. We don't have a decent port facility for shipping coal. I think that there ought to be some investment in that area in rebuilding coal ports. I am told that there is only one modern coal depot in the entire North American continent that can handle it, and that is in Vancouver.

That was done by a deliberate act, I think, through a public authority to build that facility, and they are getting the benefit of vast coal exports through that port. Meanwhile, according to this article, and I think that it is worth your looking at, there are ships lining up waiting to load coal off of our east coast ports that have delays upwards of a month with an enormous increase in the shipping costs, and a handicap to our potential for fully exploiting this market.

Senator MOYNIHAN. Would the Senator yield just for a comment to confirm what Mr. Kirkland has said.

The Committee on Water Resources has been holding hearings on precisely this subject. What Mr. Kirkland says is precisely right. The Port of Philadelphia, for example, has a 6-week wait to offload coal onto seagoing ships.

Mr. KIRKLAND. The ships wait out here to get along side for the coal to come conveniently, and it is backed up in highly expensive railcars on the railroad tracks as a means of storage. I think that that is an area that ought to be addressed.

I just simply hate to see the potential resources that are needed for that kind of development dissipated or broadcast to new shopping centers and hotels, and facilities of all kinds, and creating new tax shelters for builders, and for others.

Senator ROTH. I think we all agree that housing is not adequate for our people.

Let me make one observation. I don't disagree with what you are saying about coal. I think that that is a very strong potential of export. At the same time, I want this country to be more than an exporter of raw materials. I want to see this country export American manufactured goods because I think that means jobs here at home.

In the old days it was the colonies that exported the raw materials, and I don't think that that is the real answer. It is part of the answer, but I think what I am concerned about is that in all our industry, even our high technology, we see our competitive edge eroding and being threatened by not only Japan and West Germany, but by a lot of the newly developing countries, and even some of the underdeveloped.

I would like to ask, if I might, just one brief question because my time is up.

Would you agree that it is more meaningful to try to create permanent jobs in the private sector than to create Government jobs for helping the poor?

Should our goal be to try to expand the job work force in the private sector, that that is a higher priority than creating jobs through Government activity?

Mr. KIRKLAND. Sir, if I had that choice, if jobs were going to be offered and created, a permanent job is, per se, a better job than a temporary one. I think that most people would probably rather work in the private sector. I would rather negotiate with a private employer than with a public agency. They are more civilized. [Laughter.]

They don't have the court, the Army, the Navy, and the police at their disposal automatically.

But I doubt if that is the real nature of the choice. I think that we have an emerging situation where we have what is truly a vast number of people being thrown out of work, and there needs to be work created. Creating work, I think, is better than transitory unemployment compensation.

The only way I see for picking up a good bit of that slack is a revival and enlargement of public service employment.

Senator ROTH. Would you agree, sir, long-term that our efforts should be primarily to create an environment of growth where renewed jobs are created in the private sector, forgetting for the moment the short-range need to do something.

Mr. KIRKLAND. I would certainly hope that that would take place, sir, but I still subscribe to the notion that somehow has gotten lost in the shuffle, but which a few years ago had a wide spectrum of support at the depth of our last big recession, that the Government ought to be prepared to be the employer of last resort.

Senator ROTH. Thank you, Mr. Chairman.

I would just say that what seems to me of critical importance is that this Government adopt policies that will promote growth. The problem in the past is that we haven't.

I will just point, Mr. Chairman, that according to Mr. Felstein before the Joint Economic Committee, of our $386 billion of gross private investment, once we subtract replacement of wearing out capital stock, residential investment, antipollution and safety control equipment, real private investment amounted to about $40 billion, and many people believe that that is part of the problem. We don't have the essential capital formation.

Thank you, Mr. Chairman.

Mr. KIRKLAND. I would like to make just one other point, sir, which I touched on earlier.

I think the greatest deterrent to investment, and the greatest shock that our economy suffered, and the greatest blow to industrial growth and development, was the monetary policy that was invoked in recent months, and has been from time to time invoked with much praise in financial quarters—the curtailment of the supply, and the exorbitant increases in the price of money.

No matter what you do here, there ought to be some coordination. You can proceed along these lines in the name of stimulating investment, and tomorrow morning you could have a sudden runup in the prevailing rate of interest, and all is canceled out and nullified.

I suggest to you, sir, that the cost and supply of money in the money markets of this country have a far greater effect than taxes. If a manufacturer made a fundamental investment decision on the basis of a tax gadget, I would not be willing to bet very much on the long term survival of his firm operating on that kind of motivation.

Senator BYRD. The Senator from Texas, Mr. Bentsen.

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

Let me apologize for my lateness in arrival, but I have been chairing a hearing in the Joint Economic Committee on a somewhat similar subject.

Mr. Kirkland, I am delighted to see you here. I think you make a good point on the increasing burden of the social security tax. Something along the lines of the Bradley-Gephardt approach would help to ease that burden. I think that has to be part of the tax cut.

I personally favor a tax cut, but I think it has to be a selective one that helps beat inflation by increasing production lines, rather than unemployment lines. That means putting more goods on the shelves in a more efficient way, and at lower prices, and being more competitive.

I chaired some hearings in the Far East. In talking to people who were trying to sell U.S. products overseas, the complaints were against the American Government and the disincentives. They were also against American management for not being more interested in foreign trade.

I feel very strongly that labor and business ought to be doing everything they can to increase that foreign trade, so we are not exporting the jobs, but we are exporting products.

I believe that we can put more efficient and better tools in the hands of the American worker if we carefully approach this subject of accelerated depreciation.

I share with you the idea that there should be a low priority for new shopping centers and office buildings. What we are talking about is improving the manufacturing capacity of this country.

You made a point that I am introducing legislation on, and I would like to have the input, and that is the point about refurbishing plants where they are. There has been grave concern on the part of some of my colleagues that if we have something like 10-5-3 it is going to move it all to the Sunbelt. As one who represents a State in a very hot sunbelt, we don't want them all down there. Give us some time to breathe and catch up.

I think that we are beginning to understand that the problems of the Ohio Valley are our problems, too. We are going to help pay them one way or the other. So I am working on legislation to try to give some kind of a tax incentive to the refurbishing of a plant building in these areas.

We have some costs that are not just on the corporate balance sheet when we move a plant, such as the cost of unemployment compensation. We have the personal problems of the families that are uprooted. We have the lower tax base of the city from whence they moved.

So as we are studying this, I would like very much to have the input on how you think we can structure to help in that regard.

Now, if with that incentive they still move, then that means that the economics are just overwhelming, and they have to move. But I would appreciate any comments you might have now as to what you think we should do in that regard.

Mr. KIRKLAND. We certainly agree with your objectives on that, sir, without reference to the specific method and the contents of the legislation. One of the problems with not only the accelerated depreciation proposals, but investment tax credit was that it did tend to subsidize runaway plants, or plants that left a community in some distress and relocated elsewhere, and secured thereby some tax advantage.

Anything that would tend to neutralize that effect we would certainly view with favor, including doing it retroactively in the case of the investment tax credit.

Senator BENTSEN. Do you have any suggestions on what we can do to increase our share of exports and trade?

Mr. KIRKLAND. Sir, we have from time to time, I think, made some proposals along that line. I think reciprocity is the essence of it. I think there is a proliferation of hidden and overt devices that are leveled against us, plus the fact that many of our manufacturers have made a separate peace with the existing protectionist systems that exist in other markets.

They find it easy to accommodate themselves to those. They simply jump the fences and settle there, and then take advantage of them and work in that market. Our members cannot do that. The workers stay behind. That is a key source of the problem, and that compounds itself because once they accommodate themselves to the incentives and barriers that other countries create, they then become more and more adverse to producing here to compete with that market which they have accommodated themselves to behind those barriers.

A great mystery to me, and anyone who has traveled and looks at it carefully I think would ask himself the question, is the extraordinarily high price of American products in those markets.

Senator BENTSEN. Mr. Kirkland, do you know what we ought to do in Japan. They take out full pages in this country to advertise their cars. In business magazines, I see sections where they are advertising. We ought to take the price of American products in Japan and here, and Japanese products over here and there, and just run pages.

Mr. KIRKLAND. I would not confine it to Japan, sir. I think that you will find the thing in Europe.

Senator BENTSEN. I understand that. I was just using Japan as an example.

I would put the price of beef, and I would put the price of an automobile, of a Pinto, and of a Toyota, what it sells for in Japan, and what it sells for in the United States, right on down the line, and let their people see it and read it. I think that we would make our point.

Mr. KIRKLAND. I have observed in shops and elsewhere in Europe product after product where the delivered price of an American product is two, three, or four times what it sells for here. The case should be the reverse because of the collapse of the American dollar in those markets, which ought to permit us to easily undersell, but it has not happened.

Senator BENTSEN. Their products are selling at the same price in both places.

Thank you very much.

Senator BYRD. Just two brief questions, Mr. Kirkland.

Does the AFL-CIO favor or oppose additional restrictions on imports, particularly automobile and steel?

Mr. KIRKLAND. The answer would be yes.

Senator BYRD. What in your judgment should have top priority today, the fight against inflation, or the fight against unemployment?

Mr. KIRKLAND. I don't think that that is the real nature of the choice, sir. I believe that unemployment is inflationary. Unemployment throws this budget out of balance, and creates the deficit which common wisdom, I think, regards as inflationary.

Senator BYRD. I am delighted to hear you say that. I did not realize from your public statements that you regarded deficit as inflationary. That is a good piece of news for me today.

I have read your statement carefully, and my impression, and maybe it is the wrong impression, that it is one of opposition to any reduction in the high taxes facing the American people today, and simultaneously advocating more and more Government spending. To me that is the old New Deal philosophy, which I think is out of date these days. Obviously, you don't think so, but I think it is out of date.

Mr. KIRKLAND. No, sir.

Senator BYRD. I might say that in every election that I have ever been in, the leadership of the AFL-CIO has done everything it can to defeat me, but the working people——

Mr. KIRKLAND. With indifferent success, sir.

Senator BYRD. But the working people of Virginia do seem to have a better view of my philosophy, I am glad to say.

Mr. KIRKLAND. If I may on that point, sir. I would point out that the national AFL-CIO does not make the decision as to who endorses or supports a candidate at the State level.

Senator BYRD. That is good news. [Laughter.]

In any case, I am very happy with the decision of the bluecollar workers, and the working people in the State of Virginia. They have been very kind, and much too generous.

Thank you very much for your testimony, Mr. Kirkland.

Mr. KIRKLAND. Thank you.

[The prepared statement of Mr. Kirkland follows:]

STATEMENT OF LANE KIRKLAND, PRESIDENT, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

The AFL-CIO believes that a tax cut now is inappropriate and economically unwise.

A nation beset with inflation and recession does not need a tax cut that will make inflation worse and will do little about getting unemployed Americans back to work. Rather, the nation needs a program that will create jobs for the unemployed—and not tax breaks for those who already pay less than their fair share in taxes.

The link between a reduction in taxes—particularly a tax cut heavily weighted toward those with the highest incomes—and job creation is too imprecise, the lag in time too great. The nation needs a program that will get the eight million unemployed workers back to work as soon as possible.

America needs an economic stimulus program that is targeted to people and areas that need help the most. The nation would be ill-served by enacting an economic abstraction that ignores the differences between dollars that generate jobs, build homes or enhance a skill and those that underwrite the playgrounds of the rich, corporate take-overs or the flight of industry from hard-pressed urban area.

The nation does not need a tax cut that is politically motivated and has, at best, shaky grounding in economic fact. A tax cut program pushed through in the twilight hours of a legislative session, in the heat of a presidential election and in response to a campaign oratory would not be in the best interests of the country or taxpayers.

The AFL-CIO believes the nation would gain far more benefit from programs that would create jobs, reduce unemployment and ease the burden on the unemployed and the poor. That is why we have called for—and today reiterate the need for:

Expanded public service job opportunities;

A local public works program, financed by the federal government and which can start up quickly that would rebuild public facilities ravaged by years of neglect;

Additional funds for low and moderate-income housing:

Federal aid to maintain essential services in states and localities suffering high unemployment and resultant revenue loss;

Strengthened and extended unemployment insurance programs;

Maintenance of health care benefits and food stamps for the unemployed.

Establishment of special short-term mortgage relief and temporary housing programs for the unemployed.

Such a program would create jobs quickly and provide relief to those directly injured by the recession in a non-inflationary manner.

We believe that targeted, specific programs are more effective than broad-scale, across-the-board efforts.

That is why, if Congress decides to go ahead with a tax-cut bill, we believe it would make sense this year—or as soon as the 97th Congress convenes—to nullify any adverse effects on jobs and purchasing power that would result from the 1981 increases in contributions to Social Security.

Employee and employer contribution rates will increase from 6.13 percent to 6.65 percent on January 1, and the wage base is scheduled to increase from $25,900 to $29,700. This increase while necessary to maintain the financial integrity of the Social Security System, would deprive the economy of about $10 billion of worker and business purchasing power in fiscal 1981 and approximately $15 billion in the calendar year.

Legislation has been introduced—H.R. 7046 by Rep. Gephardt and S. 2920 by Sen. Bradley—that would provide a refundable tax credit equal to 10 percent of the Social Security contributions of employees, employers and the self employed.

As Table 5 demonstrates, this type of tax cut would more than offset the scheduled increase for most wage earners, while not affecting the financial stability of the Social Security Trust Fund.

Such a tax cut would meet the standards of fairness, targeted relief to those who need it and help in the fight against recession—standards we believe should be applied to every tax cut proposal.

The so-called Reagan-Kemp-Roth tax cut proposal does not meet the standards of fairness, equity or targeted relief. It is not the product of visionary economics; rather it is little more than the old "trickle-down" economics wrapped in a new package for the fall campaign.

The tables based on Treasury and Joint Committee on Taxation data, which we have appended to our testimony, condemn the Reagan tax cut proposal as unbalanced and inequitable.

It is evident from these figures that:

The Reagan proposal is a raid on the federal Treasury. The 10 percent across-the-board cut in tax rates and the speedup in depreciation would cost $34.7 billion in 1981; by 1985 the cost more than triples to $117.1 billion.

The Reagan proposal primarily benefits the wealthiest in this society. Despite the appearance of equity by the phrase "across-the-board," this tax cut proposal has been designed to concentrate its impact in the highest tax brackets. The average worker in the private sector, according to the Bureau of Labor Statistics, earns about $12,000 a year. The proposed tax cut for a family of four supported by this worker would be $92 a year—or $1.77 a week. That is about the cost of a gallon of milk. At the same time, a family of four with a $100,000 income would receive about $2,190 a year.

The Reagan proposal would abandon the principle of taxation on ability to pay. About 15 million low-income taxpayers, who face higher Social Security taxes on January 1, would receive no benefit from the Reagan proposal. The 86 percent of all taxpayers who earn less than $30,000 a year would receive only about 50 percent of the tax reduction. At the same time, the wealthiest 3 percent of taxpayers would net about one-quarter of the benefit of the tax cut. Combined with the business tax reductions as a result of the proposed depreciation speedup, corporations and the wealthy would receive the bulk of the tax reduction.

The Reagan proposal is even counter to the Republican platform, which pledges that the family would receive priority tax consideration. But under the proposed Reagan tax cut individuals would, (except for the $100,000 and more income bracket) receive substantially greater benefit than a family with two children.

The Reagan proposal is, in reality, an attempt to place a greater amount of the tax burden on individuals. It would accelerate the trend which started in the mid-1960s of a declining share of the cost of government being assumed by corporations. Indeed, by 1985 corporations would assume less than 12 percent of the income tax burden and only 6 percent of the cost of government if the Reagan proposal were adopted.

The Reagan proposal would nearly halve corporate income taxes. By 1985, business would receive a corporate income tax cut of about 45 percent, compared with 10 percent for individuals.

The Reagan proposal would, by 1985, give the majority of its benefit to corporations. While 90 percent of the tax cut would go to individuals in the first year, that share shrinks constantly and by 1985 individuals would receive less than half of the tax cut.

The 10-5-3 depreciation speed-up part of the plan, in addition to its huge revenue and equity costs, would replace the present system of tax depreciation—generally based on the cost and useful life of the asset—with an entirely new and dramatically accelerated system. This new method destroys any linkage between the actual cost of an asset and its actual useful life. Under the Reagan proposal, there would be only three classes of capital assets and the annual depreciation write-off would be the same for all items within the class regardless of useful life.

Buildings and structural components would be written off in 10 years. Presently, the average depreciation "life" of a building is 32.6 years. Machinery and equipment would be written off in 5 years—the present average is 10.2 years. And for autos and light duty trucks a 3-year write-off would apply, compared with the current 3.5 year average.

The measure would also retain the "double-dip" in the present law which allows companies to ignore the 10 percent investment credit when calculating annual depreciation write-offs. In other words, a company that buys a piece of equipment for $1,000, receives a $100 tax credit that cuts the actual cost of the equipment to $900. Nevertheless, the corporation can still write-off the full $1,000—in effect deducting 111 percent of its cost.

Thus, under the 10-5-3 proposal, a company would be able to: (1) write-off more than the cost of the asset; (2) do it in approximately half the normal time; and (3) front load the deductions so much that 84 percent of the actual cost would be written off in only one-third of the actual lifetime of the equipment.

Our concern about the proposed tax cuts for business is greater than its cost or the fact that it is bad tax policy. In reality, the Reagan proposal amounts to a subsidy for the business community through the backdoor.

Technically, of course, depreciation speed-ups amount to a "deferral" of tax—and not an avoidance—since the deduction eventually runs out and taxes in later years are correspondingly higher. Thus, excess depreciation is an interest-free loan. However, since firms routinely and continually invest and reinvest, the "loan" is constantly recycled and never paid off. At current interest rates, money doubles in less than 7 years. Thus, "deferring" taxes for 7 years is equivalent to paying no taxes at all, and represent a clear-cut and substantial subsidy to business.

We believe the Congress should determine needs and impact before enacting such a subsidy through the tax code. For example under the Reagan proposal industries using more capital relative to labor would receive the greatest tax subsidies. Firms that use plant and equipment with longer service lives would be given greater advantage over those using shorter-lived plants and equipment.

The Treasury Department estimates that the tax break woud be equivalent to about 20 percent of the investment of the communications industry. Yet, the three areas of the economy that are suffering the most from the current recession—primary metals, motor vehicles and construction—would receive less benefit. The primary metals industry would be able to finance about 15 percent of its investment from this tax cut proposal; motor vehicles only 8 percent and 4 percent for the construction industry. Wholesale and retail trade, along with other services, would receive lower benefits. Obviously, the benefits received from the tax break would have little or no relationship to the particular problems or needs of the industries or the economy.

In general, across-the-board business tax incentives are an ineffective and inefficient method of solving the types of economic problems the nation confronts today. If tax policies can be tailored to meet those problems—within the framework of a coordinated national effort to bring about full employment and enhance this nation's industrial base—we would be their most outspoken advocates.

Unfortunately, the track record of attempts to use general tax forgiveness to subsidize or encourage particular actions is poor. Needed revenue is dissipated through providing benefits to firms for doing what they would do anyway. The larger and more prosperous corporations that are least in need of aid get the lion's share of the benefits, and each new provision tends to develop a life of its own. The results often make the tax structure more complex. New constituencies for special privileges are generated, further eroding the tax base and loading more of the burden on those who are already paying more than their fair share.

Why, for example, should a company located in a center city with heavy unemployment be encouraged—through a tax incentive—to move elsewhere? Why not shape the incentive to induce the company to modernize its facilities and equipment and remain in the urban area.

Targeted tax incentives might apply to firms willing to invest in areas served by mass transit rather than far-away suburban parking lots. Such an incentive would make sense in terms of providing jobs for inner-city residents and public support for mass transit, which would help conserve energy.

Incentives might be used to encourage diversification of industry, particularly in communities whose destiny is linked to the performance of a single company or industry.

Moreover, in light of the huge and costly array of existing business "tax incentives," why not think in terms of sticks as well as carrots? The Investment Tax Credit alone amounts to over $18 billion in foregone annual revenue. Why not, for example, deny this credit where the investment does not fit in with national goals.

Why continue to permit tax "deferral" privileges to firms that invest abroad to produce for U.S. Markets?

Why should American tax policy provide rapid write-off benefits to a U.S.-based corporation that builds new facilities with foreign steel and materials, puts into those facilities imported machines and equipment and utilize foreign-made vehicles to transport its goods? There is little or no benefit here to American workers or American industry. Perhaps a domestic content requirement should be part of any tax benefit.

Tax policy—if it's to be a tool for reindustrialization—must be structured in terms of precise and planned goals. It must be flexible and selective, not across-the-board. If, indeed, there is a need to promote investment or discourage consumption, we must first answer the questions "whose consumption?" and "which investment?"

Rather than just providing for general across-the-board cuts in depreciation, a new targeted program should be developed. Such a program could be initiated as part of a new overall industrialization policy that includes a frame work for funding domestic federal financial assistance programs.

A new tripartite Industrialization Board should be established that would have policy responsibilities for spurring industrial development. This Board should direct the activities of a financial institution that would have a fixed amount of money budgeted for the program. The amount and type of tax incentive or accelerated depreciation allowance granted to a particular industry or company would be determined on a case-by-case basis with some type of certificate of necessity. Since such a program would be subject to the appropriations process, the Congress would maintain oversight responsibility. Yet the expertise of public and private parties would be brought together to solve the nation's economic problems. At the same time, the experience in particular segments of industry could be monitored and evaluated.

But such measures cannot be shaped in isolation or handled in the closing hours of a legislative session. And, if a precipitous, costly, across-the-board tax cut, such as the Reagan proposal, is adopted, there will be that much less available to begin the programs and measures, including tax cuts, that can put the nation back to work.

TABLE 1
ESTIMATED REVENUE COST OF REAGAN - KEMP -
ROTH TAX PROPOSAL, 1981-85

	Fiscal Year 1981	Calendar Year 1981	1982	1983	1984	1985
Ten percent tax rate reduction for individuals (in billions of dollars)	$18.9	$30.3	$36.5	$43.0	$50.0	$ 57.4
10-5-3 depreciation for businesses (in billions of dollars)	2.0	4.4	11.4	24.8	41.5	59.8
Total (in billions of dollars)	$20.9	$34.7	$48.0	$67.8	$91.5	$117.1
Percent of total tax reduction for business	9.6%	12.7%	23.8%	36.5%	45.3%	51.0%
Percent of total tax reduction for individuals	90.4%	87.3%	76.2%	63.5%	54.7%	49.0%

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

TABLE 2

THE CORPORATE SHARE OF THE COST OF GOVERNMENT

			Corporate Income Tax	
Fiscal Year	Total Federal Budget Receipts (billions)	Total Income Tax Receipts (Corp. & Indv.) (billions)	% of Total Budget Receipts	% of Income Tax Receipts
1965	$ 116.8	$ 74.3	21.8 %	34.3 %
1970	193.7	123.2	16.9	26.6
1975	281.0	163.0	14.5	24.6
1980e	517.9	306.2	12.6	21.4
1981e	604.0	344.6	11.0	19.3
1985e	1052.7	634.6	10.6	17.6

Note: 1965 - 1975 actual; 1980 - 1985 Office of Management and Budget estimates and projections

Source: The Budget of the United States various years, Mid - Session Review of the 1981 Budget

TABLE 3

REAGAN - KEMP-ROTH TAX PROPOSAL
INDIVIDUAL INCOME TAX REDUCTION*

Adjusted Gross Income	Single Taxpayer	Married Couple No Dependents	Married Couple Two Dependents
$ 8,000	$ 94	$ 52	$ 12
10,000	134	92	52
12,000	165	132	92
15,000	232	191	151
17,500	289	230	190
20,000	347	268	228
25,000	486	350	305
30,000	640	465	405
35,000	794	618	538
40,000	981	772	692
50,000	1,366	1,080	1,000
100,000	1,451	2,210	2,190

* Assumes taxpayer uses standard deduction or has deductable personal expenses of 23 percent of income, whichever is greater.

TABLE 4

REAGAN - KEMP-ROTH TAX PROPOSAL
DISTRIBUTION BY INCOME CLASS

Annual Income	Number of Taxpayers (millions)	% of Taxpayers	Tax Reduction (billions of dollars)	% of Tax Reduction	Average Reduction Per Taxpayer (dollars)
0-$10,000	20.4	28.2%	$ 1.45	4.8%	$ 71
$10- 15,000	14.2	19.6	2.76	9.1	194
15- 20,000	11.8	16.3	3.70	12.2	314
20- 30,000	15.7	21.7	7.58	25.0	483
30- 50,000	8.0	11.0	7.42	24.5	928
50-100,000	2.0	2.7	4.36	14.4	2180
100,000 & over	.4	.6	3.03	10.0	7575
Total	72.5	100.0%	$30.30	100.0%	$ 418

Source: Economic Research Department, calculations based on U.S. Treasury and Joint Committee on Taxation estimates.
AFL-CIO

TABLE 5

EFFECT OF REAGAN-KEMP-ROTH 10% TAX REDUCTION PROPOSAL
AND 10% OF SOCIAL SECURITY REDUCTION

Adjusted Gross Income	Reagan-Kemp-Roth 10% Reduction*			10% of Social Security	
	Single Taxpayer	Married Couple No Dependents	Married Couple Two Dependents	One Earner	Two Earners**
$ 5,000	$ -	$ -	$ -	$ 33	$ 33
8,000	94	52	12	53	53
10,000	134	92	52	67	67
12,000	165	132	92	80	80
15,000	232	191	151	100	100
17,500	289	230	190	116	116
20,000	347	268	228	133	133
25,000	486	350	305	166	166
30,000	640	465	405	198	200
35,000	794	618	538	198	233
40,000	981	772	692	198	266
50,000	1,366	1,080	1,000	198	333
100,000	1,451	2,210	2,190	198	396

* Assumes taxpayer uses standard deduction or has deductable personal expenses of 23 percent of income, whichever is greater.

** Assumes each spouse earns half the income.

Note: Over 15 million low and moderate income workers that pay no income tax because their incomes are below the taxable threshold would benefit from the 10% of Social Security reduction.

AFL-CIO Department of Economic Research

Senator BYRD. May I say, Senator Williams, that we regret very much holding you up. I know you have many duties, both as chairman of the Labor Committee, and on the floor of the Senate, and we regret holding you up. But there was a great deal of interest in Mr. Kirkland's testimony.

STATEMENT OF HON. HARRISON A. WILLIAMS, JR., U.S. SENATOR, STATE OF NEW JERSEY

Senator WILLIAMS. I appreciate that. I had an opportunity to hear much of it, and I appreciate that, too.

I know that you have a great deal of work ahead of you at this hearing, and many people waiting. I appreciate the opportunity to make a statement, and would ask, if I could, that my whole statement be placed in the record.

Senator BYRD. Yes, your complete statement will be made part of the record.

Senator WILLIAMS. I would like to zero in the specific item that I wanted to be here to talk about. I share what I sense is the general feeling of the wisdom of moving now on measures of tax reform and tax relief. One aspect I have introduced legislation on deals with the question of what tax action could best help the entire realty and construction sector recover from a rate of decline which far exceeds that which we witnessed during the 1974-75 recession.

I know that later witnesses will address themselves to, and I know that the committee will examine, the bill the that I have introduced, the Real Estate Construction and Rehabilitation Tax Incentives Act of 1980. I would like to very briefly review its principal provisions with the committee.

The Code would be simplified, and construction would be spurred, by providing for straight-line, 20-year depreciation for all new construction. The only exception to this rule would be a 15-year writeoff for low-income assisted housing, to assure the continued flow of investment capital. I also propose that an alternative, experimental tax credit be established on a 4-year basis. This would test a Congressional Budget Office theory that such a credit would, particularly in the rental housing area, provide a more efficient stimulus.

In tandem with these shortened depreciation lives, section 189 of the Code would be repealed. Currently, realty development is placed at a severe disadvantage by the barring of current deductions for interest and taxes permitted in other enterprises.

I would like to pause to point out that the combined estimated long-term revenue losses from these two changes would be only about one-third those occurring under the 10-year accelerated depreciation schedule proposed in the Capital Cost Recovery Act. My proposal has the further attractions of assisting rental housing and enjoying the broad support of development professionals.

Code provisions providing for the rapid depreciation of rehabilitation expenses for low-income rental housing would be updated to reflect current costs. Further, the availability of this preferential treatment would be extended to all rental projects. Our best immediate means for meeting the rental housing crisis is to upgrade and preserve as many existing units as possible.

The very effective and successful Code provisions spurring retention and rehabilitation of historic properties would be permanently enacted. Our heritage will best be preserved, and our communities best enhanced, if these incentives can be counted on.

A number of other existing provisions are changed and clarified. The incentives for removal of architectural barriers would be permanently enacted. Preopening expenses incurred within 2 years of a property's placement in service would be deductible. Greater flexibility in the use of tax-exempt housing bonds would be permitted. The ceiling would be removed for deductible realty investment indebtedness. And the closing of the "vacation home loophole" would be clarified to end its present effect of discouraging a family member from renting shelter to another.

Finally, the legislation proposes what I believe to be a most innovative and positive response to some of the problems arising in the controversial area of condominium and cooperative conversions. As the committee no doubt knows, the Code helps create much of the demand for such units, and also dictates that almost all conversions are carried out by third-party professionals rather than by the landlord-owner.

The conversion of rental units is accelerating, and is spreading to every region and every size community. A congressionally mandated study, just issued by HUD, projects that more than 1 million apartments will be converted during the next 5 years. This study also found that up to two-thirds of tenants are uprooted by conversions and that the elderly in particular are adversely affected.

I propose that a landlord be given more favorable capital gains treatment when he converts—if the terms and conditions have been worked out with a representative tenants' organization. This change would hold out the carrot of mutual economic benefits to tenants and owners by permitting them to, in effect, split the extra layer of profit now generated by the participation of the third-party converter. Landlords would receive higher profits, while tenants would get lower purchase prices and the opportunity to negotiate special provisions such as relocation assistance and long-term tenancy for the elderly.

I would further encourage the creation of less costly limited-equity cooperatives, and the reinvestment of conversion proceeds in new rental construction, through special tax-free rollover treatment.

I hope the committee will give serious consideration to this portion of S. 2969, as it could advance very worthwhile social goals with minimal revenue loss, and absent regulatory burdens.

Mr. Chairman, in closing, I would again implore that the committee's recommendations for Code changes benefiting business provide equitable treatment for all areas of construction activity, including rental housing. Revving up the massive engine of the building industry can pump new life throughout the economy, and take tens of thousands of workers off unemployment rolls and put them back onto payrolls.

Many misstatements have been made that the Code already provides too many incentives for realty investment. It is true that tax laws help to underwrite the American dream of homeownership, but when attention is focused solely on incentives for business, it is clear that present law discriminates against investment in plant versus other capital expenditures. Yet, new plant is equally important for increased productivity, and higher employment.

A fiscally responsible, carefully developed and targeted real estatge incentive package, such as I have proposed in S. 2969, will remove that discrimination and benefit all areas of the Nation.

I wish to thank the committee for this opportunity. These are very significant hearings that the committee has embarked upon, and I know your witnesses to follow will also be offering very helpful and wise counsel. I notice that a later panel will address itself, in large part, to the bill that I have just discussed.

Senator BYRD. Thank you very much, Senator Williams, for a very interesting proposal, which seems to me to have a great deal of merit.

I am not clear; does it encompass the 10-5-3 depreciation proposal?

Senator WILLIAMS. It reaches the same area. It is, I suggest, less costly, perhaps more efficient, than the 10-5-3. It is straight line 20 years, with one exception where it would be 15 years for certain of the rental assisted housing.

The witnesses to follow, from the industry, will describe their feeling about the 10 of 10-5-3, and will have comments that indicate great effectiveness and efficiency with the straight line 20 that is in this bill.

Senator BYRD. The 20-year proposal in the bill that you have introduced, does that provide for the accelerated depreciation within that 20-year period?

Senator WILLIAMS. It is straight-line, although within this bill there is the investment tax credit as an opportunity, as an alternate opportunity. Again, the witnesses to follow who work in the industry can address these with greater knowledge of impact, and how they feel that the various means would most efficiently and effectively advance what we are trying to do here, and that, of course, is bring through tax policy the stimulant into realty investment.

It is a time when we all know the problems created right now from the discouragement of investment in construction and real estate, and residential construction.

Senator BYRD. Just one final question. You mention the removal of architectural barriers. What do you mean by that?

Senator WILLIAMS. That is again using tax policy to make through architecture buildings more accessible to those who have limited access because of architectural barriers.

Senator BYRD. Thank you very much.

Senator Bradley.

Senator BRADLEY. Mr. Chairman, I have no questions, other than to say that it is always a pleasure to see my senior colleague, who through his work on the Banking Committee through the years, has been one of the real leaders in housing legislation. Anything he brings before the Finance Committee I am sure will be looked at very carefully, and his recommendations taken very seriously.

I am pleased to see you, particularly after last night.

Senator WILLIAMS. I come to you from either committee. Last night, of course, it was the Labor Committee and ERISA, and today it is from the Banking Committee and Housing. But is it always a pleasure and an educational experience to be working in partnership with the Finance Committee, and a great honor, and late work.

Senator BYRD. Thank you, Senator Williams. We were very pleased to have you.

[The prepared statement of Senator Williams follows:]

PREPARED TESTIMONY OF HARRISON A. WILLIAMS, A SENATOR FROM THE STATE OF NEW JERSEY

Mr. Chairman and members of the Committee, I very much appreciate the opportunity to testify before you regarding the crucial questions of tax relief and reform. Your deliberations and decisions on this issue will do much to determine whether this nation can successfully overcome inflation, unemployment and declining productivity.

Mr. Chairman, with your permission, I shall keep my oral statement brief and ask that my remarks at introduction, as well as the text and a summary of the legislation I shall discuss, be printed in full in the hearing record.

A survey of current economic opinion leaves the impression that, hopefully, the worst of the recession is behind us—but that recovery will be extremely slow unless stimulative action, such as a tax cut, is taken. I would urge the Committee, in fashioning such a cut, to adhere to a number of basic principles—

It should take effect in 1981, rather than being phased-in over a number of years.

It should be reasonably divided between business and individuals. On the business side, it should be carefully targeted to achieve maximum efficiency.

It should advance the goal of tax simplification.

It should be seen as helpful by those business sectors which it purports to assist. And, within each sphere of business activity, it should let individual judgments rather than the code determine investment decisions.

Earlier in this Congress, I became a cosponsor of the Capital Cost Recovery Act because I support depreciation reforms which can spur investment and productivity. However, while still in support of that bill's thrust, my further review has led me to believe that its treatment of new capital construction is inefficient and incomplete.

Let me first address a serious omission in that legislation. As Chairman of the Subcommittee on Housing and Urban Affairs. I am deeply concerned by the collapse of the private rental housing sector. The national vacancy rate and unsubsidized rental starts are at their lowest level in two decades, and there is no light at the end of this tunnel. This intolerable shortage inflates housing costs and is beginning to limit Americans' mobility, and, therefore, the ability of business to attract qualified personnel where relocation is required.

Therefore, I would implore that the Committee include rental housing within whatever alteration it reports for realty depreciation. To omit it will, quite simply, take this economic activity from the sickbed and place it in the grave.

Now, let me turn to the more general question of what tax action could best help the entire realty and construction sector recover from a rate of decline which far exceeds that witnessed during the 1974-75 recession. In this regard, I would urge the Committee to carefully review legislation which I introduced on July 24th. Senate Bill 2969, The Real Estate Construction and Rehabilitation Tax Incentives Act of 1980, proposed what I believe to be the most comprehensive revision of code treatment of this area in more than a decade. Later this morning the Committee will hear from trade associations far more expert than myself concerning the projected effects and tax expenditure consequences of this bill.

Briefly, however, it would do the following:

The Code would be simplified, and construction would be spurred, by providing for straight-line, twenty-year depreciation for all new construction. The only exception to this rule would be a fifteen-year writeoff for low-income assisted housing to assure the continued flow of investment capital. I also proposed that an alternative, experimental tax credit be established on a four-year basis. This would test a Congressional Budget Office theory that such a credit would, particularly in the rental housing area, provide a more efficient stimulus.

In tandem with these shortened depreciation lives, Section 189 of the Code would be repealed. Currently, realty development is placed at a severe disadvantage by the barring of current deductions for interest and taxes permitted in other enterprises.

Let me pause to point out that the combined estimated long-term revenue losses from these two changes would be only about one-third those occurring under the ten-year accelerated depreciation schedule proposed in the Capital Cost Recovery

Act. My proposal has the further attractions of assisting rental housing and enjoying the broad support of development professionals.

Code provisions providing for the rapid depreciation of rehabilitation expenses for low-income rental housing would be updated to reflect current costs. Further, the availability of this preferential treatment would be extended to all rental projects. Our best immediate means for meeting the rental housing crisis is to upgrade and preserve as many existing units as possible.

The very effective and successful Code provisions spurring retention and rehabilitation of historic properties would be permanently enacted. Our heritage will be best preserved, and our communities best enhanced, if these incentives can be counted on.

A number of other existing provisions are changed and clarified. The incentives for removal of architectural barriers would be permanently enacted. Pre-opening expenses incurred within two years of a property's placement in service would be deductible. Greater flexibility in the use of tax-exempt housing bonds would be permitted. The ceiling would be removed for deductible realty investment indebtedness. And the closing of the "vacation home loophole" would be clarified to end its present effect of discouraging a family member from renting shelter to another.

Finally, the legislation proposes what I believe to be a most innovative and positive response to some of the problems arising in the controversial area of condominium and cooperative conversions. As the Committee no doubt knows, the Code helps create much of the demand for such units, and also dictates that almost all conversions are carried out by third-party professionals rather than by the landlord-owner.

The conversion of rental units is accelerating, and is spreading to every region, and every size community. A congressionally-mandated study, just issued by HUD, projects that more than one million apartments will be coverted during the next five years. This study also found that up to two-thirds of tenants are uprooted by conversions and that the elderly in particular are adversely affected.

I have proposed that a landlord be given more favorable capital gains treatment when he converts—if the terms and conditions have been worked out with a representative tenants' organization. This change would hold out the carrot of mutual economic benefits to tenants and owners by permitting them to, in effect, split the extra layer of profit now generated by the participation of the third-party converter. Landlords would receive higher profits, while tenants would get lower purchase prices and the opportunity to negotiate special provisions such as relocation assistance and long-term tenancy for the elderly.

I would further encourage the creation of less costly limited-equity cooperatives, and the reinvestment of conversion proceeds in new rental construction, through special tax-free "rollover" treatment.

I hope the Committee will give serious consideration to this portion of S. 2969, as it could advance very worthwhile social goals with minimal revenue loss, and absent regulatory burdens.

In closing, Mr. Chairman, I would again implore that the Committee's recommendation for Code changes benefitting business provide equitable treatment for all areas of construction activity, including rental housing. Revving up the massive engine of the building industry can pump new life throughout the economy, and take tens of thousands of workers off unemployment rolls and back onto payrolls.

Many misstatements have been made that the Code already provides too many incentives for realty investment. It is true that the tax laws help to underwrite the American dream of homeownership. But, when attention is focused solely on incentives for business, it is clear that present law discriminates against investment in plant versus other capital expenditures. Yet, new plant is equally important for increased productivity and higher employment.

A fiscally responsible, carefully developed and targeted real estate package, such as I have proposed in S. 2969, will remove that discrimination and benefit all areas of the nation. I will reemphasize that last point, Mr. Chairman, to try to dispel the concern that incentives for new construction will draw business from the nation's older manufacturing areas. I do not believe that any member has devoted more time to this issue of plant relocation than myself. Yet, nothing I have seen indicates that federal tax treatment is more than a footnote in such decisions, or that sound revisions of such treatment will encourage relocations. The proposal I have submitted will, I believe, be neutral in its regional effect. Except that, of course, the rental housing rehabilitation should be of considerable benefit to our older cities.

Mr. Chairman, this concludes my remark. I again wish to thank the Committee. I will be glad to answer any questions, either now or in writing at a future point in your deliberations.

[From the Congressional Record, July 24, 1980]

SENATE

By Mr. WILLIAMS (for himself, Mr. Stewart, and Mr. Cochran): S. 2969. A bill to amend the Internal Revenue Code of 1954 to provide incentives for the construction and rehabilitation of real property; to the Committee on Finance.

REAL ESTATE CONSTRUCTION AND REHABILITATION TAX INCENTIVES ACT OF 1980

Mr. WILLIAMS. Mr. President, I am today introducing a comprehensive package of Tax Code changes relating to real estate, which are designed to provide stimulus to the ailing construction industry. The legislation would also provide certainty in the code's treatment of amortization of structures, and in other technical areas, and provide simplifications which will reduce the bookkeeping costs of builders and diminish the chances of disputes arising between them and the Internal Revenue Service, I am pleased that Senators Stewart and Cochran have joined me in submitting this measure.

Mr. President, there are compelling long- and short-term reasons for the expeditious consideration and passage of this legislation. Viewing requirements for the future, there is widespread agreement that the present method of depreciation permitted by the tax code is unnecessarily complex and, in the context of inflation, does not permit business to set-aside a realistic amount to accommodate replacement costs. As for immediate needs, the powerful engine of construction, so critical to the Nation's economy, has been sputtering along and is in grave need of a tune-up if we are to lift the Nation out of recession and give millions of Americans the opportunity to get out of unemployment lines and back onto payrolls.

The latest available figures indicate that the rate of decline in construction activity during the first half of 1980 has been far steeper than during the 1974-75 recession, and there are no immediate prospects for a quick turnaround. The dismissal news becomes even more depressing when we consider new starts of residential rental housing by the unsubsidized market. HUD reports that only 130,000 unsubsidized rental units were built in 1979, the lowest level in two decades, and that no more than 50,000 such units are expected to be started during 1980. The result of this collapse of residential construction is the lowest national vacancy rate since the end of the Second World War. The contracting supply of rental housing is resulting in inflationary increases in the cost of shelter; and is beginning to limit the mobility of Americans to the extent that, in some areas of the Nation, it is becoming increasingly difficult for business to attract or retain key personnel due to the shortage of affordable housing.

Mr. President, this legislation will end the Tax Code's present bias against investment in structures and in so doing will boost the Nation's productivity by encouraging the construction of modern factories. Further, it will aid in the continuing development of a supportive infrastructure of commercial and retail property, and it will help to reverse the dramatic and unacceptable collapse of rental housing construction. It will do so principally by providing for straightline, 20-year capital cost recovery for all structures; and by repealing the present code requirement that construction period interest and taxes be amortized over a 10-year period, rather than currently expensed as it is permitted for all other economic activity. My approach is widely favored by the real estate industry over the most widely discussed proposal for altering the depreciation treatment of realty, the "10" provision of the Capital Cost Recovery Act.

First, while my proposal would provide significant stimulation in comparison to current law, it would not depart as radically from the actual lives of structures as 10-year accelerated depreciation would. Second, the implementation of this approach would take full effect as of January 1, 1981, whereas the phased-in approach of that other proposal would delay full implementation and might encourage many builders to defer new projects for some time. Third, while both proposals eliminate audit disputes with the IRS centered on the proper lifetime of the structure, the Capital Cost Recovery Act would provide for punitive recaputre of excess depreciation upon the sale of such assets in comparison to present law. My proposal would eliminate recapture entirely by adopting straight-line amortization. Finally, my proposal is far less costly, and less inflationary, than the "10" portion of "10-5-3."

Initial revenue loss figures calculated, on a static and conservative basis by the National Association of Realtors, indicate that the combined cost of 20-year structure lives and repeal of section 189, including rental housing, would start at $2 billion in 1981, rising to $3.3 billion in 1982, $4.8 billion in 1983, and $6.2 billion in 1984. In comparison, Data Resource, Inc.'s estimates for 10-year accelerated depreciation of all structures, exclusive of rental housing, would be \$5.8 billion in 1981, \$6.8 billion in 1982, \$13.5 billion in 1983, and \$17.1 billion in 1984.

In sum, Mr. President, the approach I am suggesting would result in only one-third of the revenue losses of the most widely discussed alternative while curing its serious defect of omitting rental housing construction. I believe that a \$2 billion tax cut for real property construction could be easily accommodated within the total business tax reduction currently being discussed for 1981 implementation. Further, the actual revenue loss would be far less when one factors in the feedback effect of reduced unemployment compensation costs, higher incomes of construction workers, and the overall productive and revenue-generating activities of the businesses housed in more efficient new structures.

Under my proposal, the only deviation from 20-year depreciation for structures would be to provide a 15-year lifetime for assisted low-income rental housing. The many difficulties involved in constructing and maintaining these projects require that investors be given somewhat more favorable treatment to assure a continuing supply of construction capital.

Mr. President, this legislation will also provide, on an experimental basis, a 10-percent investment tax credit which can be elected in lieu of depreciation. A 1977 study by the Congressional Budget Office speculated that, in the case of residentia' rental housing, such a credit would constitute an efficient use of tax expenditure dollars. I believe it is worth trying out this concept to test its value.

Another provision of great benefit to rental housing is an extension of the present Code provision allowing for the 5-year depreciation of rehabilitation expenses, with the minimum and maximum amounts eligible for such treatment adjusted to conform with inflation-induced cost increases. This bill would also make such favorable treatment available to all residential rental housing, not just that for low-income persons, on the theory that the best immediate step we can take to address the rental housing crisis is to preserve and upgrade the maximum number of existing apartments.

This legislation also proposes what I believe is an innovative and positive response in the controversial area of conversions of rental housing to condominums and cooperatives. This is an area of prime importance, especially in light of a just-issued HUD report predicting that more than 1 million rental units will be converted between now and 1985. I am very pleased that the Senate recently passed the minimum national tenant protection and disclosure standards which I proposed, and which were embodied in title V of S. 2719, the 1980 Housing and Community Development Amendments. The new provisions of this bill can complement those reasonable standards by utilizing the incentive of mutual economic advantage to bring tenants and landlords together to shape conversions which are more affordable and which make special adjustments for tenant difficulties. The present tax laws, in the words of a March 1980 Congressional Research Service analysis, "make it more attractive for the owner of a rental building to sell to a developer than to convert the units himself." This is because a sale to a developer receives favorable capital gains treatment, while a self-conversion's profits are taxed at higher ordinary income rates. As a result, professional conversion firms have arisen which, despite the denial of capital gains treatment, can still make large profits on individual unit sales, owing to the great demand for affordable housing of any type in this time of short supply.

I propose that a landlord be permitted to receive capital gains treatment in a self-conversion situation if the terms and conditions of the conversion have been worked out with a representative tenant's organization. In effect, this would permit landlords and tenants to split the added layer of profit that now is taken by the professional converter, resulting in a better price for landlords and low unit prices, and special considerations, for tenants. I do not believe that this proposal will encourage conversions to occur, but will certainly influence how they occur to the benefit of owners and tenants alike.

I further propose that where at least half the units are sold to persons of low and moderate income, or to a tenants' organization, and the seller reinvests his proceeds in new rental construction within 2 years.

Mr. President, this bill will also make many other beneficial Tax Code changes. It will remove the approaching expiration dates for those code provisions which encourage the retention and rehabilitation of historic properties, and the removal of architectural barriers to the handicapped. These provisions have shown their effectiveness, and in the absence of alternative proposals to achieve these same goals should be made a permanent part of the code so that developers can rely on them. Other changes include:

Clarifying present law to permit preopening expenses incurred within 2 years of a property's placement in service to be currently deducted;

Providing a technical correction to the "vacation home loophole" closing enacted in 1976 to make sure that it does not discourage relatives from assisting each other by denying tax benefits which would be available if a property is rented to a non-relative;

Providing for greater efficiency and increased rehabilitation activity in the use of tax-exempt housing bonds; and

Eliminating the ceiling for individual deductions of interest and investment indebtedness.

Mr. President, I believe that this legislation is a sound and responsible response to the most pressing issues of the day in the vital realm of real estate development. Although each of them has additional comments about specific portions of the legislation which will be articulated next week in Finance Committee hearings, virtually every group involved in the construction of new realty supports the overall thrust of this measure, including both private market and subsidized residential rental property developers, as well as those active in rehabilitation. There groups include the National Association of Homebuilders, National Association of Realtors, Coalition for Low and Moderate Income Housing, National Leased Housing Association, National Realty Committee, National Apartment Association, National Rental Housing Council, Building Owners and Managers Association, International Council of Shopping Centers, and Council of State Housing Agencies.

I welcome their support for a comprehensive revision of the Tax Code's treatment of realty, particularly in the areas of depreciation and construction period interest and taxes, and hope that all of my colleagues will also find reason to support this legislation after careful review of its provisions.

Mr. President, I ask unanimous consent that the text of this bill, and a section-by-section summary of its contents, be printed in the RECORD.

There being no objection, the bill and analysis were ordered to be printed in the RECORD, as follows:

S. 2969

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; AMENDMENT OF 1954 CODE

(a) SHORT TITLE.—This Act may be cited as the "Real Estate Construction and Rehabilitation Tax Incentives Act of 1980".

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

TITLE I—CAPITAL COST RECOVERY TREATMENT OF NEW SECTION 1250 PROPERTY

SEC. 101. DEPRECIATION OF SECTION 1250 PROPERTY

Subsection (j) of section 167 (relating to special rules for section 1250 property) is amended to read as follows:

"(j) SPECIAL RULES FOR SECTION 1250 PROPERTY.—

"(1) GENERAL RULE.—Except as otherwise provided in this section, in the case of section 1250 property subsection (b) shall not apply, and the term 'reasonable allowance' as used in subsection (a) shall mean only an allowance computed under the straight line method using a useful life of—

"(A) 15 years in the case of low income housing described in clause (i), (ii), (iii), or (iv) of section 1250(a)(1)(B), and

"(B) 20 years in the case of any other section 1250 property.

"(2) APPLICATION OF GENERAL RULE.—Paragraph (1) shall apply with respect to section 1250 property placed in service after the effective date of the Real Estate Construction and Rehabilitation Tax Incentives Act of 1980.

"(3) TRANSITIONAL RULE FOR USED SECTION 1250 PROPERTY.—In the case of section 1250 property acquired after the effective date of such Act, the original use of which did not commence with the taxpayer—

"(A) which is placed in service within 60 months after such date, paragraph (1) shall not apply and the provisions of this subsection, as in effect on the day before the date of enactment of such Act, shall apply with respect to such property, or

"(B) which is placed in service more than 60 months after the date of enactment of such Act, subsection (b) and paragraph (1) shall not apply, and the term 'reasonable allowance', as used in subsection (a), shall mean, at the election of the taxpayer—

"(i) an allowance computed under the straight line method using a useful life of 20 years, or

"(ii) an allowance computed using the remaining economic useful life of the property (determined in accordance with regulations prescribed by the Secretary.".

SEC. 102. TECHNICAL AMENDMENT

Subparagraph (C) of section 312(k)(2) is amended by striking out "(j)(1)(C)" and inserting in lieu thereof "(j)".

TITLE II—INVESTMENT TAX CREDIT FOR SECTION 1250 PROPERTY

SEC. 201. CHANGE IN INVESTMENT TAX CREDIT

(a) APPLICABLE PERCENTAGE.—Subsection (c) of section 46 (relating to qualified investment) is amended by adding at the end thereof the following new paragraph:

"(7) APPLICABLE PERCENTAGE FOR NEW SECTION 1250 PROPERTY.—Notwithstanding paragraph (2), the applicable percentage for purposes of paragraph (1) shall be—

"(A) in the case of new section 1250 property with respect to which the taxpayer does not elect the application of section 167(j), 100 percent, or

"(B) in the case of new section 1250 property, with respect to which the taxpayer elects the application of such section, zero percent.".

(b) AMENDMENT OF RECAPTURE RULES.—(1) IN GENERAL.—Subsection (a) of section 47 (relating to certain dispositions, etc., of section 38 property) is amended by redesignating paragraphs (5), (6), and (7) as paragraphs (6), (7), and (8), respectively, and by inserting after paragraph (4) the following new paragraph:

"(5) SPECIAL RULES FOR NEW SECTION 1250 PROPERTY.—

"(A) GENERAL RULE.—If during any taxable year section 38 new section 1250 property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the recapture period, then the tax under this chapter for such taxable year shall be increased by the recapture percentage of the aggregate decrease in the credits allowed under section 38 for all prior taxable years which would have resulted solely from reducing to zero the qualified investment taken into account with respect to such property.

"(B) RECAPTURE PERCENTAGE.—For purposes of subparagraph (A), the recapture percentage shall be determined in accordance with the following table:

If the taxable year in which the property ceases to be section 38 property is:	*Recovery percentage*
The taxable year in which placed in service	100
The first taxable year after the year in which placed in service	80
The second taxable year after the year in which placed in service	60
The third taxable year after the year in which placed in service	40
The fourth taxable year after the year in which placed in service	20

"(C) DEFINITIONS AND SPECIAL RULES.—

"(i) SECTION 38 NEW SECTION 1250 PROPERTY.—For purposes of this paragraph, the term 'section 38 new section 1250 property' means any section 38 property which is new section 1250 property.

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

(2) TECHNICAL AMENDMENTS.—

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

(i) by striking out "paragraph (1), paragraph (1)" and inserting in lieu thereof "paragraph (1) or (5), as the case may be, such paragraph", and

(ii) by striking out "paragraph (1)" in the subparagraph heading and inserting in lieu thereof "paragraph (1) or (5)".

(B) Paragraph (6) of section 47(a) (as redesignated by paragraph (1)) is amended by striking out "paragraph (1) or (3)" and inserting in lieu thereof "paragraph (1), (3), or (5)".

(C) Subparagraph (B) of section 47(a)(7) (as redesignated by paragraph (1)) is amended by striking out "paragraph (5)" and inserting in lieu thereof "paragraph (6)".

(c) AMENDMENT OF SECTION 48.—The last sentence of section 48(a)(1) (defining section 38 property) is amended by striking out "includes only property" and inserting in lieu thereof "includes only new section 1250 property and any other property".

(d) STUDY BY SECRETARY OF THE TREASURY.—Not later than January 1, 1984, the Secretary of the Treasury shall transmit to the Congress a study of the extent to which the investment tax credit allowed by section 38 of the Internal Revenue Code of 1954 has been used in connection with new section 1250 property. The study shall include the Secretary's finding and recommendations concerning the effectiveness of the investment tax credit as an incentive for the construction of such property, and its relative efficiency for such purposes as compared with depreciation for such property in accordance with such methods of depreciation as are permitted under such Code. The study shall also include the Secretary's recommendations concerning the extension, modification, or termination of the amendments made by this title and an explanation of the reasons for such recommendations.

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to periods after December 31, 1980, and before January 1, 1985, under rules similar to the rules of section 48(m) of the Internal Revenue Code of 1954.

SEC. 202. NO ADDITIONAL FIRST-YEAR DEPRECIATION FOR NEW SECTION 1250 PROPERTY

Paragraph (1) of section 179(d) (defining section 179 property) is amended by striking out "and" at the end of subparagraph (B), by striking out the period at the end of subparagraph (C) and inserting in lieu thereof ", and", and by adding at the end thereof the following new subparagraph:

"(D) which is not new section 1250 property.".

TITLE III—DEDUCTION OF CONSTRUCTION PERIOD INTEREST AND TAXES

SEC. 301. REPEAL OF SECTION 189

(a) IN GENERAL.—Section 189 (relating to amortization of real property construction period interest and taxes) is repealed.

(b) CLERICAL AMENDMENT.—The table of sections for part VI of subchapter B of chapter 1 is amended by striking out the item relating to section 189.

(c) DEDUCTION OF UNAMORTIZED BALANCE OF INTEREST AND TAXES REQUIRED TO BE AMORTIZED BY SECTION 189 BEFORE ITS REPEAL.—To the extent that a taxpayer does not elect, after the date of enactment of this Act, to treat the unamortized balance of construction period interest and taxes (as defined in section 189(e)(1) of the Internal Revenue Code of 1954 as in effect on the day before the date of enactment of this Act) as chargeable to capital account under section 266 of such Code, the taxpayer may deduct such unamortized balance under the appropriate provisions of such Code for the first taxable year of the taxpayer ending after December 31, 1980, as if such unamortized balance constituted such interest and taxes paid or incurred in such taxable year.

(d) APPLICATION OF SECTION 263.—Paragraph (1) of section 263(a) (relating to capital expenditures) is amended—

(1) by striking out "or" at the end of subparagraph (F),

(2) by striking out the period at the end of subparagraph (G) and inserting in lieu thereof a comma and "or", and

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

"(H) interest for which a deduction is allowable under section 163 or taxes for which a deduction is allowable under section 164.".

(e) EFFECTIVE DATE.—The repeal made by subsection (a) and the amendment made by subsection (d) shall apply—

(1) in the case of nonresidential real property, to construction periods beginning on or after the first day of the first taxable year beginning after December 31, 1975, and

(2) in the case of residential real property (other than low-income housing), to taxable years beginning after December 31, 1977.

TITLE IV—EXTENSION AND EXPANSION OF EXISTING INCENTIVES

SEC. 401. PERMANENT EXTENSION, ETC., OF CERTAIN EXPIRING CODE SECTIONS

(a) SECTION 167 (k) AMENDMENTS.—

(1) PERMANENT EXTENSION OF PROVISION.— Subsection (k) of section 167 (relating to depreciation of expenditures to rehabilitate low-income rental housing) is amended—

(A) by stricking out "and before January 1, 1982," in paragraph (1), and

(B) by striking out subparagraph (D) of paragraph (3).

(2) EXTENSION OF PROVISION TO ALL RESIDENTIAL RENTAL PROPERTY.—Subsection (k) of such section is amended—

(A) by inserting "And Other Residential Real Property" in the caption of such subsection immediately after "Housing".

(B) by inserting "or residential rental property" immediately after "low-income rental housing" each place it appears in paragraphs (1), (2), and (3)(A), and

(C) by adding at the end of paragraph (3), as amended by paragraph (1)(B), the following new subparagraph:

"(D) RESIDENTIAL RENTAL PROPERTY.—The term 'residential rental property' means property which is or can reasonably be expected to be residential rental property as defined in subsection (j)(2)(B).".

(3) INCREASE IN LIMITATIONS.—Paragraph (2) of section 167(k) (relating to limitations) is amended—

(A) by striking out "$20,000" in subparagraph (A) and inserting in lieu thereof "$30,000".

(B) by striking out "$3,000" in subparagraph (B) and inserting in lieu thereof "$5,000".

(b) PERMANENT EXENTSION OF SECTION 167(n).—Paragraph (2) of section 2124(c) of the Tax Reform Act of 1976 (relating to depreciation of improvements) is amended by striking out ", and before January 1, 1981".

(c) PERMANENT EXTENSION OF SECTION 167(o).—Paragraph (2) of section 2124(d) of the Tax Reform Act of 1976 (relating to substantially rehabilitated property) is amended by striking out ", and before July 1, 1981".

(d) PERMANENT EXENTSION OF SECTION 190.—Subsection (c) of section 2122 of the Tax Reform Act of 1976 is amended by striking out ", and before January 1, 1983".

(e) PERMANENT EXTENSION OF SECTION 191.—Paragraph (4) of section 2124(a) of the Tax Reform Act of 1976 (relating to effective date for section 191) is amended by striking out ", and before June 15, 1981".

(f) PERMANENT EXTENSION OF SECTION 280B.—Paragraph (3) of section 2124(b) of the Tax Reform Act of 1976 (relating to demolition) is amended by striking out ", and before January 1, 1981".

SEC. 402. MINIMUM TAX TREATMENT OF RAPID AMORTIZATION OF LOW-INCOME RENTAL REHABILITATION EXPENDITURES

Paragraph (2) of section 57(a) (relating to accelerated depreciation on real property) is amended by adding at the end thereof the following new sentence: "In the case of property with respect to which the taxpayer has made an election under section 167(k), the amount treated as an item of tax preference under this paragraph shall not exceed the amount which would have been determined as an item of tax preference under this paragraph if the taxpayer had used an allowance computed under the declining balance method using a rate not exceeding twice the rate which would have been used if the allowance had been computed under the straight line method.".

SEC. 403. SECTION 1250 AMENDMENTS

(a) CLARIFICATION OF REFERENCE TO SIMILAR STATE OR LOCAL LAWS.—Clause (i) of section 1250(a)(1)(B) (relating to applicable percentage for certain insured mortgage section 1250 property) is amended by striking out "under similar provisions of State or local laws" and inserting in lieu thereof "under provisions of State or local laws establishing the definition of and intended primarily to finance or assist housing for families or individuals of low or moderate income".

(b) LOW-INCOME HOUSING TO INCLUDE SECTION 221(d)(4) INSURED HOUSING AND CERTAIN OTHER SUBSIDIZED HOUSING.—Subparagraph (B) of section 1250(a)(1) (relating to applicable percentage) is amended—

(1) by striking out clause (ii) and inserting in lieu thereof the following:

"(ii) in the case of dwelling units—

"(I) which, on the average were held for occupancy by families or individuals eligible to receive subsidies under section 8 of the United States Housing Act of 1937, or under the provisions of State or local law providing for subsidies of a similar nature for low- or moderate-income families and individuals.

"(II) with respect to which a mortgage is insured under section 211(d)(4) of the National Housing Act, or

"(III) which are government-assisted housing, if at least 20 percent of the units in families or individuals eligible to receive subsidies under section 8 of such Act or equivalent rental assistance to assure that tenants do not pay more than one-quarter of their incomes for rent,

100 percent minus 1 percentage point for each full month the property was held after the date the property was held 100 full months;", and

(2) by adding at the end thereof the following new sentence: "For purposes of clause (ii)(III), the term 'government-assisted housing' means housing which is financed, insured, or assisted by loan, interest reduction payments, or tax abatement under Federal, State, or local law.".

TITLE V—CONDOMINIUM AND COOPERATIVE COST REDUCTION

SEC. 501. CAPITAL GAINS TREATMENT FOR GAIN FROM RESIDENTIAL RENTAL PROPERTY CONVERSIONS

Subsection (b) of section 1231 (relating to definition of property used in the trade or business) is amended by adding at the end thereof the following new paragraph:

(2) by striking out the period at the end of subparagraph (G) and inserting in lieu thereof a comma and "or", and

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

"(H) interest for which a deduction is allowable under section 163 or taxes for which a deduction is allowable under section 164.".

(e) EFFECTIVE DATE.—The repeal made by subsection (a) and the amendment made by subsection (d) shall apply—

(1) in the case of nonresidential real property, to construction periods beginning on or after the first day of the first taxable year beginning after December 31, 1975, and

(2) in the case of residential real property (other than low-income housing), to taxable years beginning after December 31, 1977.

TITLE IV—EXTENSION AND EXPANSION OF EXISTING INCENTIVES

SEC. 401. PERMANENT EXTENSION, ETC., OF CERTAIN EXPIRING CODE SECTIONS

(a) SECTION 167(k) AMENDMENTS.—

(1) PERMANENT EXTENSION OF PROVISIONS.—Subsection (k) of section 167 (relating to depreciation of expenditures to rehabilitate low-income rental housing) ia amended—

(A) by striking out "and before January 1, 1982," in paragraph (1), and

(B) by striking out subparagraph (D) of paragraph (3).

(2) EXTENSION OF PROVISION TO ALL RESIDENTIAL RENTAL PROPERTY.—Subsection (k) of such section is amended—

(A) by inserting "And Other Residential Real Property" in the caption of such subsection immediately after "Housing".

(B) by inserting "or residential rental property" immediately after "low-income rental housing" each place it appears in paragraphs (1), (2), and (3)(A), and

(C) by adding at the end of paragraph (3), as amended by paragraph (1)(B), the following new subparagraph:

"(D) RESIDENTIAL RENTAL PROPERTY.—The term 'residential rental property' means property which is or can reasonably be expected to be residential rental property as defined in subsection (j)(2)(B).".

(3) INCREASE IN LIMITATIONS.—Paragraph (2) of section 167(k) (relating to limitations) is amended—

(A) by striking out "$20,000" in subparagraph (A) and inserting in lieu thereof "$30,000", and

(B) by striking out "$3,000" in subparagraph (B) and inserting in lieu thereof "$5,000".

(b) PERMANENT EXENTSION OF SECTION 167(n).—Paragraph (2) of section 2124(c) of the Tax Reform Act of 1976 (relating to depreciation of improvements) is amended by striking out ", and before January 1, 1981".

(c) PERMANENT EXTENSION OF SECTION 167(o).—Paragraph (2) of section 2124(d) of the Tax Reform Act of 1976 (relating to substantially rehabilitated property) is amended by striking out ", and before July 1, 1981".

(d) PERMANENT EXENTSION OF SECTION 190.—Subsection (c) of section 2122 of the Tax Reform Act of 1976 is amended by striking out ", and before January 1, 1983".

(e) PERMANENT EXTENSION OF SECTION 191.—Paragraph (4) of section 2124(a) of the Tax Reform Act of 1976 (relating to effective date for section 191) is amended by striking out ", and before June 15, 1981".

(f) PERMANENT EXTENSION OF SECTION 280B.—Paragraph (3) of section 2124(b) of the Tax Reform Act of 1976 (relating to demolition) is amended by striking out ", and before January 1, 1981".

SEC. 402. MINIMUM TAX TREATMENT OF RAPID AMORTIZATION OF LOW-INCOME RENTAL REHABILITATION EXPENDITURES

Paragraph (2) of section 57(a) (relating to accelerated depreciation on real property) is amended by adding at the end thereof the following new sentence: "In the case of property with respect to which the taxpayer has made an election under section 167(k), the amount treated as an item of tax preference under this paragraph shall not exceed the amount which would have been determined as an item of tax preference under this paragraph if the taxpayer had used an allowance computed under the declining balance method using a rate not exceeding twice the rate which would have been used if the allowance had been computed under the straight line method.".

SEC. 403. SECTION 1250 AMENDMENTS

(a) CLARIFICATION OF REFERENCE TO SIMILAR STATE OR LOCAL LAWS.—Clause (i) of section 1250(a)(1)(B) (relating to applicable percentage for certain insured mortgage section 1250 property) is amended by striking out "under similar provisions of State or local laws" and inserting in lieu thereof 'under provisions of State or local laws establishing the definition of and intended primarily to finance or assist housing for families or individuals of low or moderate income".

(b) LOW-INCOME HOUSING TO INCLUDE SECTION 221(d)(4) INSURED HOUSING AND CERTAIN OTHER SUBSIDIZED HOUSING.—Subparagraph (B) of section 1250(a)(1) (relating to applicable percentage) is amended—

(1) by striking out clause (ii) and inserting in lieu thereof the following:

"(ii) in the case of dwelling units—

"(I) which, on the average were held for occupancy by families or individuals eligible to receive subsidies under section 8 of the United States Housing Act of 1937, or under the provisions of State or local law providing for subsidies of a similar nature for low- or moderate-income families and individuals.

"(II) with respect to which a mortgage is insured under section 221(d)(4) of the National Housing Act, or

"(III) which are government-assisted housing, if at least 20 percent of the units in such, if at least 20 percent of the units in families or individuals eligible to receive subsidies under section 8 of such Act or equivalent rental assistance to assure that tenants do not pay more than one-quarter of their incomes for rent,

100 percent minus 1 percentage point for each full month the property was held after the date the property was held 100 full months;", and

(2) by adding at the end thereof the following new sentence: "For purposes of clause (ii)(III), the term 'government-assisted housing' means housing which is financed, insured, or assisted by loan, interest reduction payments, or tax abatement under Federal, State, or local law.".

TITLE V—CONDOMINIUM AND COOPERATIVE COST REDUCTION

SEC. 501. CAPITAL GAINS TREATMENT FOR GAIN FROM RESIDENTIAL RENTAL PROPERTY CONVERSIONS

Subsection (b) of section 1231 (relating to definition of property used in the trade or business) is amended by adding at the end thereof the following new paragraph:

"(5) CONVERSION OF RESIDENTIAL RENTAL PROPERTY.—In the case of residential rental property which is converted to condominium or cooperative housing for purposes of selling the dwelling units in such property, the property shall not be treated as 'property used in the trade or business' unless the dwelling units are sold after the terms and conditions of the sale such units are negotiated with, and agreed to by, an organization representing the tenants of at least 51 percent of the dwelling units in such property which were occupied or sublet by tenants as of the date on which all tenants receive notice from the taxpayer that the conversion of the property to condominium or cooperative housing is proposed by the taxpayer.".

SEC. 502. TAX-FREE ROLLOVER OF HALF OF THE GAIN FROM SALE OF RENTAL PROPERTY TO TENANTS

(a) IN GENERAL.—Part III of subchapter O of chapter 1 (relating to nontaxable exchanges) is amended by adding at the end thereof the following new section:

"Sec. 1041. Sales of Residential Rental Property to Tenants

"(a) In General.—If a taxpayer—

~~"(1) sells residential rental~~ property which is treated as property used in the taxpayer's trade or business under ~~section 1231(b)(5) in a qualified sale, and~~

"(2) within 24 months after the date of that sale enters into a binding contract for the construction of residential rental property which is section 1250 property,

then a portion (determined under subsection (b)) of the long term capital gain from the sale of such property shall not be recognized.

"(b) Determination of Nonrecognition Portion.—The portion of the long term capital gain not to be recognized under subsection (a) is 50 percent of such gain, reduced by one-half of the amount (if any) by which the proceeds of the sale exceed the cost of construction of the residential rental property described in subsection (a)(2).

"(c) Qualified Sale.—The sale of residential rental property shall be treated as a qualified sale for purposes of subsection (a) only if—

"(1) not less than 50 percent of the dwelling units in such property are sold to purchasers of low or moderate income, or the property is sold to an organization of tenants of such property described in section 1231(b)(5), and

"(2) there is a substantial likelihood that the overall economic character of dwelling unit owners will remain the same as the units are sold to subsequent purchasers.

"(d) Low or Moderate Income.—A purchaser shall be treated as a low or moderate income purchaser for purposes of subsection (c)(1) if the family income of the purchaser is 120 percent or less of the median family income for the statistical area in which the residence is located. The family income of the purchaser and median family income for the area shall be determined under regulations prescribed by the Secretary after consultation with the Secretary of Housing and Urban Development and which are consistent with the regulations prescribed under section 8 of the United States Housing Act of 1937.

"(e) No Adjustment to Basis for Constructed Property.—The basis of the residential rental property constructed by the taxpayer pursuant to the binding contract referred to in subsection (a)(2) shall not be reduced by the amount of the gain not recognized under subsection (a) on the sale of the property described in subsection (a)(1).

"(f) Statute of Limitations.—If during a taxable year a taxpayer sells residential rental property at a gain, and elects the application of this section, then—

"(1) the statutory period for the assessment of any deficiency attributable to any part of such gain shall not expire before the expiration of 3 years from the date the Secretary is notified by the taxpayer (in such manner as the Secretary may by regulations prescribe) of—

"(A) the taxpayer's cost of purchasing residential rental property which the taxpayer claims results in nonrecognition of any part of such gain,

"(B) the taxpayer's intention not to purchase such property within the period specified in paragraph (2), or

"(C) a failure to make such purchase within such period; and

"(2) such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.".

(b) Holding Period.—Section 1223 (relating to holding period of property) is amended by redesignating paragraph (12) as paragraph (13) and by inserting immediately after paragraph (11) the following new paragraph:

"(12) In determining the period for which the taxpayer has held residential rental property the acquisition of which resulted under section 1041 in the nonrecognition of any part of the gain realized on the sale of residential rental property, there shall be included the period for which the residential rental property with respect to which gain was not recognized had been held, and the period such replacement residential rental property was held as of the date of such sale or exchange.".

(c) Clerical Amendment.—The table of sections for part III of subchapter o of chapter 1 of such Code is amended by adding at the end thereof the following new item:

"Sec. 1041. Sales of residential rental properties to tenants.".

Sec. 503. Regulations To Be Prescribed After Consultation With Secretary of Housing and Urban Development

In prescribing regulations to carry out the provisions of the Internal Revenue Code of 1954 amended by this title, the Secretary of the Treasury shall consult with the Secretary of Housing and Urban Development.

TITLE VI—REMOVAL OF IMPEDIMENTS TO NEW REAL PROPERTY DEVELOPMENT

SEC. 601. LIMITATION ON DEDUCTION OF INTEREST ON INVESTMENT INDEBTEDNESS

Subparagraph (D) of section 163(d)(3) (relating to definitions for limitation on interest on investment indebtedness) is amended by inserting "(other than section 1250 property)" immediately after "property".

SEC. 602. DEDUCTION OF CERTAIN PRE-OPENING RENTAL PROPERTY EXPENSES

(a) IN GENERAL.—Subsection (a) of section 162 (relating to trade or business expenses) is amended—

(1) by striking out "and" at the end of paragraph (2).

(2) by striking out the period at the end of paragraph (3) and inserting in lieu thereof a comma and the word "and", and

(3) by inserting after paragraph (3) the following new paragraph:

"(4) amounts paid or incurred in connection with, or during the period of, the acquisition, development, construction, reconstruction, or erection of section 1250 property except to the extent that any such amount—

"(A) is a capital expenditure (within the meaning of section 263); or

"(B) is paid or incurred more than 24 months before the day on which the taxpayer begins to receive income from the property (unless the Secretary consents, upon application by the taxpayer at such time in such form and manner as the Secretary may prescribe, to a longer period because the longer period is appropriate for the particular property or circumstances).".

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply with respect, to all taxable years to which the Internal Revenue Code of 1954 applies.

SEC. 603. USE OF TAX EXEMPT BOND FUNDING IN CONNECTION WITH RESIDENTIAL REAL PROPERTY

(a) ADVANCE REFUNDING TO BE AVAILABLE.—Paragraph (7) of section 103(b) (relating to advance refunding of qualified public facilities) is amended—

(1) by inserting "or residential real property" immediately after "facilities" in the caption of such paragraph, and

(2) by inserting "or residential real property for family units" after "facility" in subparagraph (A).

(b) USE OF PROCEEDS TO REMOVE EXISTING FIRST LIENS.—For purposes of subparagraph (A) of section 103(b)(4) of the Internal Revenue Code of 1954 (relating to certain exempt activities), the use of any part of the proceeds of an issue of obligations to remove existing first liens encumbering property which is to be rehabilitiated shall be treated as a use of such proceeds to provide residential real property for family units within the meaning of section 103(b)(4)(A) of such Code.

SEC. 604. PERSONAL USE OF RESIDENCE BY FAMILY MEMBER NOT TO TRIGGER DISALLOWANCE OF DEDUCTION.

Subparagraph (A) of section 280A(d)(2) of the Internal Revenue Code of 1954 (relating to personal use of unit) is amended by inserting before the semicolon at the end thereof the following: "(unless such member of the family pays a rental which, under the facts and circumstances, is fair rental and uses the unit as his principal place of residence)".

TITLE VII—EFFECTIVE DATES

SEC. 701. GENERAL EFFECTIVE DATES

Except as otherwise provided, the amendements made by this Act shall apply with respect to taxable years beginning after December 31, 1980.

REAL ESTATE CONSTRUCTION AND REHABILITATION TAX INCENTIVES ACT OF 1980—SECTION-BY-SECTION SUMMARY

Section 1. (a) Short title. (b) Unless otherwise stated, all amendements are to the Internal Revenue Code of 1954.

TITLE I.—CAPITAL COST RECOVERY TREATMENT OF NEW SECTION 1250 PROPERTY

Section 101. All section 1250 property (real estate) placed into service after the Act's effective date is to be given twenty-year straight-line depreciation, with the exception of low-income rental housing which is given fifteen-year straight-line depreciation. Present law would continue to apply to real property in service as of the effective date, as well as to such property sold within five years after the effective date. For existing property sold more than five years after such date, a taxpayer could elect to continue depreciating the property using its remaining useful life or, in the alternative, twenty years.

TITLE II.—INVESTMENT TAX CREDIT FOR SECTION 1250 PROPERTY

Section 201. In lieu of the new depreciation schedule set forth in Title I, a taxpayer may elect to take a one-time ten percent investment tax credit. This credit would be recaptured, in whole or in part, if the property is sold within five years of being placed in service. This tax credit would be available for property placed in service from January 1, 1981 until December 31, 1984. No later than January 1, 1984, the Secretary of the Treasury shall report to Congress concerning the effectiveness and efficiency of this Title, and making recommendations regarding its extension, modification, or termination.

TITLE III.—DEDUCTION OF CONSTRUCTION PERIOD INTEREST AND TAXES

Section 301. Section 189 of the Code, requiring construction period interest and taxes to be amortized, is repealed. A taxpayer may elect to continue depreciating the balance of unamortized construction period interest and taxes carried in his capital account or, in the alternative, to deduct such balance in 1981.

TITLE IV.—EXTENSION AND EXPANSION OF EXISTING INCENTIVES

Section 401. The expiration dates are stricken for the Code sections permitting rapid amortization of rehabiliation expenses for low-income rental housing; prohibiting accelerated depreciation for new structures built on historic sites; providing for favorable depreciation of rehabilitated historic property; encouraging the removal of architectural barriers; and prohibiting deductions for the demolition of historic structures. In addition, Section 167(k), relating to rapid amortization of rehabiliation expenses for low-income rental housing, is expanded to include all residential rental housing; and the minimum depreciable per unit expenditure is raised from $3,000 to $5,000 while the maximum is raised from $20,000 to $30,000.

Section 402. The tax preference arising under Section 167(k) is equalized with that arising for new Section 1250 property, to eliminate the Code's present bias favoring new construction over rehabiliation.

Section 403. The preferential depreciation rules of Section 1250 are clarified to make clear their applicability to housing constructed under provisions of state or local law which define and primarily finance shelter for persons of low and moderate income. This preferential treatment is expanded to include Section 221(d)(4)—insured housing, and any government-assisted housing in which at least twenty percent of the units are reserved for persons eligible for Section 8 rent subsidy assistance; in addition to the existing inclusion of Section 8 housing.

TITLE V.—CONDOMINIUM AND COOPERATIVE COST REDUCTION

Section 501. The owner of residential rental property held for at least one year shall be entitled to receive capital gains treatment of the proceeds of the sales of individual units in a condominium or cooperative conversion, provided that the terms and conditions of such sales have been negotiated with and agreed to by an organization representing a majority of the units occupied by tenants residing in the property as of the date on which tenants receive notice of the proposal to convert.

Section 502. If a taxpayer is entitled to preferential tax treatment under the provisions of the preceding section through a "qualified sale" and further enters into a binding contract for the construction of new residential rental property within twenty-four months, then a portion of his capital gain may be "rolled over" without tax consequences. The portion rolled over shall be half of the gain if the cost of construction will equal or exceed the procceds of the sale; if the construction cost is less, than the deferral shall be reduced by one-half of the difference. A sale will qualify for this treatment if at least one-half of the units are sold to purchasers of low or moderate income (no more than 120 percent of area median income), or if the property is sold directly to a tenants' organization; and if the conversion project's by-laws are written to substantially assure that the overall economic character of the project will remain stable during subsequent resales. These requirements are meant to encourage the establishment of limited-equity cooperatives. The basis of the newly constructed rental property shall not be reduced by the amount of unrecognized capital gain.

Section 503. The Secretary of the Treasury shall consult with the Secretary of Housing and Urban Development in developing the regulations to carry out this Title.

TITLE VI—REMOVAL OF IMPEDIMENTS TO NEW REAL PROPERTY DEVELOPMENT

Section 601. Section 163(d) of the Code, limiting the deduction of investment indebtness interest for individuals, is made inapplicable to real property investments.

Sections 602. Current law is clarified so that pre-opening expenses incurred in connection with real property development are permitted to be currently expensed if they occur within two years prior to the property's placement in service. A taxpayer is permitted to apply for a longer period if he feels it would be appropriate.

Section 603. The advance refunding of tax exempt housing bonds is permitted, and the use of any portion of the proceeds of such bonds to remove existing first liens to permit rehabilitation is also allowed.

Section 604. The Code provision limiting deductions on "vacation homes" is technically corrected to permit a taxpayer to take deductions for repairs, depreciation, and related items where the property is rented to a relative, provided that the relative uses it as a principal residence and the rent charged is fair.

TITLE VIII.—EFFECTIVE DATES

Unless otherwise provided, the provisions of the Act take effect as of January 1, 1981.

Senator BYRD. Next will be a panel consisting of Mr. Theodore F. Brophy, chairman of the board and chief executive officer, General Telephone & Electronics Corp., and chairman of the Business Roundtable Taxation Task Force; Mr. Richard W. Rahn, vice president and chief economist, U.S. Chamber of Commerce; and Mr. Thomas J. McHugh, vice president for Taxes of Kraft, Inc., and chairman of the Taxation Committee of the National Association of Manufacturers.

Welcome, gentlemen, and you may proceed as you wish.

STATEMENT OF THEODORE F. BROPHY, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, GENERAL TELEPHONE & ELECTRONICS CORP.; COCHAIRMAN, THE BUSINESS ROUNDTABLE (BRT) AND CHAIRMAN, BRT TAXATION TASK FORCE

Mr. BROPHY. Thank you, Senator Byrd.

My name is Theodore F. Brophy, and I am chairman and chief executive officer of General Telephone & Electronics Corp., and I am appearing today as cochairman of the Business Roundtable and chairman of the Taxation Task Force of the Business Roundtable.

I have submitted a written statement, and I would respectfully request that it be incorporated in the record.

Senator BYRD. It will be published in full in the record.

Mr. BROPHY. Thank you.

The Roundtable urges the Congress to report as soon as possible a responsible tax reduction program designed to encourage savings and investment.

The issue that appears to be before Congress at this time is not, should we enact responsible and necessary tax reduction legislation, but rather, when should such legislation be enacted? The Roundtable's answer is that it is urgently needed now to set the stage for healthy long-term economic growth into the 1980's. We do not believe that an election year should be either an excuse to avoid legislative initiatives for responsible tax changes or a reason to avoid fiscal responsibility.

The Roundtable has long urged the enactment of structural changes in our tax system that would encourage capital investment and improve productivity, make America more competitive in world markets and most importantly create more jobs.

At the same time we have argued for fiscal responsibility. To that end we have supported legislation to restrain the growth in Government expenditures by establishing spending limits as a percentage of GNP.

Although there may not be unanimity, there is substantial consensus among the members of the business community on the timing of a tax cut. I can state with confidence from discussions within the Roundtable that the Roundtable membership favors: (1) A responsible tax reduction program on the order of $30 billion; (2) The enactment of such a program now; (3) The effective date of January 1, 1981; and (4) The 10-5-3 capital recovery system, S. 1435, as the cornership of such a program.

To effect fundamental changes in the tax structure that will lead to increased productivity, which is a basic solution to inflation, at least one-half of any tax reduction should be focused to encourage capital formation and savings and investment.

The program we support can hardly be called a tax cut, but rather a moderation of tax growth. The administration, in its midsession review of the 1981 budget, prepared by the Office of Management and Budget, is forecasting that receipts for fiscal year 1981 will rise by $86.1 billion over those estimated for fiscal year 1980.

It is estimated that in 1981 alone social security taxes, windfall profit tax and so-called bracket creep will account for at least $50 billion of additional tax burdens. Our economists tell us that these large scheduled tax increases, if not offset to some degree by tax reductions, will prolong the recession and make the recovery more difficult.

There are substantial risks in waiting until next year to pass necessary tax legislation. Should the economic slide continue past January, pressure on the Congress next year to do something could well lead to a round of countercyclical Keynesian-type tax cuts and spending to stimulate the economy and neglect of the supply side.

This would put us back on the roller coaster approach to economic policy that we have seen in past years and would set the stage for even greater inflation later on. A retroactive tax cut enacted in the next Congress would not likely affect investment decisions before mid-1981 and hence would be needlessly inflationary.

While the business community is concerned about the short-term recessionary problems, we are much more concerned about the long-term structural problems in the economy. Increases in standard of living come primarily from increases productivity. It is only increases in productivity that permit the GNP to grow at a positive rate that permits everyone's lot to improve without taking from one segment of society to improve the lot of another.

Over the past decade there has been a significant increase in the rate of growth in the labor force which has not been matched by a corresponding in the rate of growth of the amount of capital and plant investment.

Output per American worker grew at an annual average rate of only 1.9 percent between 1963 and 1973 and has scarcely grown at all since then. In 1979, U.S. labor productivity actually declined slightly. Yesterday's newspapers reported a U.S. productivity decline for the second quarter at an annualized rate in excess of 4 percent.

It is no secret that the United States among the principal industrialized countries of the world has the lowest rate of GNP devoted to capital formation, and also the lowest rate of productivity growth. These are well-known facts, and are borne out by Government statistics cited in my prepared statement.

Our existing tax structure does not deal, and was not meant to deal with a highly inflationary economy, and as a result taxable income computations significantly overstate the real earnings of business and industry. This creates an effective tax rate at levels well beyond statutory rates.

Accountants and businessmen for years have been trying to find an equitable and acceptable method of reflecting the effects of inflation in financial statements. In September of 1979, the Financial Accounting Standards Board, or FASB, issued statement No. 33, which is intended to require corporations to show in their annual reports the adjustment of historical cost accounting data to reflect inflation more effectively.

Price Waterhouse, a large public accounting firm, has recently published an analysis of the Fortune 500 firm reports from their 1979 annual reports. As detailed an exhibit 1 to my written statement, the Price Waterhouse study shows, using the FASB approach, that adjusting for inflation, true earnings for industrial corporations were 40 percent below what was reported on an historical basis. The effective tax rate was 53 percent rather than the average 39 percent reported.

The discrepancy between these earnings reported and those adjusted for inflation is generally attributed to the lack of adequate capital recovery rates for American business.

Current tax depreciation based on historical cost was designed in a noninflationary environment and does not take into account the declining value of the dollar when capital recovery takes place over a long period of time in an inflationary economy.

Under the current rate of inflation the real value of the dollars received from depreciation is less than half the real value of the dollars originally invested. Thus inadequate depreciation acts as a deterrent to capital investment.

The Roundtable believes that now, not later, is the time to enact a tax reduction program designed to stimulate capital investment to focus on the business side of a tax reduction program should be on an improved and simplified capital recovery allowance system. For the past several years the Roundtable has strongly advocated the enactment of such a new capital recovery allowance system as 10-5-3 which is embodied in S. 1435.

I do not believe that I have to give the details of 10-5-3 to this committee. In my memory no other single piece of tax legislation has been as widely discussed, analyzed, and debated in the business community, media, and Halls of Congress. This will has the support of a vast majority of both large and small business groups, and is sponsored by 155 Democrats and 152 Republicans in the House and 30 Democrats and 25 Republicans in the Senate.

Considering the widespread support that has been expressed for 10-5-3, we submit that there is no need to look further for alternative approaches for solutions to the capital recovery problem. We urge the enactment of S.1435.

Any individual tax reduction should be designed to stimulate capital formation and individual savings and investment rather than consumption. Positive emphasis should be on encouraging the supply side of our economy to reduce the bias in our existing tax system against capital investment and savings.

In order to provide a base for future long-term economic growth through increased productivity, increased employment and to prevent further decapitalization of American business and to permit it to compete effectively in domestic and foreign markets, the Congress should act now.

Thank you.

Senator BYRD. Thank you, Mr. Brophy.

We will now hear from Mr. Rahn of the United States Chamber of Commerce.

STATEMENT OF RICHARD W. RAHN, VICE PRESIDENT AND CHIEF ECONOMIST, UNITED STATES CHAMBER OF COMMERCE

Mr. RAHN. Mr. Chairman, my name is Richard W. Rahn. I am vice president and chief economist of the Chamber of Commerce of the United States.

We have submitted written testimony, which we request be placed in the record, and I will make brief oral remarks.

Senator BYRD. Very good.

Mr. RAHN. With me today is Christine Vaughn, director of the chamber's Tax Policy Center, and Kenneth D. Simonson, the chamber's tax economist.

The chamber is the world's largest federation, consisting of more than 99,000 business firms, chambers of commerce, and trade association members. Approximately 80 percent of our members have fewer than 100 employees.

The chamber firmly believes that Congress should move promptly to reduce the Federal income tax burden by some $25 to $35 billion. Roughly half of the needed relief should promote capital formation through enactment of the capital cost recovery program, and a reduction in corporate tax rates of 2 percentage points.

Since early 1979, the chamber has worked extensively with other organization to develop a new system of depreciation, to simplify the calculations, to promote capital formation, increase productivity, create jobs, and in the long run mitigate inflationary pressures. That proposed system, known as 10-5-3, has been pending before Congress for more than a year. It is time to act now.

We believe that Congress should also address our low rate of personal savings by adopting measures designed to encourage taxpayers to transfer funds from consumption to saving, and from less productive to more productive forms of savings and investment.

To reduce this tax bias against saving, we recommend that the Congress consider a reduction in the maximum tax rate on investment income of individuals from 70 to 50 percent, a further reduction of capital gains tax rate, broaden eligibility, and greater deductions for IRA's and Keogh plans, and deferred accounts and dividend reinvestment plans.

In addition, an across the board tax rate cut for individuals is also appropriate at this time.

The benefits of the 10-5-3 proposal and other measures to improve savings have been widely recognized by economists of different persuasions. The goal of economic policy should be to increase the real per capita income for all Americans, and supply side oriented tax relief would do exactly that. It would insure that in 1981 real disposable income in the country increases rather than decreases, which it will without that tax relief.

Properly structured tax relief would increase real business fixed investment, reverse our declining rate of productivity, improve international competitiveness, and reduce the unemployment rate.

Delay in enactment of 10-5-3 and other measures to increase the supply of savings and investment will only postpone those benefits.

There are those who argue that Congress should put off passage of the tax cut until 1981 when there is more time to carefully structure it, and then make it retroactive. But there is no reason to believe that Congress can do a better job or have better information on which to base tax decisions next year than now.

Moreover, the important issue of depreciation revision, the knowledge that improved tax writeoffs are likely sometime next year, unfortunately will entice many businesses to delay productive investment.

Furthermore, making the tax cut retroactive has little advantage. A tax cut increases the amount of savings and productive investment from the date it is passed, even if it is to take effect some weeks after passage. On the other hand, a retroactive tax cut causes a loss in revenue to the Treasury without an offsetting increase in the amount of work, savings, or investment during the retroactive period.

There are those who argue that any tax cut is inflationary. That is a complete myth. Tax cuts can either increase or decrease inflationary pressures depending upon how they are structured.

Tax cuts which encourage additional savings and investment, thus increasing industrial capacity, and the supply of goods and services, will reduce inflationary pressures, particularly over the long run.

Real per capita income can only be increased by increases in productivity, an increase in industrial capacity stemming from increased investment.

Recessions do not cure inflation. They only increase unemployment in the short run, and by reducing investment add to inflationary pressures in the long run.

Finally, there are those who have argued for increased Government spending, particularly on jobs programs to take care of our unemployment problems. Increased spending on Government programs results either in increased taxation in the private sector, thereby reducing the number of private jobs, or increases in the deficit without offsetting increases in the amount of savings, which merely adds to the rate of inflation. The increased inflation, of course, diminishes the real purchasing power of those who are employed and unemployed.

We also know from painful experience that the length of time needed by Government to implement countercyclical jobs programs causes them to come onstream much too late. On the other hand, a tax cut enacted now to take effect on January 1, 1981, will begin to have a positive benefit from the date of passage.

In conclusion, Mr. Chairman, 10-5-3, along with other proposals to increase the amount of saving and investment, have been before the Congress for more than a year. Any further delay in their enactment will only increase the stock of misery of all too many of our citizens.

We are pleased that you have called these hearings to review the important issues, and we urge the committee to make decisions now.

Thank you.

Senator BYRD. Thank you, Mr. Rahn.

We will now go on to the next witness.

STATEMENT OF THOMAS J. McHUGH, VICE PRESIDENT, TAXES, KRAFT, INC., CHAIRMAN, TAXATION COMMITTEE, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. McHUGH. Thank you, Mr. Chairman.

My name is Thomas J. McHugh, and I am vice president of taxes for Kraft, Inc., of Glenview, Ill. I am representing the National Association of Manufacturers as a member of its board of directors, and as chairman of its taxation division. With me this morning is Mr. Cliff Massa, vice president of the taxation and fiscal policy department of NAM.

I will attempt to keep my remarks this morning brief, Mr. Chairman. I will appreciate your inclusion of our complete statement in the hearing record.

Senator BYRD. Yes. It will be included in the record in full.

Mr. McHUGH. That statement offers the following three recommendations:

First, enactment of a tax reduction package in 1980, to become effective next January, is desirable, timely, and feasible. We question whether a tax bill can be enacted quickly in 1981. Waiting a year or more to enact such a package will only delay the start of the already overdue task of revitalizing American industry.

Second, the package should concentrate on reducing the Federal tax burden on savings and investment for both businesses and individuals. Providing selective relief which is intended as financial aid or stimulating general consumption is undesirable.

Third, the centerpiece of the package should be the Capital Cost Recovery Act often called the 10-5-3 depreciation bill. Additional changes should benefit both business and personal savers.

While the current recession is headline news, ominous long-term problems continue to threaten the economy. Persistent inflation, sagging productivity, inadequate rates of productive investment, and low levels of personal savings are visible signs of significant long-term problems which predate this recession and will continue beyond its recovery.

Broadbased tax changes are essential to combat our long-term economic problems. Tax increases drain productive resources away from the private sector and hinder rather than help a long-term policy to improve productivity and reduce inflation.

However, our support is not offered for quickie cuts to stimulate consumer demand as an antirecession tactic. It does not mean tax cuts for particular income groups. And, it does not mean selective measures for specific industries or for certain types of expenditures. As difficult as the current conditions are, they do not justify the use of tax subsidies for quick fixes.

We urge enactment of across-the-board changes in tax policy which encourage savings and investment, and we place depreciation reform—specifically the Capital Cost Recovery Act—at the very top of the list. A detailed explanation of the act and a discussion of its economic benefits are presented in the appendix to my written statement.

Action on a tightly structured tax bill is both possible and needed in 1980.

While an early effective date for a tax change is important, early enactment is of equal or greater importance. Financial planners will need a period of months to adjust both capital appropriations and actual spending once they are certain that a depreciation change will occur. 1980 action will provide that assurance.

We recommend 10-5-3 for the following reasons:

First, 10-5-3 will remove tax-induced higher costs and distortions related to the purchase of capital assets. The long-term economic impact of this change will be to encourage needed investment in expanded supply capacity and more productive assets, contribute to the higher productivity of labor, hasten purchases of more energy-efficient processes, create markets for new technologies stemming from innovative research, and generally expand our industrial capability to fulfill domestic consumer and defense needs and to compete in world markets.

Second, 10-5-3 will remove inequities caused by the complexity of current depreciation rules and by the historical lack of improvement in depreciation for productive structures compared to equipment.

Finally, 10-5-3 has been analyzed and discussed for over a year. The features needing attention are more well-defined and much better understood than alternative proposals which are only now being considered. It is the proposal from which the final measure can be developed most quickly.

The dramatic change proposed by 10-5-3 for treatment of structures has attracted a good deal of comment. NAM very strongly endorses the 10-year category for structures, and we urge the committee to act favorably in this area.

A dramatic improvement is needed in depreciation for business structures such as factories, warehouses, and retail buildings which are just as much productive capital assets as are the machinery and equipment placed in them. Concerns expressed over speculation and tax-motivated investors are not relevant to buildings which are integrally related with the taxpayers' manufacturing or distributing business. NAM strongly urges that 10-5-3's significant improvement for these structures not be set aside by concerns about other structures.

It is certain that there are a number of features of 10-5-3 which do not quite attain the ideal which many of us would like to reach. Briefly put, no one group is likely to find 100 percent of its objectives met by 10-5-3. However, NAM very strongly supports this bill because it provides a generally applicable system for use by both large and small firms, by manufacturers and retailers and service companies, by all areas of the country. While we do not claim unanimity, there is a high degree of support for 10-5-3 as the top priority in 1980.

The past 13 months since introduction of 10-5-3 have allowed extensive discussion of this measure. Numerous technical changes and substantive revisions have been identified and discussed. These hearings are raising those matters for further discussion. We are willing and able to respond to such proposals because we believe that the structure of 10-5-3 offers the best foundation on which to build.

Thank you.

Senator BYRD. Thank you, sir.

Mr. Brophy, Senator Long is sorry that he could not be here today. He has read your testimony, and requested that I ask you two questions.

In your prepared statement, you have called for an immediate tax cut designed to stimulate capital formation, individual savings and investment accompanied by fiscal and monetary restraint.

Secretary Miller, and some economists believe that the Congress should not enact tax cut legislation in the next few months. What do you feel are the best arguments in favor of an immediate tax cut?

Mr. BROPHY. First of all, Senator Byrd, the problem that we believe, should be addressed by a tax cut is a long-term problem requiring long-term solutions. If that is true, then there is no good reason for deferring a tax cut at this particular time.

We believe that improved capital recovery through 10-5-3 is at least a partial answer to inflation and is a structural change that is needed in our economic system to put us on a competitive mode with the rest of the world.

I have not been able to understand the argument that deferring the action on a tax cut until next year, when we recognize unfortunately that we are still going to be in a deficit position, is going to improve the economic effects of the tax cut. For the reasons I stated in my oral testimony, I believe that there are in fact severe risks and inflationary impacts that can arise from delaying the action on a tax cut.

Senator BYRD. Thank you, sir.

Senator Long's second question is this. Last week, Dr. Jorgensen, an economist, proposed a form of depreciation liberalization quite different from the 10-5-3 proposal. His suggestion was that the full discounted value of depreciation be deducted in the first year. What is your view of his suggestion?

Mr. BROPHY. The Jorgensen-Auerbach proposal has some weaknesses from my point of view. First of all, it does tie depreciation to the useful life concept, and therefore it is necessary to determine the useful life of the assets involved. Once that is done, the capital recovery is frozen to the useful life, and in a fast changing technological environment, there is no way you you can recover the capital when a piece of equipment becomes technologically obsolete and is replaced prior to the end of the useful life. So in that respect, it would put us in a worse position in industry than we are today.

There is also the problem of determining the discount rate to be used, which can be a subject of argument and discussion at a later date.

I believe that 10-5-3 has many things to recommend it, not the least of which is the very broad acceptance of the concepts of 10-5-3 across industry, large and small. I don't believe that the Jorgensen approach, when analyzed, will have that kind of reception.

Senator BYRD. I was in England over the Easter recess, and I learned—I should have known it before, but I am sorry to say I didn't—that in England a company can write off a piece of equipment as an expense in 1 year. Indeed, a company can build a factory and write it off in 1 year.

I assume that goes a little too far. I don't know. Would you have a view on that?

Mr. BROPHY. Obviously, the revenue effect of that would be substantially greater than 10-5-3, and I would think that perhaps we are not ready for that at this particular moment in time. But I think that 10-5-3 would bring us in a position to be more competitive against countries that do have the initial writeoff.

Senator BYRD. Let me ask each member of this panel this question.

There has been some talk of a tax reduction proposal, enactment of it being put off for the session after the election, or the lame duck session. I am inclined to think that that might be the worst time to have a tax bill proposed. I am wondering whether each of you have any view on that.

Mr. MCHUGH. Mr. Chairman, I think I would agree with that appraisal. I am sure many panelists will agree that the time to act is now. There has been an argument that the 10-5-3 is being channeled down a fast track for political reasons. We challenge that appraisal. It has been around for well over a year. It is trying to address problems of longer standing.

To put it in the so-called rump session after the election would induce political considerations which do not necessarily have to exist. I think that it is an economic problem to be dealt with now. To push it off to the rump session is bad. To push it off until 1981 is even worse, without removing the political considerations that some people find today.

Mr. RAHN. Mr. Chairman, I would like to agree with that. Every econometric study I have seen of 10-5-3 and some of the other related proposals to increase the amount of savings investment indicate that once they are passed, we can expect higher real per capita income, lower rates of unemployment, and a higher rate of economic growth. Given that, it seems to me there is no reason for delay.

I would personally prefer, and the chamber would prefer, to have the tax passed as soon, or as quickly as possible before Congress adjourns for election. If not, we would prefer it in the lame duck session, and not put it off until next year, because in all likelihood it would not be passed until July. Some people talked about making it retroactive, but I believe that that would be very counterproductive.

Mr. BROPHY. I would agree. I see no reason to defer the enactment of 10-5-3 until after the election. If there is to be a study of other tax measures, that surely can be taken up in the next Congress. But as the others have suggested, this is a basic reform that is needed to move our economy in the right direction, and now would seem to be the time to do it.

Senator BYRD. I have the feeling that if we could get the spending under control that the tax problem could be handled rather easily. The tax problem would take care of itself if we could get the spending under control. But we are not getting spending under control.

In this particular fiscal year, we will have the largest increase in spending in the history of the Nation, and we will also have the highest deficit in the history of the Nation, when you consider the off-budget items along with the $61 billion deficit in the budget itself. We are not getting spending under control.

I was pleased that you, Mr. Brophy, mentioned in your comments the need for fiscal restraint, because I think that that is the real key to what we will be able to do in the tax field.

Senator Dole and others introduced legislation, and it was voted on last month. I think that that legislation has a lot of merit, and it included 10-5-3. I voted against it at that time because I was concerned as to whether, with our fiscal situation being what it is, we should reduce taxes at this point.

The Democratic Caucus drew up a resolution for all the members of the Democratic Caucus to sign to mandate the Finance Committee to bring in a tax reduction proposal, and I was one of three who did not sign that. So I am in a position of having opposed Senator Dole's proposal, and having opposed the Democratic resolution also.

But since virtually every Member of the Senate feels that there should be a tax reduction at this time, I have seen the light, and I want to go along and try to help make it as responsible as possible.

I believe, just as each of you has indicated, that we need to put emphasis on the liberalized depreciation rate, which as I visualize it will tend to create additional jobs, and that is what we need now very badly, and also in the long run it is not going to be detrimental to the Treasury, just in the short run. If business eats up the depreciation too fast, then it begins to pay the greater tax, not having the depreciation to fall back on. So I think that it has a great deal of merit.

Senator Dole.

Senator DOLE. I think the question has been asked, but I would just suggest that this is a political year, and I assume that next year will be a different kind of a year. Political years come around quite often, and if we try to weigh the politics of it—if it is going to help or hurt A candidate, or B candidate, or whatever—I think we will probably not do anything very constructive.

It seems to me, as Senator Byrd has indicated, that there is a lot of sentiment on this committee, with very few exceptions, that we want to act this year. We would like to act before we adjourn in October. It seems to me that on the Senate side there will be some action. Senator Long has indicated that, and he does wield some influence on this committee. Whatever happens next year, we have agreed to make him honorary chairman, without a vote, of course. [Laughter.]

It may be 50 Democrats, and 49 Republicans, and we may want to make Harry Byrd the chairman, as an independent. We have thought of all those possibilities.

We have had the testimony of this panel, and I assume other panels, and I hope that we can work out some of the refinements of 10-5-3, because there may be some problems with 10-5-3 in its present form. There may be some problems with the rate reduction for individuals. There may be other things we ought to address. In fact, I know that several of them have been touched upon.

I would hope that you would continue your efforts to stimulate interest among your colleagues, so that they can contact our colleagues, particularly those on the House side. I am certain that we can put together a bipartisan package that will meet the needs of the 1980's, but I would rather do it now than sometime in the middle of next year, and try to back it up and make it effective January one. It would be an administrative nightmare.

Senator BYRD. Thank you, Senator Dole.

I am glad that the Business Roundtable, the United States Chamber of Commerce, and the National Association of Manufacturers are taking such a keen interest in this problem.

I might ask Mr. McHugh, I notice that you are vice president of Kraft.

Mr. MCHUGH. Yes, sir.

Senator BYRD. Isn't Kraft merging with the firm of which Justin Dart is Chairman?

Mr. MCHUGH. That is correct.

Senator BYRD. I think Justin Dart has rendered an important service to the country in developing meetings throughout the Nation to try to get business leaders more interested in the problems of government. I think that it is so very important that business leaders do take an interest in these problems, not only for the future benefit of the country, but government is injecting itself more and more into business. If business is not willing to become involved in trying to solve in a sound way some of these problems, matters may get worse from the point of view of business.

Thank you, gentlemen, very much.

[The prepared statements of Messrs. Brophy, Rahn, McHugh follow:]

STATEMENT OF THEODORE F. BROPHY, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, GENERAL TELEPHONE & ELECTRONICS CORP., ON BEHALF OF THE BUSINESS ROUNDTABLE

SUMMARY

The Business Roundtable has long urged the enactment of structural changes in our tax system that would encourage capital investment, improve productivity, make America more competitive in world markets and most importantly, create more jobs. These changes to our tax laws would stimulate capital formation and individual savings and investment. At the same time we have supported legislation to restrain the growth in government spending by establishing limits as a percentage of GNP which will assure a growing surplus. The Roundtable believes that such a program enjoys broad support and would be an effective mechanism to get the nation back on the road to economic recovery.

The issue that appears to be before Congress at this time is not—should we enact responsible and necessary tax reduction legislation—but rather—when should such legislation be enacted. The Roundtable's answer is that it is urgently needed now to set the stage for healthy long-term economic growth through the 1980's.

The Roundtable membership believes that: (a) a responsible tax reduction in the magnitude of $30 billion should be enacted now, (b) effective January 1, 1981, and (c) the cornerstone of the tax reduction program should be passage by Congress of H.R. 4646/S. 1435 (the "10-5-3" capital cost recovery system). It is widely recognized that American industry is rapidly being decapitalized due to inadequate capital recovery. Therefore, the business community believes that it is imperative that at least one-half of any tax reduction program should be designed to encourage capital formation and savings and investment. What we support can hardly be called a tax cut but rather is a moderation of tax growth.

Capital formation is essential for sustained economic growth. The need for increased capital formation in the United States has been well documented over the last several years.

Accounting rules are now requiring the inclusion of data reflecting the effects of inflation on the financial condition of our businesses. this data shows wide discrepancies between reported earnings and those adjusted for inflation, attributable generally to inadequate capital recovery rates.

Current tax depreciation acts as a deterrent to capital investment. The Roundtable supports the enactment of the "10-5-3" system (H.R. 4646/S. 1435) which would provide improved and simplified capital cost recovery. this legislation has widespread support in Congress and the business community and should be the focal point of the business side of any tax reduction program.

It is also crucial that any individual tax cuts be designed to stimulate capital formation and individual savings and investment rather than consumption. Positive emphasis should be on encouraging the supply side of our economy to reduce the bias in our existing tax system against capital investment and savings. We must act now.

STATEMENT

My name is Theodore F. Brophy. I am Chairman and Chief Executive Officer of General Telephone & Electronics Corp., and Chairman of the Taxation Task Force of The Business Roundtable (the "Roundtable"). I am pleased to have the opportunity today to present to this distinguished Committee the views of the Roundtable on the composition of a responsible tax reduction program that will benefit the long-term economic health of this nation.

Inflation is clearly our major long-term domestic problem. Inflation is a very complex disease that requires a number of remedies. The two most important steps that could be taken to help cure inflation would be the enactment of changes in the Federal tax law designed to encourage capital formation and savings and investment and statutory action to assure a reduction in Federal spending as a percentage of the gross national product ("GNP").

The Roundtable has long urged the enactment of structural changes in our tax system that would encourage capital investment, improve productivity, make America more competitive in world markets and most importantly, create more jobs. At the same time we have argued for fiscal responsibility. To that end we have supported legislation to restrain the growth in government spending by establishing limits as a percentage of GNP which will assure a growing surplus. We believe that the program we have consistently espoused enjoys broad support and is consistent with the mainstream of informed opinion in this country today.

Most recently, on June 18, 1980 we expressed the view before the Joint Economic Committee that a tax cut designed to stimulate capital formation and individual savings and investment, accompanied by fiscal and monetary restraint, would be the most effective mechanism to get the nation back on the road to economic recovery and to restore the United States to its position of economic leadership in the world.

The issue that appears to be before Congress at this time is not—should we enact responsible and necessary tax reduction legislation—but rather—when should such legislation be enacted. The Roundtable's answer is that it is urgently needed now to set the stage for healthy long-term economic growth through the 1980's. We do not believe that an election year should be an excuse not to proceed with legislative initiatives for responsible tax changes or to avoid fiscal responsibility.

The Roundtable membership believes that; (a) a responsible tax reduction in the magnitude of $30 billion should be enacted now, (b) effective January 1, 1981, and (c) the cornerstone of the tax reduction program should be passage by Congress of H.R. 4646/S. 1435 (the "10-5-3" capital cost recovery system). It is widely recognized that

American industry is rapidly being decapitalized due to inadequate capital recovery. Therefore, the business community believes that that at least one-half of any tax reduction program be designed to encourage capital formation and savings and investment. What we support can hardly be called a tax cut but rather is a moderation of tax growth.

The Administration, in its Mid-session Review of the 1981 Budget, prepared by the Office of Management and Budget, is forecasting receipts for fiscal year 1981 to rise by $86.1 billion over that estimated for fiscal year 1980. It is estimated that in 1981 alone social security taxes, windfall profits tax and so-called "bracket creep" will account for some $50 billion of additional tax burdens. Our economists tell us that these large scheduled tax increases, if not offset to some degree by tax reductions, will prolong the recession and make the recovery more difficult.

Correct fiscal policy is curical in this recession. Should the economic slide continue past January, pressure on the Congress next year to "do something" could well lead to a round of counter-cyclical Keynesian type tax cuts to stimulate the economy. This would put us back on the roller-coaster approach to economic policy that we have seen in recent years and would set the stage for even greater inflation later on.

The need for capital accumulation

While the business community is concerned about the short-term recessionary problems, we are even more concerned about the long-term structural problems in the economy. Economists have long recognized the importance of capital formation to sustained economic growth. A society increases its standard of living primarily by increasing productivity of its labor force. Sustained increases in productivity and living standards primarily come from more capital investment—from the construction of more efficient plant and equipment, the discovery and development of new energy resources and energy-saving technologies, research and development of new products and production techniques, and improvements in the skill and health of workers.

Over the past decade, there has been a significant increase in the rate of growth of the labor force which has not been matched by a corresponding increase in the rate of growth of the amount of plant and equipment; the growth rate of the amount of plant and equipment available for each employee has declined significantly. This has reduced the growth of labor productivity, reduced the growth rate of real wages, and contributed to the nation's growing list of economic problems.

If the U.S. is to overcome these problems and achieve its economic and social goals, the Federal government must reorder its priorities and adopt public policies, including tax policies, that will create an economic climate in which savings and investment at all levels will be encouraged. This would include investment in research, development and innovation, by both large and small businesses.

It is no secret that among the principal industrialized countries of the world, the United States has the lowest share of GNP devoted to capital formation, and also the lowest rate of labor productivity growth. These well-known facts are borne out by the following government statistics:

TABLE 1.—SHARE OF GNP DEVOTED TO PRIVATE, NONRESIDENTIAL GROSS CAPITAL FORMATION AND GROWTH RATES OF LABOR PRODUCTIVITY

	Investment ratio [1]		Average annual percent change in productivity [2]			
	Percent	Rank	1963–73	Rank	1973–79	Rank
Japan	19.2	1	8.7	1	3.4	1
France	14.1	2	4.6	2	2.7	3
West Germany	12.8	4	4.6	2	3.2	2
Canada	13.4	3	2.4	5	.4	4
United Kingdom	11.7	5	3.0	4	.3	5
United States	10.2	6	1.9	6	.1	6

[1] Measured as the annual average of gross private, nonresidential fixed investment at current prices as a percent of current gross national product, 1970–78, except 1970–77 for France and West Germany.
[2] Measured by growth in real gross national product or gross domestic product (Germany and France) per employed person, using own country's price weights.

Source: OECD, National Accounts, and Economic Outlook.

Output per American worker grew at an annual average rate of 1.9 percent between 1963 and 1973, but has scarcely grown at all since then. In 1979, U.S. labor productivity actually declined slightly. While productivity growth has also dropped significantly in other major industrialized countries since the early 1970's, it did not change the United States' last place international ranking. Indeed, in many instances, the gap between productivity growth in the United States and growth elsewhere widened. This has unfortunate implications for the ability of the United States to maintain its international lead in living standards among the major industrialized countries. By some accounts, output per worker in Germany has already surpassed that in the United States. And if the most recent trends in productivity growth continue into the 1980's, putput per worker in France, Japan and Canada would also exceed levels attained in the United States by 1985 or shortly thereafter.

Countries that devote the largest share of their GNP to capital formation tend to have the fastest rates of productivity growth. The poor relative productivity performance of the domestic economy can be attributed to a number of factors, such as fast employment growth, a more service-intensive economy, increasing goverment regulation, less intensive efforts on research and development and rising energy prices. However, even after allowing for these other factors, the weakness of business fixed investment over the past several years still explains a major share of the productivity slowdown. By most accounts,[1] Real nonresidential fixed investment will have to total 12 percent of real GNP in the coming years to meet our pressing—and increasingly capital-intensive—national goals and to assure a rising standard of living for all Americans. The latest data for full year 1979 and the first quarter of 1980 produce a ratio of less than 10.5 percent.

Effects of inflation on business

The capital needs of industry are directly affected by inflation, which not only increases the cost of capital, but also substantially raises the price of replacing existing plant and equipment and providing increased and more efficient capacity. Our existing tax structure was not designed to deal with a highly inflationary economy and as a result taxable income computations significantly overstate the "real" earnings of taxpaying entities with effective income tax rates at levels well beyond statutory rates.

Moreover, high inflation makes the environment for investment more speculative. The returns from a prospective investment appear more uncertain. As a result, businessmen are reluctant to commit resources to making additional investment, plants beome outmoded and the rate of productivity growth declines.

During the past several years business has reported "record" annual earnings in their published financial statements. These favorable earnings reports were all the product of existing "generally accepted accounting principles." The calculation of profits of a business enterprise by conventional accounting methods is accurate in a non-inflationary economy, but brings about a substantial overstatement of profits in an inflationary period when the dollar is constantly changing in value.

Accountants and businessmen have for years been trying to find an equitable and acceptable method of reflecting the effects of inflation on financial statements of diverse business enterprises. In September 1979 the Financial Accounting Standards Board issued FASB Statement No. 33, "Financial Reporting and Changing Prices," which is intended to require corporations to show in their annual reports the adjustment of historical cost accounting data in order to reflect inflation's effect. Price Waterhouse, a large public accounting firm, has recently published an analysis of the data reported by some of the Fortune 500 firms in their 1979 annual reports. As detailed in the attached Exhibit I, the study by Price Waterhouse shows that using the FASB Statement No. 33 approach, adjusting for inflation, reported earnings for industrial corporations were 40 percent below what was reported on the normal historial basis, and the effective tax rate was 53 percent rather than the average 39 percent reported. Stock prices for industrial companies during the period 1975–79 only grew 24 percent rather than the reported 74 percent, when adjusted for the effects of inflation. The discrepancy between earnings reported and those adjusted for inflation is generally attributed to the lack of adequate capital recovery rates for American business.

Composition of a tax reduction program

The Roundtable believes that now is the time to enact a tax reduction program designed to stimulate capital investment and to give a clear signal to the country that we intend to increase productivity, combat inflation, create jobs and provide the underpinning for future real economic growth. A tax reduction on the order of $30 billion appears not only reasonable, but a necessary first step to improve

[1] Reports of Joint Economic Committee, 1979 and Council of Economic Advisors in the last three Administrations.

productivity on a long-term basis. A tax reduction of this magnitude, with the correct composition, enacted in this session of Congress and effective January 1, 1981, would only partially offset tax increases already imbedded in the Fiscal Year 1981 Federal Budget and would start us on the way toward long-term solutions to our inflation problem. There is a growing awareness among economists, academicians, public officials and businessmen that increasing supply rather than restricting demand is the more appropriate way of combating inflation.

The focus of the business side of a tax reduction program should be on an improved and simplified capital cost recovery allowance system. Current tax depreciation, based on historical cost, was designed in a noninflationary environment and does not take into account the declining value of the dollar when capital recovery takes place over a long period of time in an inflationary economy. Under the current rate of inflation the real value of the dollars originally invested. Thus, inadequate depreciation acts as a deterrent to capital investment. For the past several years the Roundtable has strongly advocated the enactment of a new capital recovery allowance system such as that embodied in H.R. 4646/S. 1435.

I do not believe that I have to give the details of "10-5-3" in this document. In my memory no other single piece of tax legislation has been as widely discussed, analyzed and debated in the business community, media and halls of Congress as H.R. 4646/S. 1435. This bill has the support of the vast majority of both large and small business groups and is sponsored by 155 Democrats and 152 Republicans in the House and 30 Democrats and 25 Republicans in the Senate. Considering the widespread support that has been expressed for "10-5-3", we submit that there is no need to look further for alternative approaches for solutions to the capital recovery problem.

Outright abandonment of the useful lives concept for depreciation will greatly simplify our tax laws and will accelerate the rate at which businesses recover their cost of investment in plant and equipment. Since "10-5-3" contains an incentive through the 3-year class for smaller businesses to purchase automobiles and light trucks, the passage of this legislation may encourage the replacement of fuel inefficient motor vehicles that have substandard anti-pollution controls and could serve as a major stimulus to a seriously damaged U.S. auto industry and industries dependent thereon.

Clearly, because of the phase-in contained in the "10-5-3" bill the revenue impact in the earlier years is very low and therefore, consistent with the goal of a noninflationary reduction in the tax burden and the need to minimize Federal budget deficits. Feedback stimulus to the economy from "10-5-3" will also help to reduce the original revenue cost of the bill. Since a change in depreciation rates essentially constitutes a change in the "timing" of a tax deduction, acceleration of capital recovery does not represent a permanent loss of revenue to the Treasury.

It is also crucial that any individual tax cuts be designed to stimulate capital formation and individual savings and investment rather than consumption. Positive emphasis should be on encouraging the supply side of our economy to reduce the bias in our existing tax system against capital investment and savings.

In order to provide a base for future long-term economic growth through increased productivity, increased employment and to prevent further decapitalization of American business and to compete effectively in domestic and foreign markets, we must act now.

EFFECTS OF INFLATION AS PUBLISHED IN ANNUAL REPORTS PER FASB STATEMENT NO. 33

Industry Group	Net Income 1979		Tax Rate 1979		Growth in Stock Price 1975-79	
	Reported	Inflation Adjusted	Reported	Inflation Adjusted	Reported	Inflation Adjusted
Industrial	100%	60%	39%	53%	74%	24%
Financial	100	95	28	28	69	22
Retailing	100	42	42	68	12	(21)
Transportation	100	56	30	44	99	42
Utilities	100	31	34	62	(4)	(32)

SOURCE: PRICE WATERHOUSE STUDY, MAY 1980

Exhibit I

STATEMENT OF RICHARD W. RAHN ON 1980 TAX REDUCTION PROPOSALS

My name is Richard W. Rahn. I am the Vice President and Chief Economist of the Chamber of Commerce of the United States, and I am accompanied today by Christine L. Vaughn, Director of the Chamber's Tax Policy Center, and Kenneth D. Simonson, the Chamber's Tax Economist.

The Chamber of Commerce of the United States is the worlds's largest business federation, consisting of more than 95,000 business firms, 2,700 chambers of commerce in the United States and abroad, and 1,300 trade and professional associations. On behalf of the Chamber's 99,000 business and trade association members, we welcome this opportunity to present our recommendations for the prompt enactment of tax relief.

SUMMARY

In light of current economic conditions, the Chamber of Commerce of the United States recommends that Congress move promptly to reduce taxes by $25 to $35 billion. At least one-half of this needed tax relief should promote capital formation. Specifically, the Chamber recommends that Congress:

Replace the present outmoded depreciation provisions with the capital cost recovery system proposed in S. 1435 (the so-called "10-5-3" system).

Reduce corporate tax rates by at least two points.

Correct present law to place American workers overseas on an equal basis with their foreign counterparts.

Adopt tax changes to encourage more savings and investment by individuals,

(1) Lowering the maximum tax rate on individuals from 70 to 50 percent;

(2) Reducing the tax on capital gains; and

(3) Providing more favorable treatment of retirement savings, other tax-deferred savings accounts and dividend reinvestment plans.

Consider across-the-board reductions in individual tax rates, accompanied by substantial additional cuts in spending.

Reject the use of general revenues to finance social security, along with reductions or offsets to social security taxes, without thorough evaluation of the entire system.

Tax relief is warranted by the need to reverse the decline in productivity, to promote capital formation, to create jobs, to curb the unprecedented increase in the federal share of gross national product, and to improve our ability to compete for international markets.

Investment-oriented tax changes ought to be enacted in 1980 and made effective as quickly as possible. We cannot afford to delay measures to improve productivity and create a more favorable investment climate. Such tax reductions create jobs from increased investment and permit more efficient use of greater industrial capacity. This in turn adds to the supply of goods and services without increasing costs, which will help moderate the economic downturn without exacerbating inflation.

Current economic conditions make this an especially favorable time for noninflationary, supply-oriented tax reductions. Interest rates have fallen dramatically since early spring, consumers have reduced their debt, and businesses have scaled back plans for borrowing and are now operating far below capacity. All of these factors imply that any modest increase in the federal deficit resulting from these tax changes would not be inflationary, particularly when accompanied by fiscal and monetary restraint.

THE NEED FOR PROMPT TAX RELIEF

The economic slump

Early this year the economy entered a recession, which the Chamber forecasts will continue through the end of 1980. Real GNP and its major components, as well as employment, industrial production, capacity utilization, and productivity, all began falling by the second quarter or before and are forecast to continue dropping at least through the fourth quarter of this year.

By early next year, the unemployment rate is likely to exceed 9 percent, far above the 7.7 percent rate reported for June. The Chamber forecasts that without an appropriate tax cut business fixed investment will decline until 1982. The merchandise trade balance faces the dismal prospect of record deficits in each of the next three years, providing further evidence of our weakening competitive position in world trade, and brought on to a large extent by inadequate investment and declining productivity. Completing the unhappy picture, the personal savings rate, which sank to a 30-year low of 4.5 percent in 1979, is in danger of staying below that level during the next three years.

Swollen tax receipts

The Administration's "Mid-Session Review of the 1981 Budget" released on July 21 estimates that federal receipts will jump by a record $86 billion between fiscal 1980 and 1981. This amounts to one-third of the increase in GNP forecast for the fiscal year, crowding out business and individual investment.

The estimated increase in receipts arises from four sources: economic growth, inflation, previously enacted tax increases, and proposed legislation. In a healthy economy, growth should be the main source of increased revenues. But when the economy is slipping as at present, or growing slowly, tax increases only weaken the recovery by leaving less disposable income for investment and consumption.

The Administration estimates that without changes in law, receipts would rise by approximately $44 billion, due almost entirely to "bracket creep" in individual taxes and other inflationary effects. Previously-enacted increases in social security taxes and the windfall profit tax add an aggregate of roughly $31 billion. Finally, the Administration has proposed new receipts of $11.5 billion, including $3.4 billion from its proposal to withhold 15 percent from dividend and interest payments to individuals and $3.5 billion from an additional to the excise tax on gasoline. This triple blow of inflation, previously-enacted tax increases, and new taxes will exact a high price from our economy in terms of lost jobs and investments, and will slow the economic recovery during 1981.

Problems with productivity, savings and economic competitiveness

The need for immediate tax relief to stimulate investment becomes apparent when one examines the dismal capital formation record of the United States, with our failing rates of personal savings and productivity, and compares it to the experience of our competitors. All of our major trading partners, even Great Britain, have devoted a larger share of GNP to investment than we have. At least part of the difference in investment rates is due to the comparatively low rate of personal savings in the United States. This is illustrated in the following table.

TABLE 1.—AVERAGE INVESTMENT AND PERSONAL SAVINGS RATES IN THE UNITED STATES AND OTHER INDUSTRIALIZED COUNTRIES, 1970–79

[In percent]

Country	Investment rate [1]	Personal savings rate [2]
United States	17.5	6.4
Great Britain	18.7	12.6
Italy	[3] 20.4	[4] 21.3
Netherlands	[3] 22.4	[3] 14.5
Canada	22.7	9.0
West Germany	23.1	14.9
France	[3] 23.3	17.2
Japan	33.1	[3] 20.5

[1] Gross fixed private and nonmilitary government investment as a percent of gross national product.
[2] Savings as a percent of disposable personal income.
[3] 1970–78; 1979 data not available.
[4] 1970–77; 1978–79 data not available.

Source: U.S. Department of Commerce, "International Economic Indicators," September 1979 and June 1980.

We have already experienced some of the effects of this low investment rate. Unless the trend is changed, these difficulties will be even more severe in the future. Low investment means inadequate replacement of worn-out and technologically outdated productive capacity and insufficient expansion of developing, efficient industries. Without plentiful, modern capital, productivity suffers.

Productivity growth has slowed in recent years. Productivity in the entire U.S. economy grew at an average rate of 3.1 percent from 1955 to 1965, 2.3 percent from 1965 to 1973, and less than 1.0 percent from 1973 to 1978. Productivity actually fell for the second time in postwar history in 1979, and is likely to continue falling in 1980 and 1981 as well. A falling productivity rate is serious because it means that more resources must be used to produce each unit of output. This makes goods and services more costly for Americans to buy, and reduces both our real income and our competitiveness with most of our trading partners, whose productivity has been rising steadily. Over the period 1970–78, productivity in U.S. manufacturing rose an average of 2.5 percent per year, a smaller increase than all but one of our seven major trading partners.

TABLE 2.—AVERAGE PRODUCTIVITY GROWTH IN MANUFACTURING IN THE UNITED STATES AND OTHER INDUSTRIALIZED COUNTRIES, 1970–78

[In percent]

Country	Total	Productivity growth per year
United States	22.2	2.5
Great Britain	18.6	2.2
Canada	35.1	3.8
Italy	41.9	4.5
Japan	45.3	4.8
France	48.7	5.1
West Germany	50.8	5.3
Netherlands	62.2	6.2

Source: U.S. Department of Commerce, "International Economic Indicators," June 1980.

Reductions in real income which result from falling productivity hurt savings, as individuals save less in an attempt to maintain previous levels of consumption. Predictably, the personal savings rate in the U.S. has been falling along with the productivity rate, from a savings rate exceeding 7 percent of disposable personal income in the early 1970s to a 30-year low of 4.5 percent in 1979.

Falling productivity has made the current recession more severe, increased the unemployment rate, and will slow down the recovery. Thus, tax changes designed to improve productivity would play a vital role in restoring long-term economic health.

CHAMBER RECOMMENDATIONS

In order to combat the complex problems of a sluggish economic recovery, inadequate investment, falling productivity and low savings rates, excessive levels of inflation and taxation, and weakened international competitiveness, the U.S. Chamber recommends that Congress move promptly to reduce taxes by $25 to $35 billion. At least one-half of this needed tax relief should promote capital formation. While about one-third of tax reductions traditionally has been directed toward investment, the current pressing need to boost capital formation and productivity requires an increased commitment to this end, primarily through the adoption of the capital cost recovery system proposed in S. 1435, a reduction in corporate tax rates of at least two points, and tax changes to remove existing impediments to exports.

In addition, it is timely to consider a variety of provisions that would reduce the tax bias against individual savings and investment. These changes should include lowering the maximum tax rate on individuals from 70 to 50 percent, reducing the tax on capital gains, and providing more favorable treatment of retirement savings provisions, tax-deferred savings accounts, and dividend reinvestment plans.

THE IMPACT OF PROPERLY STRUCTURED TAX RELIEF

It is imperative that we continue efforts to hold down federal spending and the growth of the money supply. These actions are not in themselves sufficient, however, to correct sluggish economic growth while controlling inflation. They must accompany significant tax relief.

All taxes affect both the supply of, and demand for, goods and services. However, some tax changes affect supply more immediately or directly than do others. To illustrate, a small one-time rebate for each taxpayer provides a temporary increase in buying power and thus stimulates demand, but does nothing to lower the marginal tax rate on either labor income or investment income. Therefore, it does not encourage any additional work effort or investment.

In contrast, reductions in business taxes, marginal personal income tax rates, and taxes on individual savings and investment raise the after-tax return on capital investments and leave workers with greater returns for work effort. These changes produce increased supplies of capital and labor, and lead to greater output and productivity. The resulting expansion of physical capacity eliminates bottlenecks and shortages which can drive up prices. Furthermore, increases in personal savings and in retained earnings by business add to liquidity and lower demand for debt, reducing pressure on interest rates. The combination of lower tax and interest rates will lead to greater output by businesses that are dependent on outside financing, and to increased residential investment. In addition, increased supply and higher after-tax rates of return will help boost exports and attract foreign capital, which should improve the balance of payments and the exchange rate.

Immediate economic effects

An immediate, supply-oriented tax reduction of the size and type recommended by the Chamber will speed the recovery from the current recession, with an accompanying decrease in unemployment. GNP, investment, productivity and real disposable income would increase.

To illustrate these effects, the Chamber used the Data Resources, Inc., quarterly model to compare a forecast exclusive of any tax change with the same forecast including a tax reduction of $30 billion, starting in January, 1981. Approximately half of this hypothetical tax reduction consisted of the "10-5-3" capital cost recovery proposal, a two-point cut in corporate tax rates, and other investment-oriented changes, with the remainder comprising personal income tax rate reductions.

The benefits of such tax reduction plan would be immediate and dramatic, and are illustrated in the following table:

TABLE 3.—ECONOMIC EFFECTS OF PROPERLY STRUCTURE TAX RELIEF

[In percent]

	1981		1982	
	With tax relief	Without tax relief	With tax relief	Without tax relief
Percent change, year over year:				
Real gross national product	0.9	0.2	5.0	4.5
Real business fixed investment	−3.8	−5.8	7.1	1.3
Productivity	1.4	1.1	3.0	2.5
Real disposable income	.6	−.6	3.1	2.6
Consumer price index	9.1	9.1	8.9	8.8
New employment (millions)	2.3	1.9	3.3	2.9
Unemployment rate (percent)	8.9	9.1	8.0	8.5

Source: U.S. Chamber Forecast Center.

Real GNP (GNP adjusted for inflation) would grow substantially faster each quarter during 1981 and 1982. Real Business fixed investment would rise by a strong 7.1 percent in 1982, rather than the 1.3 percent which will occur in the absence of any tax relief. Supply-oriented tax relief would lead to the creation of 400,000 additional jobs a year in 1981 and in 1982, thereby reducing the average unemployment rate in 1982 by 0.5 percent compared to no tax relief.

Productivity would be up by an additional 0.3 percent in 1981 and 0.5 percent in 1982. Real disposable income would grow nearly one percent in 1981 instead of continuing to fall, and in 1982 this figure would be 1.7 percent higher than it would have been in the absence of a tax reduction. Equally as important inflation would be virtually the same with or without this tax change. The consumer price index is forecast to rise by 9.1 percent in either case in 1981, and by 8.9 percent in 1982 with a tax cut, 8.8 percent without one.

Impact on inflation

Properly structured supply-oriented tax reduction would not have to be inflationary, even though some increase in the deficit might result. To see why this is so, it is helpful to recall that inflation is "too much money chasing too few goods." Tax reductions which encourage savings and investment lead to higher productive capacity through greater investment, thus increasing the supply of goods and services. When tax reductions cause the supply of goods and services to grow more rapidly than the money supply, the change is actually deflationary.

The Federal Reserve Board plays a key role in ensuring that tax relief will not be inflationary by maintaining a steady monetary policy, even when the federal deficit increases. Only when Congress allows the deficit to increase excessively, putting unnecessary pressure on the Fed to accommodate the increase by purchasing some of the added debt, do inflationary pressures increase. Over the past year, the Fed has shown a commendable determination to hold down the growth of the money stock. A modest increase in the deficit at this time from tax reductions structured primarily to promote long-term growth should not cause the Fed to abandon this policy. Moreover, increases in the deficit can be kept small by additional reductions in federal spending.

Current economic conditions make this an especially favorable time for noninflationary, supply-oriented tax reduction. Interest rates have fallen dramatically since early spring, consumers have reduced their debt, and businesses have scaled back plans for borrowing and are operating at far below capacity. Accordingly, a modest increase in the federal deficit at this time caused by a properly-structured tax reduction will not trigger a surge in interest rates or require the Fed to add to monetary growth by purchasing the added debt.

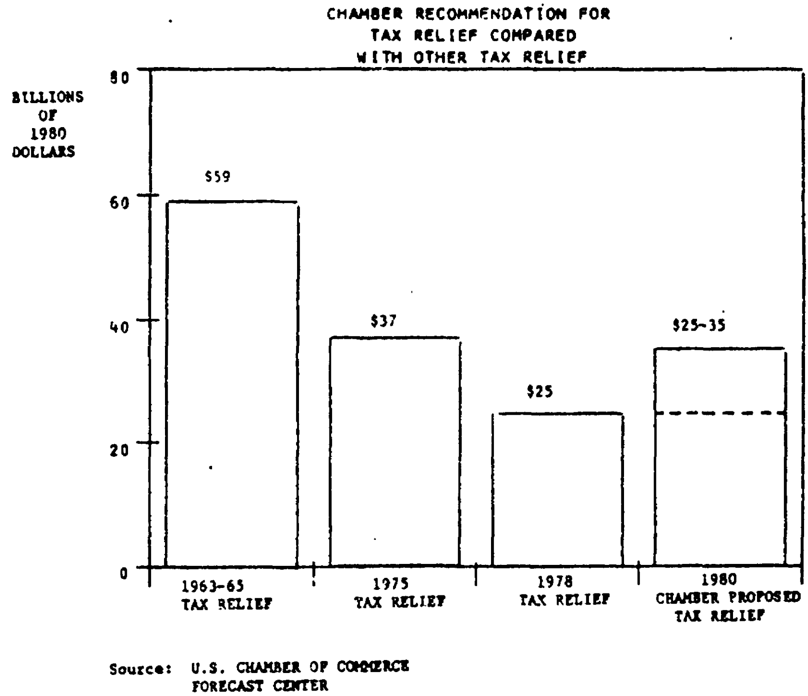
Nevertheless, it is still important that Congress take the lead in fighting inflationary risks from a tax cut by continuing efforts to hold down spending.

The proper size of tax relief

Tax relief must be large enough to provide an effective incentive to capital formation. But it should not be so large as to put impossible pressure on the Fed or on capital markets. A supply-oriented reduction of $25 to $35 billion is modest and appropriate, when judged against the growth of receipts, the current federal share of GNP, or the size of past tax relief. Such a reduction would add significantly to investment and personal savings, thus increasing productivity, employment, and the strength and durability of next year's recovery.

The first concurrent budget resolution anticipated an $88 billion tax increase from fiscal 1980 to 1981. This figure was based on economic forecasts made three months ago, before it was obvious that the country had entered a steep recession. Presumably, revenues will not be as high in fiscal 1981 as the Budget Committees had forecast. The Chamber forecasts that, without a tax cut, receipts would rise by $66 billion in fiscal 1981 and would account for 21.7 percent of GNP. To keep receipts in 1981 at the fiscal 1980 level of 20.6 percent of GNP would require tax relief of about $28 billion. This level is still a peacetime record high. To start toward achieving the more moderate tax levels of the 1960s, our last period of sustained growth, taxes should be reduced still further. It would be desirable for these reductions to be accompanied by further spending cuts.

Another way of measuring the appropriate size of tax relief is by comparing it to previous reductions. As the chart below shows, the most successful tax reduction in recent decades, the Kennedy-Johnson reductions of 1963-65, amounted to nearly $60 billion in terms of today's economy. Even the more modest reductions of 1975 and 1978 amount to $37 billion and $25 billion, in 1980 terms.



Business Tax Relief

CAPITAL COST RECOVERY

The centerpiece of any tax reduction must be enactment of a capital cost recovery system, such as that contained in S. 1435, to replace the outmoded depreciation provisions of current law. During the first half of 1979, the Chamber worked extensively with other organizations to develop a new system of depreciation that would promote capital formation, increase productivity, and create jobs, while providing major simplification of the tax laws.

An overwhelming consensus has developed throughout the business community and in the Congress that the present depreciation system, adopted almost 10 years ago, needs substantial change. yet its proposed replacement, the so-called "10-5-3" system, has been pending before the Congress for more than a year. The time for its adoption is now.

More rapid capital cost recovery under the "10-5-3" system will raise the rate of return on investment in fixed assets and encourage more business investment. With more capital in place, American workers will become more productive, raising the standard of living in this country and making American business more competitive in world markets.

Deferring adoption of depreciation reform until the next Congress would force businesses to postpone investment decisions until certainty in the law has been provided. Delaying legislative action would be a serious mistake, one which risks prolonging the current recession and putting off the much-needed revitalization of American industry.

The 10-5-3 system

The Capital Cost Recovery Act will streamline and simplify the depreciation of buildings and equipment, by divorcing the recovery period for capital assets from the concept of useful lives and by assigning assets to three classes for depreciation over 10, 5, or 3 year periods. This proposal will provide more rapid capital recovery, and will substantially reduce the burden and expense of tax compliance by eliminating many complex provisions of existing law.

The capital cost recovery allowance which taxpayers would be entitled to deduct each year varies among three classes of investment:

Class I—Investments in buildings and their structural components would be written off over 10 years.

Class II—Investments in tangible property other than that in Class I or Class III would have a 5 year write-off. Equipment and machinery would be included in this class.

Class III—Up to $100,000 per year of investments in automobiles, taxis, and light-duty trucks would have a 3-year write-off.

The bill lessens the bias in present law against long-lived assets. The capital costs of all equipment thus will be recoverable over the five-year period. The proposed system also reduces the wide disparity, for depreciation purposes, between equipment and commercial and industrial structures, recognizing that businesses consist of an interrelated set of both types of assets. Reducing the life of buildings as is done in Class I parallels the reductions in lives provided under the system for equipment.

The concept of useful lives

Our federal income tax system for many years has attempted to calculate depreciation allowances for each taxpayer by permitting the cost or other basis of deprecia ble property to be written off over the estimated useful life of the property. This has necessitated a determination, at the time an asset is purchased or constructed, of the estimated useful life that it will have in the hands of the taxpayer. There is obviously no way to determine in advance the future length of life of buildings and equipment, and accordingly we have gone through various methods of estimating those lives.

At one time the Internal Revenue Service produced in Bulletin F a list of 10,000 types of assets with a life for each that was ordinarily acceptable to the Service, but Bulletin F soon became outmoded. Later, the Service in 1962 reduced the number of categories substantially, grouping assets by broad industry or by asset type, with "guideline lives" listed for each category. The determination of useful life, however, could still depend upon all the facts and circumstances of the particular case. In 1971 the Treasury and the Service amended the income tax regulations to institute an Asset Depreciation Range (ADR) system, which recognizes that the attempt to predict the future useful life of property is difficult and uncertain, and thus allows each taxpayer to choose a life that is within a range 20 percent higher or 20 percent lower than a guideline life. The ADR system represents a substantial improvement in depreciation, but one that is limited by the fact that it was designed as a regulation interpreting an existing statute that required depreciation to be measured by estimated useful life.

While ADR gives recognition to the obvious fact that future useful life is extremely difficult to predict, it cannot, without a change in the statute, eliminate the problems that necessarily flow from reliance on the useful life concept. Useful life has been estimated by trying to collect data as to past experience regarding the average length of time particular industries have used their assets and then assuming this experience will continue in the future. But changes in technology, in environmental requirements, in competition from foreign countries, in availability of raw materials and a myriad of other factors occur with an ever accelerating pace, making the experience of the 1960's and 1970's an unreliable base upon which to judge the future life of assets to be built of brought during the 1980's. The federal income tax should take into account the substantial possibility that useful lives in the future may, for a variety of reasons, be shorter than then have been in the past.

The Chamber firmly believes that it is time to amend the statute to abandon the attempt to estimate future useful lives of assets and instead to enact specific statutory lives to apply acoss the board to all industries, with a specified allowance in each taxable year in lieu of the complex system of allowances now in the Internal Revenue Code.

Effects of inflation

Our existing depreciation rules permit write-off only of the actual cost of an asset, and do not take into account rapidly increasing costs of replacements. As plant and equipment wear out or become outmoded, they must be replaced by new assets that inevitably are more expensive because of the ravages of inflation. According to the Department of Commerce estimates, depreciation allowances for all fixed assets except residential structures were over $16 billion short of replacement costs in 1977, and $19 billion short in 1978. Private economists place the disparity much higher. Dr. Martin Feldstein, presidednt of the National Bureau of Economic Research, Inc., has estimated that the cumulative effect of inflation reduced the depreciation allowed to corporations on existing plant and equipment by over $39 billion in 1977. While some have suggested that an "indexing" system be applied to depreciation to allow for inflation in replacement costs, indexing of depreciation involves numerous difficulties, notably complexity in calculation, and especially so for small business. Since depreciation is at best a rough approximation, a far simpler approach is to adopt shorter lives as a means of allowing for the factor of inflation.

The "10-5-3" approach has the advantage of eliminating the difficulties and controversies that have existed in the continuing effort to predict future useful life. Because in general S. 1435 will shorten lives that are presently in use, it will automatically make allowances for the uncertainties that lie ahead in the 1980's and beyond. The "10-5-3" approach will take into account the risks that are inherent in the investment in plant and equipment so essential to our productivity and to jobs. It will make allowance for the increased cost of replacement of assets in an inflationary period. It will provide certainty as to the income tax treatment of such investments, and will put American industry in a better position to compete with industry in foreign countries, many of which now have more liberal depreciation allowances.

Needs of small business

Of prime importance, the "10-5-3" system would achieve a major simplification of depreciation calculations. This is a matter of great significance, especially to small business. Most small firms do not elect to use the ADR system, which they seem to find too complex to use. The ADR system contains over 100 guideline class lives for assets (excluding most real property), and imposes a number of formal accounting and reporting requirements.

The Treasury Department estimates that while nearly 92 percent of corporate taxpayers with depreciable assets of $1 billion or more elected ADR in 1974, only 0.36 percent with assets of $500,000 or less did so. Adoption of a capital cost recovery system will make the accelerated methods and shorter recovery periods built into the "10-5-3" approach available to all taxpayers. This would redress the underdepreciation which presently occurs as a result of the inability of small firms to use ADR, and would provide certainty to those taxpayers without access to sophisticated tax advice. Certain cost recovery will be simpler for small firms to use than present depreciation rules, even aside from ADR, because the new system substitutes three asset classes, each with a single recovery allowance, for the plethora of classes, accelerated and straight-line methods, and computation of salvage value required under present law.

To encourage the modernization and expansion of productive facilities in order to make American industry fully competitive, the present depreciation provisions should be replaced with an efficient, equitable and simple capital cost recovery system. The Chamber believes S. 1435—

Will increase much needed capital investment;

Will improve our lagging productivity;

Will permit us to compete more effectively in the world markets;

Will redress the significant understatement in present depreciation allowances that fail to reflect marked increase in cost of replacement due to the ravages of inflation; and

Will simplify depreciation allowances to the great advantage of the Internal Revenue Service and business, and particularly so for small business.

CORPORATE RATE REDUCTION

To complement adoption of a capital cost recovery system, Congress should lower corporate tax rates by at least two percentage points. Consideration also should be given to lowering the tax on corporate capital gains. Corporate rate reductions will encourage greater investment, and by raising the after-tax rate of return on corporate outlays will enable companies to retain more earnings, a vital ingredient in funding capital expansion.

In 1978, President Carter recommended that the corporate tax rate be reduced from 48 to 44 percent. Congress cut only two points from the top rate, however, setting it at 46 percent, while setting four lower rates on lesser amounts of income. It is time that the maximum rates were lowered by at least two points, to no more than the 44 percent rate proposed 2½ years ago. Moreover, reduced rates of tax on lower levels of corporate income are appropriate as part of a program of tax relief for small business.

Taxation of Americans employed abroad

Evidence exists that the competitive position of United States industry in international trade has been declining. Contributing to this unfortunate trend has been the absence of a clearly stated national emphasis on export expansion, the lack of a carefully designed and consistent set of government policies and programs to encourage exports, and the insufficient awareness on the part of American firms and individuals as to the economic benefits to be derived from exporting.

One impediment which has been the subject of much criticism is the taxation of Americans employed abroad. The costs to U.S. firms of employing American workers overseas have risen dramatically in recent years, in large part because companies often provide "tax equalization" programs for these employees. In some instances, rising tax costs have forced U.S. employers to reduce the number of their American workers, or to replace them with foreign nationals. This trend has serious consequences for U.S. exports. American workers responsible for purchasing goods or services for their companies are more likely to specify American-made products in fulfilling job requirements abroad than would their foreign counterparts. Increased tax costs hit particularly hard at the service industries, our most rapidly growing area of export, since the product sold by these industries is the technical know-how and managerial expertise of the American worker.

U.S. tax treatment of foreign earned income should encourage, rather than discourage, U.S. citizens to work abroad. Tax relief should be adopted to place American workers overseas on an equal basis with their foreign counterparts.

INCOME TAX RELIEF FOR INDIVIDUALS

Congress should give high priority to tax relief for individuals. Despite the $15 billion reduction in taxes enacted in 1978, the Administration forecasts that individual income tax receipts will rise by nearly $100 billion between fiscal 1978 and 1981. This increase will send individual income tax receipts to a record 12.3 percent of personal income in fiscal 1981. Historically, Congress has maintained the ratio of receipts to income in the 9 to 11 percent of personal income, enacting tax reductions whenever it started to exceed this amount. This is illustrated by the following table.

TABLE 4.—*Ratio of Federal individual income tax to personal income, 1951-81*

1951	10.0	1967	10.3
1952	11.1	1968	11.2
1953	10.9	1969	12.2
1954	9.7	1970	11.0
1955	9.8	1971	9.9
1956	10.2	1972	10.9
1957	10.3	1973	10.4
1958	9.9	1974	10.9
1959	10.1	1975	9.6
1960	10.5	1976	10.2
1961	10.3	1977	10.6
1962	10.6	1978	11.0
1963	10.6	1979	11.7
1964	9.3	1980	[1] 11.7
1965	9.5	1981	[1] 12.3
1966	10.0		

[1] Administration estimate based on 1981 Budget Mid-Session Review.

Source: U.S. Department of Commerce.

The unprecedented 12.3 percent ratio which the Administration currently forecasts for fiscal 1981 must be reduced if the tax burden on Americans is to be restored to acceptable levels.

Improving the tax treatment of savers and investors

Congress should address our low rate of personal savings with proposals designed to encourage taxpayers to transfer funds from consumption to savings and from less productive to more productive forms of savings. Properly designed reductions in the tax bias against individual savings and investment must strike a balance among at least three objectives: providing an effective incentive, keeping the revenue loss affordable, and making compliance burdens manageable. The measures discussed below meet these objectives.

50 percent maximum rate

Reducing the maximum rate on investment income of individuals from 70 to 50 percent is desirable from the standpoint of economics and equity because a 50 percent maximum rate on all income would remove the existing bias against investment income compared to earned income, which already is subject to a 50 percent maximum rate. It also would raise the after-tax rate of return on investments which are currently taxed at higher rates, improving the attractiveness of such investments. Moreover, providing the same maximum rate for investment and earned income would simplify the tax system and eliminate numerous taxpayer controversies with the Internal Revenue Service over that constituted earned income.

Rapid inflation, along with the growing prevalence of two-earner families, has drastically increased the number of taxpayers being pushed into brackets above the 50 percent level. Thus setting a maximum rate on all income of 50 percent would directly affect substantial numbers of taxpayers. Small businesses, which often operate as partnerships or sole proprietorships, also would be helped substantially, a fact recognized in the recommendations of the White House Conference on Small Business.

The increased investment induced by cutting the top individual rate would lead to greater employment and higher wages at all income levels. Conventional estimates of revenue losses from tax cuts fail to account for these expansionary effects. This error overstates the revenue loss from all investment-stimulating changes, but nowhere is the error likely to be greater than with rate cuts. In 1964, rates were cut across the board, and the maximum rate was lowered from 91 to 77 percent. Yet taxes paid by the highest income group, those with adjusted gross incomes of $100,000 or more, rose by 20 percent, from $2.46 billion in 1963, to $2.95 billion in 1964. When rates were cut again in 1965 to a maximum of 70 percent, taxes paid by this group rose an additional 27 percent, to $3.76 billion. It is reasonable, therefore, to expect favorable revenue results from a cut in the maximum rate from 70 to 50 percent.

Reducing the tax on capital gains

The effective rate of tax on capital gains should be reduced in order to increase the availability of investment capital.

Until 1978, a noncorporate taxpayer could deduct from gross income 50 percent of net capital gain for the taxable year. In its version of the Revenue Act of 1978, the Senate approved an increase in this deduction from 50 to 70 percent, and the final legislation contained a 60 percent figure. The reason given for this change by the Senate Finance Committee remain valid today: The committee believes that lower capital gains taxes will markedly increase sales of appreciated assets, which will offset much of the revenue loss from the tax cut, and potentially lead to an actual increase in revenues. In addition, the improved mobility of capital will stimulate investment, thereby generating more economic activity and more tax revenue. (S. Rep. No. 95-1263, p. 192)

In the two years since the 1978 change was enacted, uprecedented high inflation and low personal savings rates have strengthened the case for further capital gains tax relief. Such relief can be achieved at modest revenue cost, since it induces many taxpayers to realize gains on assets they would not otherwise have sold. In 1978, the Joint Committee on Taxation staff estimated that the first-year cost of increasing the deduction from 50 to 60 percent was $1.2 billion, net of the revenue pickup from increased realizations. Presumably, a further 10 percent increase in the deduction, to 70 precent, would have a roughly similar cost today. "Feedback" from added investment would reduce these revenue losses still more. For these reasons, we think that a further reduction in the tax on capital gains is appropriate.

Improving retirement savings

Retirement savings efforts in the private sector—by employers, employees, and the self-employed—play a substantial role in meeting individual retirement income needs and provide a stable source of long-term investment capital. Increased private retirement savings will help alleviate the pressures on an already-overburdened Social Security system to provide higher benefits without increasing payroll taxes to fund them. The Chamber therefore supports tax changes to encourage greater availability and use of tax-deferred retirement savings plans.

Present law is needlessly complex, providing tax incentives for retirement savings to some but not to others. We urge this Committee to create a statutory environment that will encourage greater retirement savings by all individuals, a recommendation that also was made in the May 1980, Interim Report of the President's Commission on Pension Policy.

Specifically, (1) individuals who are active participants in any type of qualified employer plans should be permitted to make voluntary, deductible contributions to either their employer's plan or to an Individual Retirement Account (IRA); (2) the limit on deductible contributions to IRA or Keogh plans should be increased and the use of nondeductible contributions considered; and (3) non-working or low earning spouses should be allowed greater access to IRAs.

Current laws permit employees who are not active participants in qualified pension plans to receive a deduction for annual contributions to IRAs of the lesser of 15 percent of compensation or $1,500 ($1,750 for IRAs covering non-working spouses). Self-employed persons may establish similar accounts (known as Keogh plans), with a maximum annual contribution of 15 percent of compensation or $7,500. Income and gain on these accounts generally are non-taxable provided funds are not withdrawn until the taxpayer reaches age 59½. Employees who are active participants in qualified pension plans and non-working spouses cannot contribute to IRA or Keogh plans nor can employees deduct their contributions to employer-sponsored retirement plans.

The changes we propose would be simple to implement because they build upon an existing mechanism, the IRA, with which taxpayers and the Internal Revenue Service are already familiar. Expanding eligibility to use IRAs would be particularly helpful to low and middle income taxpayers, the very individuals for whom increased retirement savings to supplement Social Security are so critical. It would also encourage younger workers, who may not be fully "vested" in their employers' plans, or those who change jobs and lose benefits, to set aside additional savings. Finally, raising the limit on deductible contributions would remedy part of the erosion to this savings incentive caused by inflation.

Tax-deferred savings accounts and dividend reinvestment plans

The U.S. Chamber endorses adoption of tax-deferred savings accounts and qualified dividend reinvestment plans as a way to reduce the tax bias against equity capital and promote capital formation.

S. 1964, introduced by Sen. H. John Heinz, III (R-Pa.), would permit individuals to establish special savings accounts maintained by a financial institution or other trustee approved by the Secretary of the Treasury. No tax deduction would be granted for contributions to the account, but the income and gain on qualified contributions could build up without being subject to tax each year. Holdings could be switched from one type of investment to another as long as nothing were withdrawn from the account. When an amount is withdrawn, it would become includible in the gross income of the individual establishing the account to the extent of untaxed income or capital gain in the account.

Use of these plans would promote capital formation and direct flows of capital to more productive investments by allowing taxpayers to "roll over" investments from on type of holding to another without paying tax immediately on the gain or income from the rollover transaction. Furthermore, the deferral of tax on dividend and interest income left in the account would encourage individuals to save these funds rather than spend them.

S. 1543, introduced by Sens. Gaylord Nelson (D-Wis.) and Lloyd M. Bentsen (D-Tex.), would allow taxpayers to defer tax on up to $1,500 per year ($3,000 for joint returns) of dividends which they elect to receive in the form of new common stock issued by the corporation paying the dividend. The additional stock would be subject to long-term capital gains tax on its entire value upon disposition, if held more than a year, rather than being taxed as dividend income when received.

The companies which would be most likely to use these plans are capital-intensive firms, such as utilities, which currently pay relatively high dividends and must frequently raise large amounts of capital. There seems to be little doubt that participating companies would be able to attract more equity capital through these plans. Furthermore, the existence of such plans would make these companies more attractive to individuals, particularly those who do not now buy stocks.

Individuals rate reductions

Tax rate reductions for individuals are badly needed in order to offset the "bracket creep" from inflation expected in 1981. Rate reductions are preferable to tax rebates, or to increase in the zero bracket amount or the personal exemption, because reductions in marginal rates reduce the disincentive to additional work effort and investment.

A portion of the tax reduction for individuals should go to correct the so-called "marriage penalty" that exist under our current tax system. Under present rate schedules a married couple with both spouses working pays higher taxes than they did as two single workers. This feature of the tax law imposes a penalty upon the institution of marriage. The great increase in recent years in the number of two-earner families has caused this to become a frequent and serious problem on which prompt action is needed.

The size of individual rate relief should depend on how much Congress reduces spending. Congress has made a beginning toward cutting outlays for fiscal 1981, and should act swiftly to approve the spending reductions included in the reconciliation process as part of the first concurrent budget resolution. We hope that Congress will make these cuts permanent, cut spending further in 1981, and adopt a strict, effective limit on outlays as a percent of GNP to hold down spending in future years.

Social security taxation

The Chamber urges caution in the consideration of any changes in financing the social security system, based upon our overriding concern that the solvency of the system be maintained. We remain opposed to the use of general revenues to finance social security, and cannot support reductions or offsets to social security taxes without a thorough evaluation of their impact upon the entire system. Our concern has been heightened by the most recent report of the Trustees of the social security trust funds, which revealed that current payroll tax revenues are barely adequate to meet anticipated benefit needs over the next few years. Indeed, unless legislative steps are taken, the old age and survivors insurance trust fund will be exhausted sometime next year. Thus, this is a most inappropriate time to consider cutting FICA taxes.

Using general revenues to finance social security threatens the principle of financing all benefits from a designated source. This principle has served to keep the growth of benefits from outstripping the means of paying for them.

Social Security tax rates are scheduled to increase on January 1, 1981 by 0.52 percent for employees and employers (from 6.13 percent currently to 6.65 percent) and by 1.2 percent for self-employed workers (from 8.1 to 9.3 percent). In addition, the wage base, or maximum wage subject to social security tax, is scheduled to rise from $25,900 to $29,700. For employees, a 10 percent income tax credit would be equivalent to a payroll tax rate cut of 0.665 percent, more than the scheduled 1981 increase of 0.52 percent in the payroll tax rate. For self-employed workers, a 10 percent credit would be equivalent to a payroll tax cut of 0.93 percent, less than the scheduled 1.2 percent rise in the social security tax rate. And for all workers earning close to the new wage base, the income tax credit would not be sufficient to offset their combined payroll tax rate and wage base increase. Finally, taxpayers whose income is from sources other than wages or self-employment would receive no benefit from this plan.

Accordingly, an income tax credit geared to social security taxes would have significant inequities. It would do nothing to encourage saving and investment, and thus would be less helpful in expanding supply or reducing inflation than would tax changes targeted to savings and investment, or even a general rate reduction. A one- or two-year credit would provide temporary relief at best, since it would not lead to a permanent expansion of employment or output. The credit that would be allowed to employers would be a substitute for the present employer deduction for social security tax expenses and thus would benefit employers far less than employees. Moreover, the refundable portion of the credit for employers would be equivalent to a selective subsidy directed only to businesses with little or no income tax liability. The proposal to allow an income tax credit for 10 percent of social security taxes paid thus would have an uneven effect, not proportionate to the forthcoming rise in social security taxes. We question the wisdom of this action.

Clearly, both the short-run and long-run outlook for social security warrant a close examination of new financing approaches. But the Chamber remains opposed to direct or indirect reductions in social security taxes as a solution. We believe such changes would only jeopardize the system further.

CONCLUSION

The need for investment-oriented tax relief is clear. Our declining rates or productivity and personal savings have contributed greatly to the unprecedented inflation of recent years. If we are to reverse this pattern, our tax laws must encourage people to save and businesses to invest.

We have outlined a number of ways that taxes can be reduced and investment stimulated without adding to inflation. These changes are needed now if our economy is to begin to grow once again.

Deferring adoption of a capital cost recovery system until the next Congress would force businesses to postpone investment decisions until certainty in the law has been provided. Delaying legislative action would be a serious mistake, one which risks prolonging the current recession and putting off the much-needed revitalization of American industry.

NAM

TESTIMONY OF

THOMAS J. McHUGH

ON BEHALF OF

THE NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE COMMITTEE ON FINANCE

UNITED STATES SENATE

July 30, 1980

"A 1980 Tax Reduction Bill"

My name is Thomas J. McHugh, and I am Vice President-Taxes for Kraft, Inc. of Glenview, Illinois. I am representing the National Association of Manufacturers as a member of its Board of Directors and as Chairman of its Taxation Committee. We offer the following summary comments and recommendations for your consideration.

(1) Enactment of a tax reduction package in 1980 (to become effective next January) is desirable, is timely and is feasible. It is questionable that a tax bill can be enacted quickly in 1981. Waiting a year or more to enact such a package will only delay the start of an already overdue task of revitalizing American industry.

(2) The package should concentrate on reducing the federal tax burden on savings and investment for both businesses and individuals. Providing selective relief which is intended as financial aid or stimulating general consumption is undesirable.

(3) The centerpiece of the package should be the Capital Cost Recovery Act, or CCRA (S. 1435), often called the 10-5-3 depreciation bill. Now cosponsored by a broad bipartisan majority in Congress, CCRA has an unparalleled breadth and depth of support within the business community. CCRA is an essential prerequisite if the creation of new capital is not to be offset by the erosive effects of the useful life concept. If additional reductions are possible, they should benefit both businesses and personal savers.

CURRENT ECONOMIC SITUATION

The Recession

The long-forecasted recession is upon us, and there appears to be as much uncertainty now about its length and depth as there was several months ago about when it would begin. Concern about the severity of this recession is heightened in those sectors which are experiencing extreme increases in unemployment as sales drop and profits fall. Such problems in the steel, auto and rubber industries are well-known because they are featured in every publication and on every news broadcast.

But while the recession is headline news, ominous long-term problems continue to threaten the economy. Inflation has been persistent in recent years, and early 1980 figures set record high levels. The most recent indicators show 10% to 12% annual rates which are "moderate" only in relation to earlier 15% to 20% annual rates. Productivity gains have sagged steadily since the 1960's, and they have turned negative in many sectors. Long-term rates of productive investment have lagged behind those of our foreign competitors, and personal savings fell to incredibly low rates in 1979 and early 1980 These are visible signs of significant long-term problems which predate the recession and will live beyond recovery from the recession.

The political response to these concerns from some quarters has focused solely on the recession with predictable proposals. Pump priming with spending for public works and other income maintenance programs has been suggested. A different version of this approach is selective help to specific sectors--particularly through the tax law--to provide quick cash to firms or stimulus to consumption. Spending our way out of a recession has been the usual remedy since the mid-1940's.

Regrettably, this traditional approach to the current recession does not address our long-term economic problems. In fact, it is increasingly obvious that such use of federal fiscal policy to respond to or to influence short-term economic circumstances has contributed greatly to the long-term problems. Emphasis on stimulating demand through ever growing spending has overlooked or even discouraged personal savings and business investment in larger, more efficient supply capacity for American industry. It has created deficits which have been financed by both loose monetary policy and by massive federal borrowings from the private sector. These pressures, coupled with tax policy that inhibits investment, have been the major contributors to inflation and uncompetitive situations for American industry generally.

POLICY CHANGES

NAM's concern over the state of American industry is expressed in a comprehensive program entitled "Revitalization of American Industry." This program offers several proposals for action through the early 1980's. NAM urges Congress to adopt such broadbased policy changes which will attack the long-term problems of inflation, sagging productivity and insufficient investment rather than enact quick fixes for the current recession. Two critical areas in the "Revitalization" program are affected by actions of this Committee. Those are spending restraint and tax reform to remove barriers to savings and investment.

Spending Restraint

The first concurrent budget resolution for fiscal 1981 made a small but firm step toward fiscal responsibility by limiting the growth in spending for 1981. The reconciliation process has begun to enforce such spending restraint. The mid-year economic report indicates how difficult it will be to continue such restraint. But it also reinforces the need to hold the line on spending in the second resolution and to enact a long-term spending limitation. It is through limited spending rather than higher taxes that the federal budget should be balanced.

Tax Policy

While meaningful spending restraint can reduce inflationary pressure, broadbased tax changes are also essential to combat our long-term economic problems. Tax increases drain productive resources away from the private sector and hinder rather than help a long-term policy to improve productivity and reduce inflation. However, our support is not offered for quickie cuts to stimulate consumer demand as an anti-recession tactic. It does not mean tax cuts for particular income groups. And, it does not mean selective measures for specific industries or for certain types of expenditures. As difficult as the current conditions are, they do not justify the use of tax subsidies for quick fixes.

We urge enactment of across-the-board changes in tax policy which encourage savings and investment, and we place depreciation reform--specifically the Capital Cost Recovery Act or CCRA (S. 1435)--at the very top of that list. Depreciation is critical to the long-term needs of our economy because it provides nearly two-thirds of all the funds available for investment. Therefore, depreciation reform is the most logical and most effective area to tackle first. (A detailed explanation of CCRA and a discussion of its economic benefits are presented in the APPENDIX.)

NAM certainly recognizes that other business and personal tax changes can improve the climate for savings and investment. For businesses, corporate rate cuts and a higher investment credit are potential changes. For individuals, capital gains changes, interest and dividend reforms and reductions in top rates offer improvements. Our support for depreciation reform and specifially for CCRA is based on our judgment that now is the time for this issue. Public and congressional awareness of the relationship between depreciation and investment has grown significantly. A broad array of business representatives have urged prompt action.

Depreciation reform is not the only answer to investment woes. But, it is the proposal which is right for 1980, and it needs attention first.

1980 ACTION

Action is both possible and needed in 1980 on a tightly structured tax bill. The shortness of time prior to congressional adjournment this fall should enhance rather than reduce the prospects for drafting a tax bill which is not adorned with numerous attractive ornaments. In fact, NAM would like to work with the Committee in this regard by minimizing or eliminating the "laundry list" approach for priorities after CCRA. If action is delayed until 1981, it seems more likely to us that the process will be lengthy. Following organization of the Congress, the tax legislative process probably could not begin before spring. With no time pressures for action, the prospects would increase for extensive discussion of long lists of proposals.

It is likely that these factors would push enactment into late 1981 or 1982.

The need for 1980 action is heightened by the fact that we face a long, hard task in the revitalization of our industrial base. An early effective date for a tax change is important, but early enactment is of equal or greater importance. We believe that a major depreciation change will encourage increased levels of capital spending over a period of years as suggested by the econometric analysis presented in the APPENDIX on pages A8 and A9. But such increases will not occur overnight. Financial planners will need a period of months to adjust both capital appropriations and actual spending once they are certain that a depreciation change will occur. 1980 action will provide that assurance. Waiting until 1981 will cost several months, if not a year or more, in the planning process.

The longer we delay in revamping our complex and counterproductive depreciation system, the greater the risk that more American industries will slide into an uncompetitive stance around the world. We cannot identify with certainty which industries might be the most prone to slip into the uncompetitive category, nor is there any reason to attempt to identify them for purposes of either special help or concern. But we believe that a failure to address basic economic policy issues now--and particularly the depreciation issue--will simply insure that other problem industries will develop during the 1980's.

This possibility is illustrated by the current problems in the steel and auto industries. They did not develop just because we slid into this recession, and they will not be cured simply as we climb out of this recession. There have been international factors, regulatory demands and capital formation restrictions which have caused these problems. These factors have been at work over many years, and many years will be needed to overcome their effects.

The sagging export picture for manufactured goods reinforces the need to move with speed. While many factors impact our ability to compete with foreign firms, the strength of our domestic industrial base is the most important. Until American industry is revitalized, we cannot expect a long-term improvement in export competition or even in domestic competition with imports.

For these reasons, it is vitally important that major policy changes be enacted as soon as possible for the entire range of productive business. Such a broad scale change encourages economic forces to allocate the capital resources to needed industries. If it is still deemed essential that federal support be offered to industries which are now in dire straits, that should be debated after and in addition to broad changes rather than as the first order of business. Failure to undertake broad changes now simply increases the prospects for debating more selective relief at a later time.

THE CAPITAL COST RECOVERY ACT

NAM strongly recommends that Congress take a major step this year in implementing broad policy changes. That major step should be a basic overhaul of tax depreciation rules. Specifically, we recommend that the Committee start with the Capital Cost Recovery Act or CCRA (S. 1435), which is now cosponsored by 55 members of the Senate including 12 members of this Committee.

We make this recommendation for the following three reasons:

- CCRA will remove tax-induced higher costs and distortions related to the purchase of capital assets. The long-term economic impact of this change will be to encourage needed investment in expanded supply capacity and more productive assets, contribute to the higher productivity of labor, hasten purchases of more energy-efficient processes, create markets for new technologies stemming from innovative research, and generally expand our industrial capability to fulfill domestic consumer and defense needs and to compete in world markets.

- CCRA will remove inequities caused by the complexity of current depreciation rules and by the historical lack of improvement in depreciation for productive structures compared to equipment.
- CCRA has been analyzed and discussed for over a year. The features needing attention are more well-defined and much better understood than alternative proposals which are only now being considered. It is the proposal from which the final measure can be developed most quickly.

Economic Benefits

CCRA's principal economic effect is to eliminate the concept of depreciation which stretches tax deductions over periods of years estimated to be the useful lives of the assets. This process produces artifically high costs for buying such assets by requiring that the taxpayer either forego other income-producing investments while its capital is recovered or pay higher interest costs for the use of borrowed capital. The longer the useful life of the asset, the greater the impact of such higher costs. A drastic reduction in the longest recovery periods coupled with the creation of a very limited number of write-off categories will dramatically reduce these adverse effects. CCRA provides just such reductions.

Once this artificial tax factor is reduced, market pressures will allocate capital more efficiently as well as enhance the return on many investments, thereby encouraging new capital formation. The result will be a steady increase in the desirability and the feasibility of investments in many areas:

- expanded supply capacity generally;
- more efficient assets to improve labor's productivity;

- more energy-efficient assets;
- more technologically advanced processes developed by innovative research and development; and
- a generally expanded industrial base to serve domestic consumers, export markets and defense hardware needs.

These results are intertwined, and they stimulate one another. Major depreciation reform provides the framework on which all of these activities can build during the 1980's. Rather than targeting these and other concerns for specially constructed tax changes, Congress should move in 1980 to make the fundamental change which then frees market forces that move capital resources into these areas simultaneously as businesses, investors and consumers dictate.

Much has been written and said about the relative impact of CCRA on investments in long-lived and short-lived equipment. It has been alleged that the use of only a 5-year category will "distort" investment and push capital into the longer-lived assets. We expect that there will be shifts in investment patterns, but we disagree with the allegation that such shifts will be distortions. As noted earlier, current law imposes a higher cost on the purchase of long-lived asets. In our view, eliminating the current tax-induced differences removes a distortive effect.

Equity

Two areas of equitable concerns are the simplification of depreciation so that firms of all sizes work under the same rules and the significant change in attitudes dealing with structures. Each has an economic impact.

Simplification. Current depreciation has been improved by accelerated deductions and by the ADR system which allows a 20% reduction in depreciable lives. But the processes required to understand, to implement and then to explain decisions during audits are just too much for most small firms to handle. Current techniques are desirable because they are applied to the great mass of industrial assets, but they are not uniformly available. CCRA's extreme simplicity creates a system which applies the same rules to taxpayers of all sizes with varying resources to use in complying with the law.

The transition rules under CCRA have been criticized as being too complex to follow and, therefore, an adverse feature of the bill. We believe that a transition rule is appropriate to restrain the revenue impact, but we would be glad to support a period of less than the proposed five years. The mechanism itself has been unjustly criticized. The use of transition subcategories for the machinery category is much simpler than current law, and it provides a reasoned approach to long-term implementation of this needed reform.

Structures. The dramatic change proposed by CCRA for treatment of structures has attracted a good deal of comment. NAM very strongly endorses the 10-year category for structures, and we urge the Committee to act favorably in this area.

In recent years, no serious attention has been given to depreciation for business structures. Factories, warehouses and retail buildings are just as much productive capital assets as are the machinery, equipment and delivery vans which produce and distribute products for customers.

Structures in general certainly are not purchased as often as machinery, and factory buildings in particular do not equal the dollar value of industrial investments in machinery and equipment. Yet, they are critical to an up-to-date industrial base and distribution system. New structures are essential for capacity expansion. They are needed when new processes are developed. They are required when old structures are just worn out or waste so much time, energy or space that they are uneconomical.

However, while cost recovery for machinery and equipment has been improved dramatically in the last 20 years--by 1962 changes in Bulletin F lives, by the investment tax credit and by ADR in 1971--treatment of structures has not been changed. Their depreciation periods are <u>very</u> long. An NAM survey of its members early this year indicates that 66% of the respondents use lives in excess of 25 years and 52% use lives in excess of 30 years. Using straight line or, at the best, 150% declining balance, the annual deductions are very small, thus increasing the tax-induced cost of structures.

A dramatic improvement in the treatment of business structures is needed. Concerns expressed over speculation and tax-oriented investors are not relevant to factories, warehouses and retail buildings which are integrally related to manufacturing or distributing goods. We urge that CCRA's significant improvement for these structures not be set aside by concerns about other structures.

<u>Business Support</u>

It is certain that there are a number of features of CCRA which do not quite attain the ideal which many of us would like to reach. It is equally certain that there are a number of provisions which are of much less importance to manufacturers than they are to retailers, wholesalers and service industries. Briefly put, no one group is likely to find 100% of its objectives met by CCRA. However, NAM very strongly supports this bill because it provides a generally applicable system for use by both large and small firms, by manufacturers and retailers and service companies, by all areas of the country. It was first analyzed and is now supported by a broader range of business groups than any proposal in recent memory. Business sectors which do not significantly benefit in a direct way nonetheless are supporting CCRA because they foresee considerable economic benefits for their services--such as the construction of new factories--and for the sale of their products--such as new and more efficient technologies to industries laboring under very long depreciation periods.

CONCLUSION

The past thirteen months since introduction of CCRA have allowed extensive discussion of this measure. Numerous technical changes and substantive revisions have been identified and discussed. These hearings will raise those matters for further discussion. We are willing and able to respond to such proposals because we believe that the structure of CCRA offers the best foundation on which to build.

We believe that it is essential that the Congress enact a tax bill this year and that CCRA be the major component affecting business investment. A delay until 1981 will only allow more time to pass before long-term improvements in our industrial base can be conceived, planned and implemented.

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APPENDIX

The Capital Cost Recovery Act (CCRA) in the U.S. House of Representatives is H.R. 4646 and in the Senate is S. 1435. The major features of CCRA are briefly described below.

Specifics of the Bill

Write-off Periods. CCRA would allow the business taxpayer to recover capital investments over very short periods that are not related to useful lives. The current useful life depreciation concept, which stretches depreciation deductions over varying periods of time based on someone's best guess of how long the asset will be in use, would be eliminated. Instead, all investments in physical assets (except land) would be subject to one of these recovery periods:

Asset group	Recovery period
Buildings (except residential rentals)	10 years
Machinery and equipment	5 years
Autos, taxis and light duty trucks (up to $100,000 of annual purchases)	3 years

Percentage deductions. Instead of having to choose among several accounting techniques and then make a series of calculations, the taxpayer would simply use the following deduction schedule for each asset group as provided in the bill. These deductions, based on existing accelerated deduction techniques and accounting principles, would be the maximum allowed each year.

Year	10 years (structures)	5 years (machinery and equipment)	3 years (autos, taxis, light trucks)
1	10%	20%	33%
2	18	32	45
3	16	24	22
4	14	16	
5	12	8	
6	10		
7	8		
8	6		
9	4		
10	2		

Discretionary use. The taxpayer could take the maximum deduction each year or carry forward any portion of it. The unused part would be added to the next year's maximum and the same discretion would apply. This would allow the taxpayer to spread deductions over as long a period as necessary.

Investment credit. The investment tax credit (ITC) would be 10 per cent for the five-year category and 6 per cent for the three-year category. In the event of early dispositions, a recapture of two percentage points per year is included. While current rules for relating the ITC to useful lives would be abolished, the definition of qualified ITC property would not be changed.

Salvage values. Unlike present law, no salvage values would be deducted from the cost of the asset. The entire cost would be eligible for CCRA.

Placed-in-service rule. CCRA would be applied in the year costs are incurred, if that is earlier than the year an asset is placed in service.

Used property. There would be no distinction between new and used property for capital recovery purposes. Both would be treated in the same way.

Transition. To minimize the immediate budget impact, the ten-year and five-year categories would be phased in over a five-year period. The three-year category would be available immediately. The transition procedure would drastically cut the number of current law categories of assets and improve asset write-offs by immediately applying all CCRA rules affecting accelerated deductions, salvage values, ITC, and the like.

Why Enact CCRA

There are three principal reasons for enacting a rapid capital recovery allowance system.

First and most important, the overall long-term economic impact would be significantly beneficial. America must renew its commitment to achieving real economic growth and baking a bigger and better economic pie rather than bickering over how to divide stagnant or shrinking shares. We must improve the efficiency and expand the capacity of the industrial sector, as well as develop better distribution and service sectors that link industry to consumers.

A faster rate of recovery on productive assets would lower the tax-induced distortions in the cost of physical capital and encourage larger investments in plant and equipment. The resulting expansion and modernization of industrial capacity would improve U.S. productivity that, in turn, would ease domestic price pressures. The result would be real wage increases for American workers and improved export opportunities which could mean new jobs. Essential energy-related investments and the nation's increased defense hardware needs in the 1980's only emphasize the need.

Second, a simplified system would extend the benefits of rapid recovery to all firms without burdening them with complex record-keeping and accounting rules. This is particularly important to smaller firms that rely heavily on internally generated funds but cannot use the current complex accelerated systems. Taxpayer/IRS problems with depreciation controversies would be reduced dramatically.

Third, faster recovery would reduce the erosion of capital due to the effects of inflation under the existing long depreciation periods known as "useful lives." Inflation's impact on depreciation will become more obvious as the nation's largest firms provide supplementary inflation-adjusted data in their annual reports as required by Financial Accounting Standards Board Statement #33.

The impact of a major change in capital recovery can be very dramatic. About two-thirds of this country's pool of private savings is provided by corporate and individual depreciation deductions. Since every desired investment dollar must be matched by a dollar of savings, a sizable improvement in such a major source of savings would significantly boost the the level of productive investment.

Economic Needs

The anti-inflation fight is the number one priority for our economy--and rightly so. Raging inflation must be contained and then stopped. This will be a long and unpleasant task because inflation's roots have grown deep through years of outright nurturing by government policy. Long-term restraint in federal spending and balanced budgets, combined with a reasonable monetary policy, are essential to solving this serious problem.

While inflation statistics are highly visible, other figures such as sagging productivity and low levels of capital investment also represent major problems. They have developed over a long period and, like inflation, will need many years to correct. The statistics may seem dry and lifeless. But they signal serious problems that affect all of us, and they need attention now.

Productivity gains. Simply stated, productivity is the measure of output per unit of time worked. Increased productivity means that one unit of labor (*e.g.*, 1 man-hour) produced more output this year than it did last year. When labor generates more output in the same period of time, labor's services are more valuable than before. Thus, productivity gains generate *real* wage increases, as opposed to those which merely keep pace with inflation.

Regrettably, American productivity gains have been slipping. Table 1 shows the annual productivity changes for non-financial corporations in the 21 years from 1959 through 1979. During the first ten years, there were nine annual gains of 2 per cent or more. There were only five such gains during the second ten years, and two years showed annual productivity losses. Worse yet, 1979 actually registered a *loss* in productivity, and 1980's early figures are discouraging.

Table 1 Changes in Productivity
(Seasonally adjusted percentage changes from preceding period, for non-financial corporations)

Year	Percentage change	5-year period	5-year average
1959	4.4		
1960	2.0		
1961	3.3		
1962	4.9		
1963	4.1	1959-63	3.74
1964	3.8		
1965	3.2		
1966	2.1		
1967	1.1		
1968	3.3	1964-68	2.70
1969	.3		
1970	- .1		
1971	3.4		
1972	3.6		
1973	2.1	1969-73	1.86
1974	-3.8		
1975	3.1		
1976	3.3		
1977	1.1		
1978	1.0	1974-78	0.94
1979	- .4		
1980 (estimate)	- .7		

Source: Department of Labor, Bureau of Labor Statistics, July 1980 (The 1979 estimate is a projection based on BLS statistics through September.)

Total productive investment. Sad as the productivity statistics are, they should not be too surprising. An economy cannot maintain significant steady increases in productivity if it does not invest in the new, more efficient plant and equipment that generate those increases. For many years, government spending and tax policies have encouraged high levels of consumption and discouraged the savings and investment needed to develop the capacity to supply efficiently the consumers' demands. Meanwhile, our industrialized foreign competitors have achieved and maintained higher levels of investment. Table 2 shows the relative rates of investment in non-residential business assets by the United States and our major foreign competitors. The United States is behind even the United Kingdom in the percentage of gross domestic product which is devoted to productive investment.

Table 2 Real Non-Residential Fixed Investment as a Percentage of Real Gross Domestic Product, 1966 - 1976

Country	Per cent of real gross domestic product
Japan	26.4
West Germany	17.4
Canada	17.2
France (1970-75)	16.7
United Kingdom	14.9
United States	13.5

Source: Economic Report of the President, 1979, Organization for Economic Cooperation & Development

The general economic problems caused by inadequate productive investment are increasingly recognized by the average employee and by Congress. The severe financial problems of major industrial corporations, the closing of major steel plants, the aging of automobile plants and tire factories--these and other headline situations drive home the need to put more of the nation's product into new and expanded productive capacity. This pressure is being intensified in the early 1980's by two special circumstances: the need for greater energy-related investments and the increased strain on industry caused by the projected surge in defense hardware purchases.

Energy Investments. The long-term needs to build more energy-efficient plants and equipment and to develop viable alternative energy sources are two more important reasons to enact CCRA. American industry has already proven that it can conserve energy. From 1973 through 1978, industry reduced its total energy demand by 6 per cent, and our petroleum demand fell by 6.7 per cent. With industrial production rising 11.8 per cent, industry realized a 16 per cent improvement in energy efficiency during that period. The market incentive to minimize the impact of higher energy costs stimulated this response, but even more conservation-related investments can be made. As industry retools for the 1980s, the energy efficiency of each investment will be weighed carefully. Unfortunately, long depreciation periods distort and drive up the cost of capital needed for these investments. Removing this tax barrier would further encourage existing market incentives that direct capital to energy conservation by making all new investment in plant and equipment less expensive.

Defense Spending. The increased real federal spending for national defense through 1985 is another reason to enact the Capital Cost Recovery Act. Our industrial base must be expanded to allow for the efficient production of the defense hardware now being contemplated. Many domestic industries already have problem supplying consumer demands efficiently. The dramatic increase in the purchase of military hardware would severely aggravate this problem in areas such as aerospace that draws on numerous industries for raw materials, component parts and sophisticated systems.

An increased industrial base is needed over the next few years if we are to avoid a situation where defense needs must replace production of commercial goods. A sensible policy will encourage expanding and modernizing the total industrial base rather than squabbling over an allocation of existing capabilities.

Investment Distortions. CCRA addresses these economic needs by virtually eliminating a major obstacle to productive business investment--the useful life concept of depreciation. The whole process is at best imprecise and at worst a complete distortion of reality. Serious studies of true economic depreciation of assets have produced recommendations that vary from stretching out lives and using straight line percentages to shortening lives.

Critics of CCRA argue that some variation in lives is essential. In their view, eliminating the useful life concept will lead to investments that favor assets with longer lives over those with shorter lives. They argue that government policy should not encourage such distortions.

The problem with this view is that it proceeds from the wrong point of departure. CCRA will remove the distortion that useful life depreciation itself causes. A truly neutral capital recovery system for tax law would treat all capital expenditures alike no matter what the estimated useful life. This neutrality would remove the tax-induced distortions that now make longer-lived assets relatively more expensive because the cost of investing in them is increased due to the period of years over which such cost must be carried.

CCRA would move federal tax law dramatically toward neutrality. Investments would then flow to areas as dictated by market forces.

Simplification

Another principal problem addressed by CCRA is the myriad of rules, formulas and regulations under present depreciation. This area is of particular importance to smaller firms.

Disputes with IRS agents over lives and determination of depreciable basis after salvage values are the major depreciation controversies for business taxpayers. The Class Life System and the Asset Depreciation Range (ADR) reforms, instituted under the Revenue Act of 1971, have improved the available rate of recovery. The two systems, however, have created major recordkeeping problems. As a result, few firms have been able to use ADR, although a major portion of all productive assets are covered by it.

Early this year, NAM asked some 9,800 member firms to provide general information on their depreciation problems and investment patterns. The survey was not intended to be a scientific study. Even so, the high 18 per cent response rate and the estimated $46 billion annual depreciable investments of the responding firms suggest that the sample represents a reasonably good picture of the circumstances faced by American manufacturers of all sizes.

A number of questions asked how depreciation rules affect firms. The principal findings are summarized here.

> The most significant issue in depreciation disputes with IRS involves the useful life of an asset. The deduction of salvage values is a major problem. The appropriate records, the appropriate starting state for depreciation and the method for calculating deductions are also problem areas.
>
> ADR is not used by six out of ten responding firms. Almost 38 per cent of these based their decision on the complexity and expense of compliance, and 18 per cent report they do not understand the system. While 4 per cent have other reasons, the remaining 40 per cent conclude that ADR would provide no benefit over their current practices.
>
> One out of six responses were from former ADR firms which had left the system. The complexity/expense problem and the lack of benefit were each identified by 40 per cent of these firms as their reason for change. Other reasons were given by 20 per cent.
>
> Among the present and former users of ADR, a significantly increased volume of records is reported by 30 per cent of the responses. Additional staff is required by 18 per cent, and 12 per cent even continue to have disputes with IRS over classifying assets within useful life categories.

CCRA tackles these matters directly. The useful life problem--the most significant one noted in the survey responses--would be eliminated. Salvage values would be eliminated, and the calculation of deductions would be replaced by statutory tables. Records would still be needed, but the volume should be drastically reduced by the simplified system.

Inflation Offset

The investment benefits and the simplification resulting from the capital recovery system are primary reasons for its enactment. An important additional reason has surfaced--the perverse effect of inflation. It erodes the value of recovered capital while increasing the real tax rate on business income, which has not taken into account the lost purchasing power of depreciation deductions. Recent double-digit rates of inflation have aggravated this problem.

The 1979 financial reports of major corporations are required by Financial Accounting Standards Board Statement #33 to include supplementary information about the effects of inflation on income, monetary assets, inventory, plant and equipment. The result is a dramatic portrayal of the increase in real taxes due largely to the under-depreciation of assets. CCRA would substantially reduce this effect.

Economic Impact of CCRA

The Analysis of Tax Impact Model, developed by Norman B. Ture, Inc., projects that the CCRA system would induce significant increases in physical capital investment and larger total tax deductions. Table 3 summarizes these areas of impact for 1981 (presumed to be the first year under the system), 1985 (the end of the five-year phase-in) and 1990 (the tenth year after enactment). This analysis updates an earlier Ture report to the NAM using 1980 as the year of implementation.

The model does not forecast specific quarterly economic developments. Rather, it is based on a general trend over a long period of years. Therefore, the projections in both Tables 3 and 4 must be read as an indication of the direction and order of magnitude of the economic impact of the proposed system.

Table 3 CCRA Induced Changes in Depreciable Investment and Tax Deductions (billions of current dollars)

	1981	1985	1990
Increased depreciable investment	$ 29.9	$119.9	$ 78.6
machinery & equipment	14.0	51.3	39.1
structures	15.9	68.5	39.5
Increased recovery deductions	10.7	177.7	259.6
due to CCRA applied to expected investment under present law	7.1	116.1	171.3
due to CCRA applied to increased investment stimulated by the system	3.6	61.6	88.3

*All estimates reflect increases (or decreases) above what would otherwise occur under present law in the given year. Totals may not add due to rounding.

Source: Norman B. Ture, Inc., July 16, 1980

The positive effect of CCRA on capital stock is clear. This increase in the stock of physical capital will create a multitude of economic benefits in the areas of employment, real wages, output and federal revenues over a decade (Table 4).

Table 4 General Economic Effects of CCRA*
(current dollars)

Changes in:	1981	1985	1990
Fulltime jobs (thousands)	170	460	570
Annual wage increase	$160	580	1,030
GNP (billions)	$ 27	110	213
Business investment (billions)	$ 21	134	75
Federal revenues (billions)			
Initial impact	($7)	(55)	(83)
Net of feedback	($3)	(51)	(59)

*All estimates reflect increases (or decreases) above what would otherwise occur under present law in the given year.

Source: Norman B. Ture, Inc., July 16, 1980

Senator BYRD. Now we have a panel of six witnesses. Mr. Jack Carlson, executive vice president of National Association of Realtors; Mr. Herman J. Smith, first vice president, National Association of Homebuilders; Mr. Alan Aronsohn, tax counsel for the National Realty Committee; William J. Langelier, chairman of the Coalition for Low- and Moderate-Income Housing; Mr. Myles Tanenbaum for the International Council for Shopping Centers; and Gardner McBride, executive vice president of Building Owners Managers Association, International.

Welcome, gentlemen. We will first hear from Mr. Jack Carlson.

Mr. LANGELIER. Excuse me, Senator, but Mr. Carlson has been kind enough to yield to me, since I have an airplane to catch.

Senator BYRD. Then why don't you proceed, sir.

STATEMENT OF WILLIAM J. LANGELIER, CHAIRMAN, COALITION FOR LOW- AND MODERATE-INCOME HOUSING

Mr. LANGELIER. Mr. Chairman, my name is William J. Langelier. I am Chairman of the Coalition for Low- and Moderate-Income Housing. I am accompanied today by Charles L. Edson of the law firm of Lane and Edson, P.C.

Thank you for the opportunity to present to the committee the views of the Coalition for Low- and Moderate-Income Housing. The coalition was organized in 1975 to bring together all associations, trade groups, business organizations and individuals who are involved with Government-assisted low- and moderate-income housing. Our members participate in all aspects of this housing, including financing, production, rehabilitation, and operation.

Housing generally is now in a deep recession with housing production falling toward its lowest level since 1946. The production of housing for persons of low- and moderate-income has also taken a significant drop. This will have an even more severe impact on the shortage of general housing because the persons who qualify to live in low-income housing have few, if any, alternatives. They depend upon the housing created for them by private industry under Federal and state housing laws and regulations.

Because of the numerous restrictions imposed by the Federal Government on the rate of return, rental fees, and resale opportunities for this government assisted housing, the only principal encouragement for new construction and substantial rehabilitation are the tax incentives available.

Without these tax advantages, housing for low- and moderate-income persons will not be built, since investors will prefer market rate housing which is not subject to the redtape and other problems frustrating participation in the Federal programs.

For this reason, we strongly oppose those tax incentives, such as 10–5–3, which do not include low- and moderate-income housing, indeed any housing, in their incentive plan, and we support instead the bill introduced by Senator Williams, S. 2969.

Senator Williams' bill provides for a straight 15-year useful life for new low-income housing, compared to a straight 20-year useful life for all other real estate. This differential means slightly higher depreciation deductions each year for low-income housing. This differential is critical if the Federal Government expects any low-income housing to be built in the next 10 years.

There must be more favorable tax incentives for investment in low-income housing as compared to all other real estate in order to compensate for the restrictions on return, and limited potential for appreciation inherent in low-income housing. Our only concern is whether this differential suffices to offset the detriment to investing in housing for our lower-income population.

Unfortunately, just when these tax incentives are so badly needed, an existing tax incentive is being taken away by legislation passed in 1976. Beginning in 1982, individuals constructing low-income housing will not be able to fully deduct the construction period interest. Instead, a portion of these expenses must be capitalized and deductions deferred for future years.

We must emphasize that tax and interest payments made during the construction period are real, out-of-pocket expenses for which, in any other industry or business, the taxpayer would be allowed a current deduction.

For all real estate other than low-income housing, the requirement that construction period interest and taxes be amortized is now effective. Even when Congress imposed this requirement in the Tax Reform Act of 1976, it recognized that it was necessary to retain the deductions for construction period interest and taxes with respect to low-income housing in order to continue the incentive to private investment in this housing.

Congress hoped that by providing the five-year grace period that alternate non-tax incentives for the production of low-income housing might be developed. No alternatives have been developed, however, and it may well be that there are no better alternatives available.

Unfortunately, because of the long lead time necessary in housing production, this matter cannot be left until 1981. The full deduction of construction period interest and taxes should be permitted in the future as it is now for low- and moderate-income housing.

We also tentatively support the removal of this restriction for other real estate as well, since conventional rental housing and commercial real estate are in need of tax relief. However, this support is conditioned on the five-year differential in depreciation period for low- and moderate-income housing discussed above.

We must take this stand as low- and moderate-income housing needs even greater incentives than conventional real estate if it is to compete in the market. In the absence of a distinction in the depreciation period, we would urge continuation of present law permitting the advantages to the owners of low- and moderate-income housing in the deduction of construction period and interest and taxes.

We strongly support the bill introduced by Senator Williams, S. 2969, as an alternative to the "10" in 10-5-3. Significantly, the entire initial revenue loss of the Williams bill would be less than half the cost of the "10" in 10-5-3.

In addition, the Williams bill contains a number of important provisions, such as the extension of Section 167(k) rehabilitation incentive, the extension of benefits for historic preservation, the advance refunding of housing bonds, the ability to freely use revenue bond proceeds for rehabilitation of low-income projects and clarification of the trade or business status of real estate developers, to insure that the Nation's housing needs will be met in the next decade—not by expensive Government programs but by specific incentive for private industry. We urge its prompt adoption.

Thank you again for letting me speak out of turn. Mr. Edson will remain here to answer any questions.

Senator DOLE. Thank you.

I say this, and not out of any disrespect, to the following witnesses. You may all be here alone, and there will not be any questions. We are trying to find other Senators to be here.

So if you can summarize your statements, they will all be made a part of the record. If there are points that you want to stress, we certainly will want you to do that.

Are you next, Jack?

Mr. CARLSON. Yes, sir.

STATEMENT OF JACK CARLSON, EXECUTIVE VICE PRESIDENT AND CHIEF ECONOMIST, NATIONAL ASSOCIATION OF REALTORS

Mr. CARLSON. I am Jack Carlson, executive vice president of the National Association of Realtors, representing over 700,000 members.

We strongly recommend slower growth of Federal taxes as soon as possible, and certainly by the beginning of fiscal year 1981, on October 1, 1980. Specifically, we recommend the following:

One, allow 15-year straight line depreciation on all structures: rental housing, commercial, industrial, and agricultural structures.

Two, allow phasein of 5-year depreciation on equipment.

Three, allow current expensing of construction period interest and taxes.

Four, eliminate the $10,000 ceiling on the cost deductibility of investment interest expense.

Five, increase the allowable amount of interest and dividend income excludable from Federal individual income taxes to $500, or $1,000 for joint returns, to encourage additional personal savings.

Six, adjust the personal income tax rates to offset the increase in taxes that will be caused by inflation during the next 12 months.

We also recommend that this tax relief be accompanied by restraint on the growth of Federal spending. Specifically, we urge that the Congress slow Federal spending growth by 2 percentage points from the double-digit increases proposed for next year, and after 1981 restricting Federal spending growth to 2 percentage points less than the growth in people's incomes.

Slowdowns in spending growth of these proportions would allow even larger tax relief directed to encouraging savings and investment to be considered in the future, and allow interest rates to trim downward and further encourage investment.

A significant slowdown in spending growth which is now running along at 17.2 percent rate would be required to commit to a 3-year large consumption stimulating personal income tax reduction.

We have not included recommended tax relief for future years because of the need to consider more complex changes to the tax code and the need to more fully assess the pace of economic recovery.

The tax package we are now recommending would simplify the code and would:

Reduce the incentive for the Federal Government to increase its revenues because of inflation;

Slow the all-time record growth of tax receipts from the $86 billion currently proposed for 1981 to $64 billion, or $19 to $22 billion lower;

Cause the full employment budget to be in surplus, and cause the surplus to be declining in 1981 more toward balance;

Provide one-third of tax relief now and one-half finally to encourage investment, productivity, better jobs, and a higher standard of living;

Provide significant tax relief for middle and low income, the elderly and minorities;

Significantly boost investment in productivity—increasing new plant and equipment;

Encourage construction and thus bring the construction industry out of a great depression;

Revive housing construction, including rental units, to improve the quality of life for all Americans.

Our recommendations would improve the health of the entire economy. They would:

End the recession sooner;

Provide new jobs for 50,000 to 100,000 people within 1 year, and 500,000 people within 5 years, I might say that over 5,000 of those jobs would be in the State of Kansas;

Lower consumer price levels during the next 12 months, and by 2 percentage points within the next 5 years;

Lower long-term interest rates by about two percentage points;

Increase income by $275 per household by the end of the first year, and $600 by the end of the fourth year;

Help crippled industries recover, including those industries facing severe competition from abroad who have been hurt by Government overregulation, such as steel and automobiles;

Increase investment in new equipment by nearly 25 percent and investment in commercial and industrial structures by nearly 18 percent;

Boost housing construction by 250,000 units per year, thereby helping hold down rent and housing price inflation, and provide better housing for young families and low-income families. I might say that about 3,000 of the additional units each year would be found in the State of Kansas.

Thank you.

Senator Dole. I would say to those who have presented their testimony that there probably will not be any questions, except for the question, do you favor action this year to be effective next year?

Mr. Carlson. No, sir. We are recommending action now to be effective this year. We think that it will actually hurt investment if you propose a change in January, and people delay making investments until that change. It should be effective now.

Senator Dole. It is probably not going to happen, but I understand. It is going to be hard enough to make it happen to be effective next year. There are only 96 days before the election, and if you take out the weekends, and the conventions, and other things that happen, it does not give us much time.

We will now hear from Herman J. Smith.

STATEMENT OF HERMAN J. SMITH, FIRST VICE PRESIDENT, NATIONAL ASSOCIATION OF HOMEBUILDERS

Mr. SMITH. I am Herman J. Smith, first vicê president of the National Association of Homebuilders. Let me say that I am from Fort Worth, Tex., and nobody is in a hurry right now to catch a plane back to Fort Worth, Tex., with a temperature of 110°F. But I will be very brief in my comments because I realize the shortage of time, and I will submit our prepared testimony for the record.

Senator DOLE. I don't want to cut anyone off. We are not that short of time.

Mr. SMITH. I want to brag a little bit on Senate bill 2745, and I am sure that when we get down to that I can take longer.

NAHB favors a targeted tax cut structured to avoid inflationary pressures, and directed toward improvement of productivity and creating jobs. For the housing industry, a tax cut should be structure, we feel, in two areas of results.

One, provide a stable source of single-family financing at interest rates families can afford; two, stimulate the production of multifamily housing.

As you can well see, following the trends in the last 3 years, we have had a tremendous downturn. Although in the testimony and the charts that are presented for the record today we allude to a small turnaround in the last few weeks, but caution you on looking at any great turnaround in the near future, especially with interest rates still in the area where they are today.

We see, for example, a significant change in the unemployment in construction trades because it has moved into the area of 17.5 in the last few weeks. This has an economic loss on jobs of somewhere in the neighborhood of 1 million people.

Our testimony alludes to the demand for housing in the 1980's, and I will not get into the details of this. We do want to make in the record here the specific recommendations as far as incentives for housing for the American people in the area of mortgage financing.

First, NAHB supports Senator Nelson's bill, S. 2560, and Senator Dole's bill, S. 2745. We think those certainly have the incentives needed, and are headed in a good direction. We, of course, have supported the Senate provision on the tax exempt revenue bonds, and especially your resolution of a few weeks ago.

In the area of rental housing, NAHB supports the 15-year straight line depreciation scheduled as adopted by Senator Williams' bill. NAHB urges repeal of RSC 189 so that the construction period interest in taxes can be deducted in the year payments are made.

I might add, Mr. Chairman, that at a time when multifamily construction, and multifamily starts are at the very bottom, with the need the greatest—we have a chart in our presentation today showing the present occupancy factors in major urban areas throughout the country. There is a great need for multifamily starts, but very few multifamily starts being made, especially in the private sector, and with conventional financing. They just will not reach as far as the economics are concerned at today's rents, interest rates, and cost of construction.

Any time we take an item such as the interest and taxes that cannot even be deducted in the year they are paid out certainly compounds this problem, along with other factors such as rent controls, and I could go down a long list.

We have carefully chipped away at the delivery system for multifamily housing, and now have it to the point that you have a net loss of multifamily units available on hand from the year before by the time you take the teardowns, and the conversions, and so forth, at hand.

We have successfully, I am sorry to say, eliminated a very effective delivery system over a period of years for multifamily housing, and it is a sad occasion for the American needs.

We have alluded to the capital gains treatment as favored for the conversion, as far as individual tenants are concerned in the purchasing of units.

Let me say in conclusion that we support a targeted tax cut structured to be noninflationary. With respect to the housing industry such a tax cut should stimulate apartment development, and provide more affordable interest rates for single-family houses. If properly structured, we believe a tax cut could moderate long-term inflationary pressures in home prices.

Thank you. We appreciate the opportunity to testify, and we will be pleased to answer any questions you may have.

Senator DOLE. I don't have any questions, but just out of interest how many 2 by 4's did you buy?

Mr. SMITH. I have not bought any lately, but I know that there have been a few millions shipped to Washington.

Senator DOLE. I was curious, but just as a matter of trivia, I guess, there are probably enough there to build a pretty good size house.

Mr. SMITH. Yes. Our people were very concerned.

Senator DOLE. I think that it was a good difference.

Mr. SMITH. The little man was the one who took the time to ship these, the millions that have been laid off from construction jobs. They were quite involved, but they had nothing else to do. I want you to know that the leadership did not really write all of those messages.

Senator BRADLEY. I have heard that before.

Mr. Aronsohn is the next witness.

STATEMENT OF ALAN J. B. ARONSOHN, TAX COUNSEL, NATIONAL REALTY COMMITTEE

Mr. ARONSOHN. My name is Alan J. B. Aronsohn. I appear today as tax counsel for the National Realty Committee. We have a statement, which I would request be printed, and I will just touch on what we think are the most important points we have to make.

You have already heard a great deal about the necessity for revisions in the tax system, and improving particularly the depreciation system. We support the notion that depreciation system in the current code is archaic and very much in need of improvement.

We generally approve the concept of 10-5-3. However, we have some very substantial problems with the "10" part of 10-5-3, the part that is applicable to real property, and we would like to bring those problems to your attention.

In that first place, we agree with prior speakers, the omission from 10-5-3 of residential rental property is a serious defect which should be remedied.

More important as far as we are concerned, is the recapture rule which is included in 10-5-3, apparently grounded on the notion that whenever you create a very highly accelerated, short capital recovery period for an investment asset, you are bound to induce a considerable amount of tax shelter investing by both corporations and individuals. The intended cure, apparently, in the minds of some, is to have full recapture of depreciation upon any sale.

The problems with this are at least twofold. One, a depreciation recapture rule does not seriously inhibit investing in tax shelters. You only pay a depreciation recapture tax when you sell. It does not affect you when you go into the transaction. Our experience in the past has been that depreciation recapture rules do not affect or diminish tax shelter investments that are very attractive at the front end.

Unfortunately, also, recapture taxes do not generate a great deal of revenue for the Government because the practical effect of them is to defer sales and to almost make sales impossible. In our prepared statement, we have included an example of what I think is a normally financed real estate investment, and under 10-5-3 after 5 years of ownership the taxpayer is in a position where if he tries to sell the property at its original cost, he would have to come up with so much cash in excess of the cash that he received on the sale to pay for the tax that it would be absurd for him to make a voluntary sale. This is the economic box that results from what we might call over accelerating depreciation.

Senator DOLE. You address that in your statement?

Mr. ARONSOHN. We believe that Congress should pick a life which is consistent with the inclusion of residential rental property in the depreciation system in terms of revenue loss, and is also consistent with the notion of being able to permit people to take such a life without having a recapture rule based on full section 1245 recapture.

In other words, a period consistent with 1250 recapture. We think that the life that is suggested in the Williams bill, for example, would be appropriate for those goals.

That is our total comments.

Senator BRADLEY. You say that you don't think that this would stop the tax shelter business.

Mr. ARONSOHN. I don't think it would.

Senator BRADLEY. Why? You think that it would accelerate the tax shelter business?

Mr. ARONSOHN. Yes.

Senator BRADLEY. You don't think that they will not see that far down the road?

Mr. ARONSOHN. My experience over about 30 years has been that if I start a bonfire down the block and tell people that I will give them a tax deduction for throwing dollar bills in the fire, they will do it.

We have seen people go into movie deals, book deals, lithographic plates, virtually everything that anybody can devise, and I have yet to come across the investor who is so concerned about what is going to happen 5 years from today, or 10 years from today. He is concerned about paying taxes today, and of course in a very highly inflationary economy, he is not all wrong. If he does not pay today, and he can put off the evil day for 10 or 20 years, or even 5 or 6 at the current rate of inflation, just the use of the money from the deferment of tax makes it profitable.

Taxpayers are optimists. They figure that maybe they will die. [Laughter.]

Senator BRADLEY. If you don't mind, Mr. Aronsohn, I will write that one down. [Laughter.]

Are you saying that the present depreciation recapture provisions are better than the 10 of 10-5-3 with the recapture provisions in the bill?

Mr. ARONSOHN. I think they are better from the standpoint of theoretically being sounder because most of your gain on the sale of assets held for any length of time is the result of inflation, which is not real gain at all. If you subject inflationary gain to 70 percent tax rates that is real capital confiscation.

Second, having nothing to do with theory, but just pragmatically, the current depreciation recapture rules for real property do maintain a viable real estate investment market, permitting people to resell, and we are very frightened that a full recapture rule will substantially reduce the voluntary resale market, which we don't think is good for the economy as a whole. It restricts the mobility of capital too much.

Senator BRADLEY. Thank you very much.

Mr. Tanenbaum, or Mr. McBride.

STATEMENT OF MYLES TANENBAUM, INTERNATIONAL COUNCIL OF SHOPPING CENTERS

Mr. TANENBAUM. Mr. Chairman, my name is Myles H. Tanenbaum. I am appearing in behalf of the International Council of Shopping Centers.

By way of personal background, I spent 13 years in law practice specializing in Federal income tax work, but for the past 10 years I have been in the business of developing and managing shopping centers as a member of the firm of Kravco, Inc., King of Prussia, Pa.

Our written testimony has been submitted, and we hope that it will be included in the record. I would like to highlight for you several of the points that are in the statement, and then to express my views concerning their desirability.

Our organization supports depreciation reform much along the lines described by Mr. Aronsohn. Our organization also supports full current deductions for construction period interest and taxes, which is a major item to our industry. ICSC supports repeal of the limitation on the deductibility of investment interest, and the clarification of the rules relating to the time when real estate investment activity constitutes engaging in business.

Our reasons for supporting the four proposals referred to may best be understood by my sharing with you my personal experience in coping with the current problems faced by our industry.

There was a time not long ago when accelerated depreciation was permitted without recapture, when the Internal Revenue Service was more reasonable in reviewing the depreciable lives of property, when construction period interest and taxes were currently deductible in full, when there was no limitation on deducting mortgage interest, and when ordinary business expenses incurred by a developer were fully deductible without challenge. At that time, shopping center development and most real estate development was expanding.

Our industry, in particular, found that we were increasing employment, both during the construction of shopping centers and in the many jobs that are created in shopping centers after they are opened for business. Also, local government was supported by the revenues produced by an expanding tax base.

Our company, my own company, was one which saw the advantages which that tax structure provided. In fact, that is how I was able to leave law practice, and go into business. Kravco was born then and it now has grown to the point where there are over 40,000 people employed in our shopping centers. These shopping centers generate State and local taxes, exclusive of sales tax, of nearly $30 million annually.

Today, because developers no longer can defer tax in the manner alluded to, shopping center development has slowed. The dollars that flowed into development by reason of deferred taxation enabled my partners and me, and others like us, to gain access to this industry. It is vital to retain that potential within the fabric of the tax system if other people, small people, are going to have the opportunity for upward movement in the United States.

There are now fewer developers. Those remaining are larger. It is exceedingly difficult, and unlikely under the present tax laws, for a new comer to gain entry into our industry, and that is sad. Employment in the building trades is down, and rent has risen dramatically. A once dynamic, expanding industry has become part of the national malaise.

I can tell you firsthand that a principal cause for the rise in our construction costs is that there are fewer subcontractors in business today than there were just 10 years ago. I can tell you first hand that our rental income, which is good for us, has risen rapidly because the number of new, large shopping malls coming on the market has declined. That produces a seller's market.

I can tell you firsthand that the once negligible capital required to develop a shopping center only 10 years ago has been converted into a far more substantial sum, the product of high direct costs and the higher Federal income tax. These burdens find their way into our operating expenses on a daily basis.

If you long to see an America where the entrepreneurial spirit is awakened so as to draw people into business, whether it is into construction, development, leasing, or management, the reward for doing so must be real. Otherwise the enterprising spirit will be converted into the easy choice, and potential entrepreneurs simply will take a job with a large company and let somebody else have the burden of meeting the payroll and handling the risk.

I can tell you firsthand that as proud as we are of our personal accomplishments, we are saddened by the series of supposedly well-intentioned pieces of tax legislation enacted over the past decade that have combined to impair and prevent others from matching or exceeding our accomplishments. That is, unless this committee and the Congress have the courage and the wisdom to act now to change the tax laws.

Of the four proposals that we strongly support, the most important from the standpoint of our industry and the real estate industry is that which permits the full current deduction of construction period interest and taxes. Under the current law, we are leaving too many dollars in those projects and as a result we are short of money.

One of the major problems in regard to depreciation, is the time that we waste in disputes with the IRS over useful lives. Currently, we are spending a great deal of time on three major tax cases dealing with this aspect of depreciation. We ought to have a crisp, set, audit proof rule for the recovery period of depreciation that does not involve the wasteful expenditure of our time and the Government's time. You can do a very fine job in that regard by adopting the proposals that we have outlined concerning depreciation. They will work.

My time has run out, and there is no reason to repeat the written discussion of the other items.

Thank you.

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

I have no questions.

Mr. McBRIDE.

STATEMENT OF GARDNER McBRIDE, EXECUTIVE VICE PRESIDENT, BUILDING OWNERS AND MANAGERS ASSOCIATION, INTERNATIONAL

Mr. McBRIDE. My name is Gardner McBride, and I am the executive vice president of the Building Owners and Managers Association, International. The holdings of our members comprise about 1 billion square feet of commercial office space, and many, many residential units across the country with a focus in the downtowns.

My written remarks are adequate, I think, to form a complete consensus on this panel on what changes in the tax code are necessary for the real estate industry. Therefore, I will not read them, but ask that they be included in the record.

Senator BRADLEY. All of your statements will be included in the record.

Mr. McBRIDE. Thank you very much.

Senator BRADLEY. Thank you very much.

I would like to thank this panel for their thoughts. We appreciate your contributions to the committee's deliberations.

[The prepared statements of the preceding panel follow:]

Senator BRADLEY. Let's go on to the next panel. Mr. Marshall McDonald, and John J. Curtis. Marshall McDonald is chairman of the board and chief executive officer of the Florida Power & Light Co., and chairman of the board of the Edison Electric Institute.

John J. Curtis is director of taxes, Pacific Lighting Corp., and he is speaking on behalf of the American Gas Association.

Welcome, and I hope that you have seen the direction that we are heading. We are running out of time, so I hope that you will summarize your statements, and get right to the point of what you would like us to know about your view at this tax writing session.

COALITION FOR LOW AND MODERATE INCOME HOUSING

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SUMMARY OF PRINCIPAL POINTS
OF
STATEMENT OF WILLIAM J. LANGELIER, CHAIRMAN
COALITION FOR LOW AND MODERATE INCOME HOUSING

Before the Senate Committee on Finance
July 30, 1980

I. There is a great need for tax incentives for the badly depressed housing industry and particularly in the area of housing for persons of low and moderate income.

II. Any tax incentive legislation must recognize that the restrictions put on low income and other government assisted housing require that a greater tax incentive be given to investors in this area.

III. We support the 15-year straight line depreciation provision of S. 2969 and do not favor the more expensive 10-year provision of 10-5-3.

IV. The 5-year grace period for individuals constructing low income housing to allow them to continue deducting interest and taxes paid during the construction period should be made permanent. This grace period runs out in 1981 and action must be taken promptly.

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STATEMENT

WILLIAM J. LANGELIER, CHAIRMAN
COALITION FOR LOW AND MODERATE INCOME HOUSING

Before the Senate Committee on Finance
July 30, 1980

Mr. Chairman and Members of the Committee,

Thank you for the opportunity to present to the Committee the views of the Coalition for Low and Moderate Income Housing. The Coalition was organized in 1975 to bring together all associations, trade groups, business organizations and individuals who are involved with government-assisted low and moderate income housing. Our members participate in all aspects of this housing, including financing, production, rehabilitation and operation.

Housing generally is now in a deep recession with housing production falling toward its lowest level since 1946. The production of housing for persons of low and moderate income has also taken a significant drop. This will have an even more severe impact than the shortage of general housing because the persons who qualify to live in low income housing have few, if any, alternatives. They depend upon the housing created for them by private industry under federal housing laws and regulations.

The Need for Tax Incentives

Because of the numerous restrictions imposed by the federal government on the rate of return, rental fees and resale opportunities for this government assisted housing, the only principal encouragement for new construction and substantial rehabilitation are the tax incentives available. Without these tax advantages, housing for low and moderate income persons will not be built, since investors will prefer market rate housing which is not subject to the red tape and other problems frustrating participation in the federal programs. For this reason we strongly oppose those tax incentive proposals, such as 10-5-3, which do not include low and moderate income housing, indeed any housing, in their incentive plan, and we instead support the bill introduced by Senator Williams, S. 2969.

Senator Williams' bill provides for a straight 15-year useful life for new low income housing, compared to a straight 20-year useful life for all other real estate. This differential means slightly higher depreciation deductions each year for low income housing. This differential is critical if the federal government expects any low income housing to be built in the next 10 years. There must be more favorable tax incentives for investment in low income housing as compared to all other real estate in order to compensate for the restrictions on return, and limited potential for appreciation inherent in low income housing. Our only concern is whether this differential suffices to off-set the detriment to investing in housing for our lower income population.

Construction Period Interest and Taxes

Unfortunately, just when these tax incentives are so badly needed, an existing tax incentive is being taken away by legislation passed in 1976. Beginning in 1982, individuals constructing low income housing will not be able to fully deduct the construction period interest. Instead, a portion of these expenses must be capitalized and deductions deferred for future years. We must emphasize that these taxes and interest payments made during the construction period are real, out-of-pocket expenses for which, in any other industry or business, the taxpayer would be allowed the deduction.

For all real estate other than low income housing, this requirement for amortization of these expenses is now effective. Even when Congress imposed this requirement in the Tax Reform Act of 1976, it recognized that it was necessary to retain these deductions for construction period interest and taxes with respect to low income housing in order to continue the incentive to private investment in this housing. Congress hoped, by providing a five-year grace period, that alternate non-tax incentives for the production of low income housing might be developed. No alternatives have been developed, however, and it may well be that there are no better alternatives available.

Unfortunately, because of the long lead time necessary in housing production, this matter cannot be left until 1981. The full deduction of construction period interest and taxes should be permitted in the future as it is now for low and moderate income housing. We also tentatively support the removal of this restriction for other real estate as well, since conventional rental housing and commercial real estate are in need of tax relief. However, this support is conditioned on the 5-year differential (15 v. 20) in depreciation period for low and moderate income housing discussed above. We must take this stand as low and moderate income housing needs even greater incentives than conventional real estate if it is to compete in the market. In the absence of a distinction in the depreciation period, we would urge continuation of present law permitting the advantages to the owners of low and moderate income housing in the deduction of construction interest.

Conclusion

We strongly support the bill introduced by Senator Williams, S. 2969, as an alternative to the "10" in 10-5-3. Significantly, the entire initial revenue loss of the Williams bill would be less than half the cost of the "10" in 10-5-3.

In addition, the Williams bill contains a number of important provisions (such as the extension of the §167(k) rehabilitation incentive, the extension of benefits for historic preservation, the advance refunding of housing bonds, the ability to freely use revenue bond proceeds for rehabilitation of low income projects and clarification of the trade or business status of real estate developers) to insure that the nation's housing needs will be met in the next decade - not by expensive government programs but by specific incentives for private industry. We urge its prompt adoption.

STATEMENT
on behalf of the
NATIONAL ASSOCIATION OF REALTORS®
regarding
TAX RELIEF
to the
SENATE COMMITTEE ON FINANCE
by
DR. JACK CARLSON
July 30, 1980

I am Jack Carlson, Executive Vice President and Chief Economist of the NATIONAL ASSOCIATION OF REALTORS®. I am accompanied today by John Ams, who is Director of Tax Programs in the Government Affairs Division and Hugh Graham, Director of the REALTORS® Forecasting Center.

On behalf of the more than 700,000 members of the NATIONAL ASSOCIATION we greatly appreciate the opportunity to present our views on tax and spending policies to improve the economic health of the country.

SUMMARY

We recommend slower growth of federal taxes beginning in fiscal year 1981 (October 1, 1980), specifically:

(1) allow 15-year straight-line depreciation on all structures: rental housing, commercial, industrial and agricultural structures;

(2) allow phase-in of five-year depreciation on equipment;

(3) allow current expensing of construction period interest and taxes;

(4) eliminate the $10,000 ceiling on interest cost deductability of investment interest expense;

(5) increase the allowable amount of interest and dividend income excludable from Federal individual income taxes to $500 (or $1,000 for joint returns) to encourage additional personal savings;

(6) adjust the personal income tax rates to offset the increase in taxes that will be caused by inflation during the next 12 months.

We also recommend that this tax relief be accompanied by restraint on the growth of Federal spending. Specifically, we urge that:

- Congress slow Federal spending growth by 2 percentage points from the double-digit increases proposed for next year, and
- after FY 1981, restricting Federal spending growth to two percentage points less than the growth in people's incomes.

Slowdowns in spending growth of these proportions would allow even larger tax relief to be directed to encouraging savings and investment to be considered in the future. We have not included recommended tax relief for future years because of the need to consider more complex changes to the tax code and the need to more fully assess the pace of economic recovery.

The tax relief package we are now recommending would:

- simplify the tax code;
- reduce the incentive for the Federal government to increase its revenues because of inflation;
- slow the all-time record growth of tax receipts from

the $86 billion currently proposed for 1981 to $64 billion;

- cause the full employment budget surplus in 1981 to move toward balance;
- provide one-third of tax relief now and one-half finally to encourage investment, productivity, better jobs and a higher standard of living;
- provide significant tax relief for middle and low income, the elderly and minorities;
- significantly boost investment in productivity-increasing new plant and equipment;
- encourage construction and thus bring the construction industry out of a great depression;
- revive housing construction, including rental units, to improve the quality of life for all Americans.

Our recommendations would improve the health of the entire economy. They would:

- provide new jobs for 60,000 people within one year and 500,000 people within 5 years;
- lower consumer price levels during the next 12 months and by 2 percent within 5 years;
- increase income by $275 per household by the end of the first year and $600 by the end of the fourth year;
- help crippled industries recover, including those industries facing severe competition from abroad and who have been hurt by government over-regulation, such as steel and automobiles;
- increase investment in new equipment by nearly 25 percent and investment in commercial and industrial structures by nearly 18 percent;
- boost housing construction by 250,000 units per year, thereby helping to hold down rent and housing price inflation.

PROPOSAL FOR TAX RELIEF

The NATIONAL ASSOCIATION OF REALTORS® believes that Congress should immediately enact tax relief legislation to boost the level of economic activity, to slow down the growth in Federal taxes, to stimulate investment and savings and to improve the American quality of life.

We prefer to advocate "tax relief" rather than "tax cuts" since we are not proposing to lower tax revenues from their present levels, but merely to restrain the excessive growth in taxes which has already occurred and will continue under current law.

Between FY 1976 and FY 1981, Federal taxes will rise from $300 billion to $604 billion, a 101% increase (see Table 1).

TABLE 1

THE HISTORY AND PROJECTION
OF FEDERAL TAXES

Year	Federal Taxes (Billions of Dollars)	Taxes as a Share of People's Income 1/	Taxes per Household	
			Average Amount	Equivalent in 1980 Prices
1976	300.0	26.3	$4,117	$5,584
1977	357.8	27.6	4,815	6,115
1978	402.0	27.6	5,287	7,132
1979	465.9	28.4	5,968	6,581
1980	517.9	28.9	6,497	6,497
1981	604.0	31.3	7,414	6,750
1982	711.4	33.0	8,545	7,154
1983	818.3	34.0	9,628	7,497
1984	930.4	34.7	10,720	7,814
1985	1052.7	35.4	11,893	8,089

Source: Revenue Estimates from the Mid-Session Review of the 1981 Budget: Income figures from the Bureau of Economic Analysis; Data Resources, Inc. and the Forecast Center, NATIONAL ASSOCIATION OF REALTORS®.

1/ Personal income less government transfer payments to individuals.

As a result, the share of people's income going to federal taxes will increase from 26.3 percent in 1976 to an estimated 31.2 percent in 1981, while federal taxes per household will rise from $4,100 to $7,400 over the same period. This represents the highest share of income going to federal taxes in the history of the nation. Moreover, without tax relief, this trend toward the Federal government taking even larger shares of people's incomes through taxes will continue. Under current law, federal taxes will increase to nearly $11,900 per household by FY 1985, or 35.4 percent of people's incomes. Even after adjusting for expected increases in prices, taxes per household per year are expected to increase by $2,600 over the next 5 years.

In the light of these facts, the question is more one of when tax relief will be forthcoming and in what form, rather than whether tax relief will be provided. Will it be tax relief now or will it be delayed until after the recession is over and recovery is occurring? More importantly, will this tax relief be in a form aimed at increasing savings and investment to fight inflation and increase living standards, or will it merely be designed to boost personal consumption? And is this tax relief to be phased in gradually, together with slower growth in federal spending, or will the tax relief be excessively large, without an accompanying slowdown in federal spending growth so that the economy is pushed into another boom-bust cycle and many important sectors, including housing, are adversely affected.

Our tax relief proposals and related recommendations are designed primarily to overcome some of the basic and underlying economic problems that have plagued the economy in the last decade, as well as providing a modest stimulus to the lagging level of economic activity. The U.S. economy has entered another recession with employment declining, inflation and interest rates still in the double digit range and spendable incomes falling, after adjustment for price increases. The current cyclical downturn is, however, only the latest manifestation of the series of problems which has plagued the economy during the last ten years. Increases in real output and incomes per worker in the U.S. have lagged behind those in other major industrial countries, while the underlying rate of inflation has been trending upwards (after subtracting out the effects of "special" factors such as OPEC oil price increases). In addition, the rapid growth of the labor force during this period of a low rate of investment in the U.S. has led to stagnant capital formation per worker and inadequate additions to new plant, equipment and housing. Our urgent national need is for substantial policy initiatives to start to remedy these problems. Otherwise these economic trends are expected to continue in the 1980s.

We believe it is essential to take the intellectual step now to recognize the problems of inadequate savings and investment, slowed and minimal productivity growth, stubborn high inflation, and lagging spendable income growth. It is equally essential to take the political step of enacting needed legislation now so that savers and investors will know that rewards in future years will be different and better. Even the Administration appears to have taken the intellectual step of recognizing some of the underlying problems, as indicated in Secretary Miller's recent testimony to this Committee and by the following reference in the Administration's Mid-Session Review:

> "....Policy measures to increase investment, productivity, and economic growth -- with beneficial effects on unemployment and inflation in 1981 and later years -- will be developed carefully in close consultation with the Congress and others in the months ahead.
>
> 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."

Clearly, the Administration appears not ready to act now. We urge this Committee and the Congress to act now -- this year -- by legislating appropriate tax relief, coupled with spending restraint now and in the future, to initiate the steps which can lead back toward economic health.

One reason for the reluctance of the Administration to adopt sounder policies is its failure to appreciate the causes of many of our nation's economic problems. The Administration has all too frequently blamed OPEC oil price hikes for the acceleration in inflation during the last 18 months. However, increases in world oil prices were a less important cause of inflation, being responsible for only one-third of the increase in consumer prices in 1979.

Excessive growth in federal spending, higher taxes that add to the costs of production, the increasing cost of government over-regulation and the excessive growth of credit have been the major causes of the recent acceleration in inflation, increasing prices nearly 5 percent in 1979 alone. Government has accounted for

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over one-half of the acceleration in inflation from 4.8 percent during 1976 to 13.2 percent during 1979 and 14.2 percent so far in 1980.

Another reason for the failure of the Administration to adopt sounder economic policies is that it has underestimated inflation in each of its annual budget and economic messages, and we believe it has done so again this year (see Table 2).

TABLE 2

THE ADMINISTRATION'S INACCURATE CONSUMER INFLATION FORECASTS
(December to December)

	1977	1978	1979	1980	1981
President Carter	5.3	5.2	6.0	6.3 1/	8.6 3/
Actual (and REALTORS® Latest Estimates for 1980 and 1981)	6.8	9.0	13.2	12.3 2/	12.1 2/
Difference - Carter and Actual (or REALTORS® latest estimates)	1.5	3.8	7.2	6.0	4.5

Sources: Budgets of the United States and 1981 Budget Revisions, Office of Management and Budget; NATIONAL ASSOCIATION OF REALTORS®.

1/ In the January 28, 1980, budget the Administration revised this upward to 10.4 percent; on March 31, 1980 the Administration's Budget Revisions forecast 12.8 percent; on July 21, 1980, the Administration revised to 12.0 percent.

2/ NATIONAL ASSOCIATION OF REALTORS® Forecast, July 1980.

3/ The Administration's March 31, 1980 Budget Revisions forecast 9.0 percent; on July 21, 1980, its 1981 Mid-Session Review forecast 9.8 percent.

The Economic Outlook

The nation's output of goods and services declined at an annual rate of 9.1 percent in the second quarter of this year, making the current recession already as severe as the average of all post war recessions. Further declines in output are expected during the current quarter of this year before a gradual improvement occurs beginning early next year (see Table 3). Because unemployment has risen sharply as a result of the economic downturn, with over 1 million people laid off since March, the NATIONAL ASSOCIATION OF REALTORS® expects that the unemployment rate will rise further to nearly 9 percent this year, with an additional 1.5 million people looking for jobs.

Because of tight credit conditions and excessive growth in federal spending and taxes, investment has suffered disproportionately in the latest decline in output -- investment in residential construction declined at an annual rate of over 60 percent last quarter while investment in new equipment fell at a 20 percent rate and non-residential structures dropped by 12.6 percent at an annual rate. These declines in investment come just at a time when an increase in the rate of new capital formation is needed to fight inflation and raise living standards.

The record declines in output in the second quarter have led to lower interest rates, which will be reflected in a reduced rate of inflation in the months ahead. However, without a marked change in federal economic policies, these gains are likely to be only temporary.

TABLE 3

SHORT-TERM ECONOMIC OUTLOOK
(Calendar Years; Dollar Amounts in Billions)

	Actual 1979	Forecast		
		1980	1981	1982
Major Economic Indicators				
Gross national product (percent change 4th quarter over 4th quarter):				
Current dollars	9.9	6.4	14.2	13.1
Constant (1972) dollars	1.0	-3.1	3.6	4.2
GNP deflator (percent change, 4th quarter over 4th quarter)	8.9	9.5	10.6	8.9
Consumer Price Index (percent change, 4th quarter over 4th quarter	12.8	12.3	12.1	13.6
Unemployment rate (percent, 4th quarter)	5.9	8.6	8.5	7.2
Annual Economic Assumptions				
Gross national product:				
Current dollars:				
Amount	2,369	2,556	2,840	3,223
Percent change, year over year	11.3	7.9	11.1	13.5
Constant (1972) dollars:				
Amount	1,432	1,412	1,433	1,498
Percent change, year over year	2.3	-1.4	1.5	4.5
Incomes:				
Personal income	1,924	2,118	2,340	2,639
Wages and salaries	1,228	1,325	1,463	1,649
Corporate profits	237	223	220	254
Price level:				
GNP deflator:				
Level (1972=100), annual average	165.5	180.7	198.0	215.9
Percent change, year over year	8.8	9.4	9.6	9.0
Consumer Price Index:				
Level (1967=100), annual average	217.7	247.2	274.7	309.8
Percent change, year over year	11.4	13.6	11.1	12.8
Unemployment rates	5.8	7.6	8.6	7.5
Interest rate, conventional mortgages (percent)	11.23	13.45	12.26	12.7

Source: NATIONAL ASSOCIATION OF REALTORS®

As the economy improves modestly next year, both inflation and interest rates are likely to rise again, further hindering a sustained economic recovery in the next 3 years.

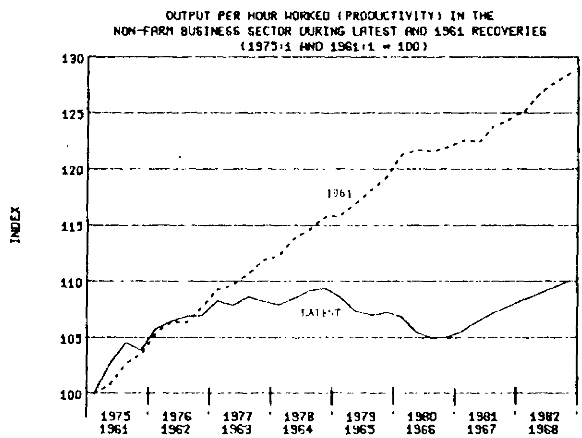
While the current recession will likely reduce federal tax revenues and increase the federal deficit, the full employment federal budget -- a more accurate indicator of the amount of fiscal drag imposed on the economy by higher taxes -- shows a $34 billion surplus. Clearly, the depth of the current recession not only creates a need for tax relief now, but also ensures that an appropriately structured package initially providing around $23 billion per year in tax relief will have no significant inflationary impact during the next 12 months. Moreover, by accompanying this tax relief with a modest slowdown in the growth of federal spending and directing the tax relief primarily at boosting savings and investment, significant declines in the rate of inflation can be accomplished in future years.

It is important to note that the same claim cannot be made for some of the more well known proposals for tax relief. Specifically, plans to cut personal income taxes by 10 percent per year over the next 3 years, as well as implementing the "10-5-3" package of depreciation reform, will lead to excessively large increases in the federal deficit and cause inflation and interest rates to increase. Many important sectors of the economy, especially housing, would be more harmed than helped by these policies.

The Productivity Problem

One of the major factors behind the increase in the rate of inflation has been the slow growth in worker productivity in the United States. The growth rate in average output per worker has declined from the 3.5 percent per year achieved in the early 1960s to near zero from 1977-1979. After adjusting for recessions, productivity growth has slowed considerably since 1975 compared with the average over the post-war period (see Chart 1).

CHART 1



Source: U.S. Department of Commerce, Bureau of Economic Analysis for historical data; NATIONAL ASSOCIATION OF REALTORS® for forecast data.

A recent study by Data Resources, Inc. indicates that almost half of the slowdown in productivity growth in the United States is attributable to slow growth in capital per worker (see Charts 2 and 3).

CHART 2

REAL NET CAPITAL STOCK PER EMPLOYEE
AND OUTPUT PER HOUR WORKED (PRODUCTIVITY)
(non-farm business sector)

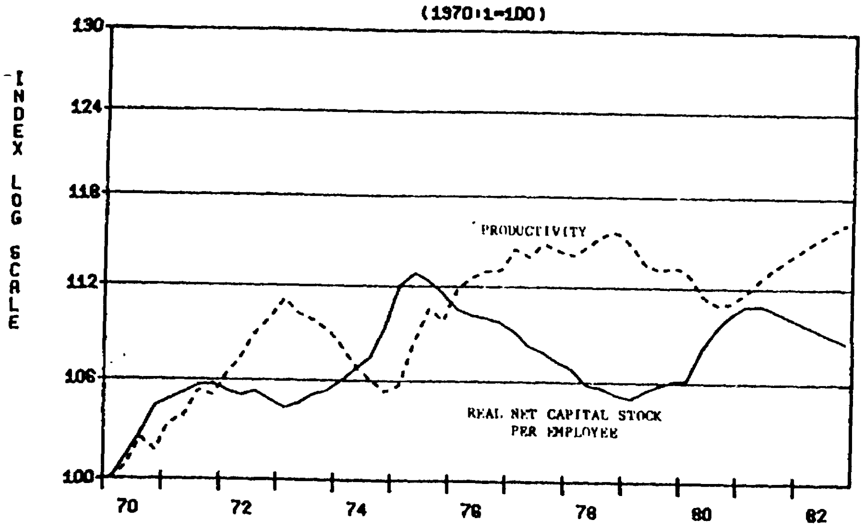
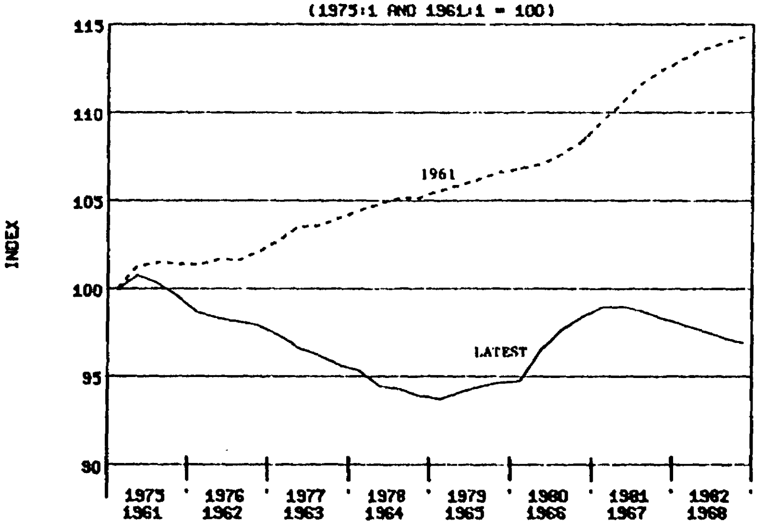


CHART 3

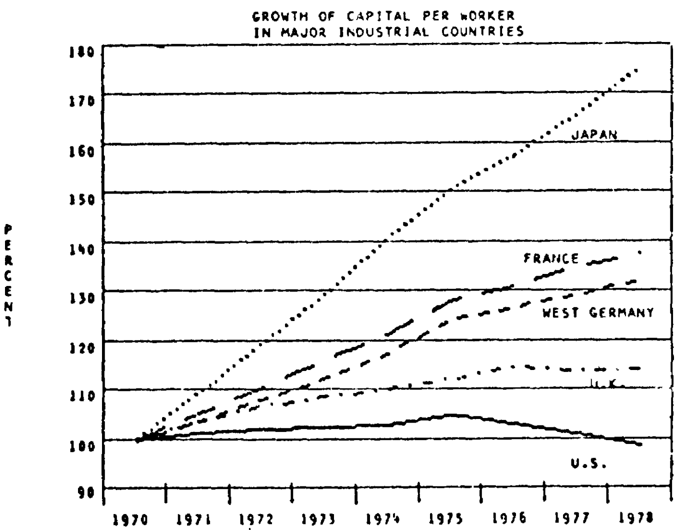
REAL NET CAPITAL STOCK PER EMPLOYEE
DURING LATEST AND 1961 RECOVERIES
(1975:1 AND 1961:1 = 100)



During the current period of very rapid growth in the labor force, it is vital that the rate of capital formation be increased in order to restore the growth in productivity to normal levels and to lower inflation.

The United States has the lowest rate of capital investment among the major industrial powers. The United States presently invests less than 17% of its gross national product in capital (including housing), whereas West Germany and Japan invest 25 percent and 35 percent respectively. Growth in capital per worker has been high or at least positive among industrialized countries in recent years, except for the United States (see Chart 4).

CHART 4

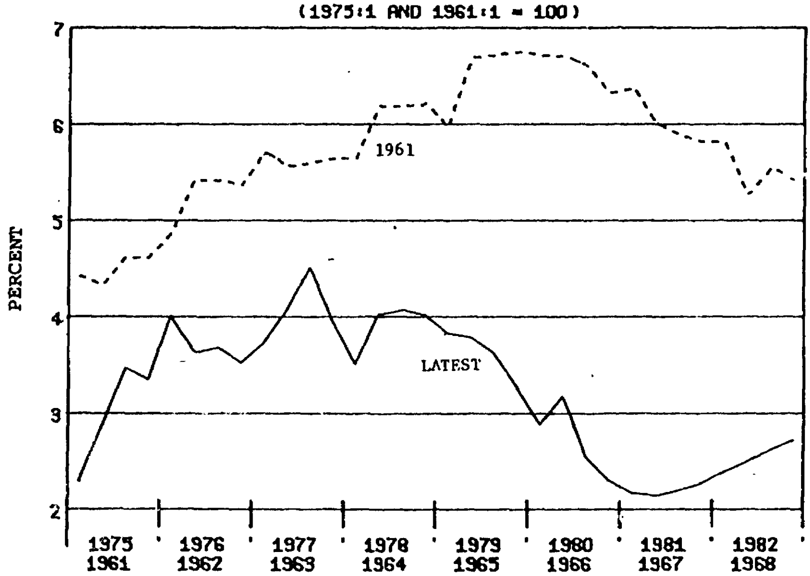


Source: Organization for Economic Cooperation and Development and NATIONAL ASSOCIATION OF REALTORS®.

Investment within the United States has been low partly because after tax profits from current production have fallen to less than 4¢ on each sales dollar and are forecast to drop below 3¢ (see Chart 5), after adjusting for corporate taxes, inadequate depreciation and overstatement of profits from inventories. High Federal taxes are a major cause of this decline in investment incentive -- Federal taxes will siphon away more than 56 percent of profits from current production during 1980 (see Chart 6).

CHART 5

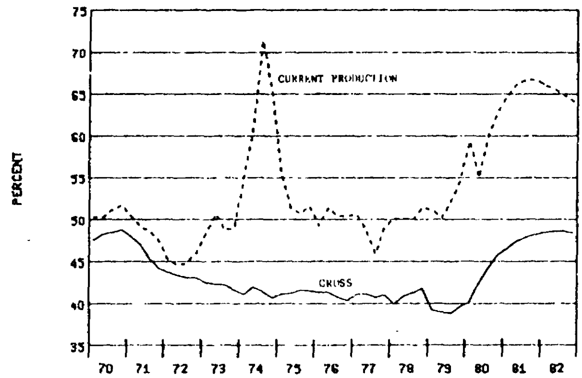
CORPORATE PROFITS AFTER TAXES FROM CURRENT PRODUCTION AS A PERCENT OF GNP DURING LATEST AND 1961 BUSINESS RECOVERIES (1975:1 AND 1961:1 = 100)



Source: U.S. Department of Commerce, Bureau of Economic Analysis for historical data; NATIONAL ASSOCIATION OF REALTORS® for forecast data.

CHART 6

CORPORATE TAX RATES AS PERCENT OF
GROSS PROFITS AND CURRENT PRODUCTION PROFITS



Source: U.S. Department of Commerce, Bureau of Economic Analysis for historical data; NATIONAL ASSOCIATION OF REALTORS® for forecast data.

Our savings performance ranks the lowest of major industrial countries -- less than 4 percent of personal disposable income was saved by households in 1979 compared with 13 percent in West Germany and 20 percent in Japan. Although some modest increase in the savings rate in the U.S. is expected during 1980 as a result of the current recession, without effective efforts to boost personal savings it is unlikely that the savings rate will rise significantly above 4.5 percent over the next 5 years.

Increases in the savings rate allow larger increases in productivity-improving investment in new plant and equipment and housing by:

- increasing the supply of investable funds to business;
- putting downward pressure on interest rates and therefore business borrowing costs; and

- diverting resources away from personal consumption, thereby allowing larger increases in investment without placing inflationary demand pressure on the nation's capacity to produce.

It is for these reasons that our tax recommendations include incentives for individual savers. We believe that these tax incentives offer a fundamentally sound and attractive way to provide tax relief for individuals that benefits primarily low and middle income earners and the elderly, which meets the national need for higher savings, and to provide that relief consistent with the principle of economic freedom of choice for individuals.

GOVERNMENT SPENDING

Excessive growth in Federal spending is a major cause of our economic problems. Excessive increases in government spending not only push up interest rates and inflation directly, diverting resources away from productive investment in new structures, equipment and housing, but also effectively reduce the size of any tax relief which can be directed towards stimulating increased savings and investment and force the Federal Reserve Board to lean against inflationary pressures through tight monetary policy.

The Federal government is continuing the trend of federal spending taking even larger shares of people's income and the nation's output (see Table 4).

TABLE 4

FEDERAL SPENDING AS A SHARE OF GROSS NATIONAL PRODUCT (GNP)

Year	Federal Spending Budget and Off-Budget ($ Billion)	Gross National Product ($ Billions)	Share of Gross National Product (Percent)
1929	3.1	103.4*	3.0*
1940	9.5	95.4*	9.9*
1950	42.6	264.8	16.1
1960	92.2	497.3	18.5
1970	196.6	959.0	20.5
1975	334.2	1457.3	22.9
1976	373.7	1621.0	23.1
1977	411.4	1843.3	22.3
1978	461.2	2060.4	22.4
1979	506.1	2313.4	21.9
1980	594.9	2516.0	23.6
1981	655.5	2739.2	23.9

* Estimates by the NATIONAL ASSOCIATION OF REALTORS®

Source: The Budget of the U.S. Government, 1981; the Economic Report of the President, 1980; the Mid-Session Review of the 1981 Budget.

Federal spending as a percent of Gross National Product will break peacetime records this year and next year according to the Administration's Mid-Session Review for 1981, accounting for 23.6 percent of national output in 1980 and 23.9 percent in 1981. If the FY 1980 pattern of year-around escalation of spending is repeated for FY 1981, even the 23.9 percent record would be exceeded.

After submitting initial budgeted spending targets, the Administration and Congress have continued excessive spending growth by repeatedly adding on further increases in expenditure during the same fiscal year. This tendency is revealed in Table 5, which shows the history of revisions to the 1980 budget, a process not yet complete. Based on the Administration's latest estimate, 1980 budget spending will be 17.2 percent above 1979, compared to a 7.7 percent increase originally proposed by the Administration just 18 months ago, with the claim of "lean and austere."

TABLE 5

FY 1980 FEDERAL BUDGET

	Budget Outlays (Billions)	Increase Over 1979 Actual	% Increase Over 1979 Actual
President's original 1980 Budget (submitted January 1979)	532	38	7.7
First Budget Resolution (May 1979)	532	38	7.7
Second Budget Resolution (November 1979)	548	54	10.9
President's January 1980 estimate	564	70	14.2
Revised Budget Resolution (June 1980)	573	79	16.0
President's Mid-Session Review (July 1980)	579	85	17.2
Final	?	?	?

National defense spending has not been the major source of the current explosion in government spending even though the Administration and Congress have expressed priority for national defense -- increasing authority to spend by 12.9 percent and outlays by 14.7 percent in 1981.

Growth in non-defense areas will be the main source of increases in Federal spending over fiscal years 1980 and 1981, constituting about 70 percent of the total increase over this period. Income security expenditure, the largest single component of spending, will grow 15.2 percent in 1981 following a huge 19.2 percent increase in 1980.

To support this excessive spending growth the Federal government proposes increasing taxes by more than $529 per household this year and $917 in 1981, the largest one-year increase in history. Much of this increase in taxes represents unlegislated increases in effective tax rates (i.e. an increase in the share of people's incomes going in taxes due to the impact of inflation pushing individuals into higher tax brackets and due to decreases in the real value of depreciation allowances for business).

The recommendations which this Association has made in the past and makes again now, is for 2 percent slower growth than the double-digit growth proposed for next year (1981) -- and 2 percent slower spending growth than the rate of growth of people's income in 1982 and subsequent years.

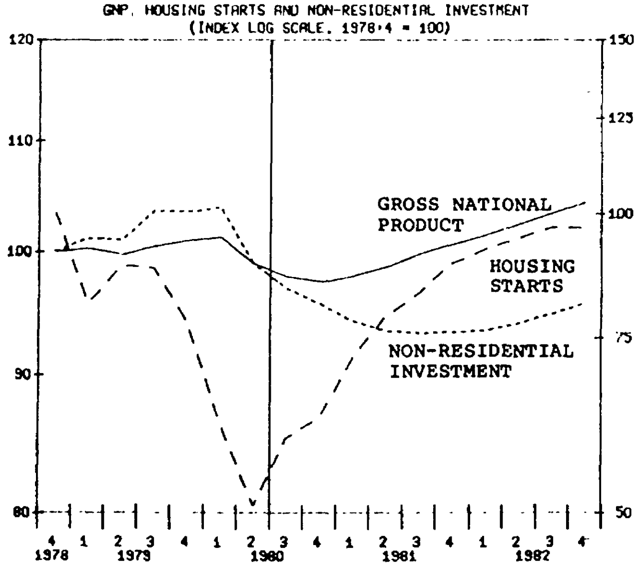
HOUSING

Housing and other investment clearly suffer disproportionately whenever inflation and excessive growth in Federal spending and taxes drive up mortgage interest rates (see Chart 7). New housing starts fell by over 57 percent between November 1978 and May of this year while sales of existing homes dropped by 43 percent. This is the worst decline in housing activity in the post war era. Although housing activity is showing an encouraging upturn this summer, new starts for the year are expected to total only around 1.3 million units, nearly 1 million homes below the underlying demand for housing. This shortfall in new housing construction will not be easily made up in future years -- it will take at least 4 years under optimistic assumptions, to make up the nearly 1 million units of lost construction from this year's downturn alone.

The shortage of new housing construction is already showing up in the form of record low rental vacancy rates. At the national level, the vacancy rate is currently hovering around 5 percent -- a level traditionally indicating rental housing shortages, while many areas of the country have even greater shortages. Unless a substantial impetus is given to housing construction over the next five years, this housing shortage will get worse and rent increases and housing prices will accelerate faster than general inflation.

CHART 7

THE CURRENT RECESSION: DECLINE IN GNP, HOUSING STARTS AND NON-RESIDENTIAL INVESTMENT (INDEX LOG SCALE, 1978:4 = 100)



PROPOSED TAX RELIEF LEGISLATION

The NATIONAL ASSOCIATION OF REALTORS® urges this Committee to favorably report tax relief legislation at the earliest opportunity to stimulate savings and investment, to stimulate the economy and to boost productivity, fight inflation in the long run.

The NATIONAL ASSOCIATION OF REALTORS® proposes that legislation be enacted now to provide around $23 billion in tax relief in 1981, with $18 billion tax relief for individuals and a $5 billion investment incentive stimulus for investment and with larger incentives for investment in future years. The share of tax relief directed at stimulating savings and investment should average over 50 percent during the next five years.

Specifically, the tax relief package, which is discussed in greater detail below, should include:

- For increased investment,
  - -- Accelerated depreciation allowance on new equipment placed in service after January 1, 1981, with tax lives reduced to 5 years for equipment other than cars and light trucks and 3 years for cars and light trucks. These shortened tax lives should be phased in over 3 years.
  - -- Accelerated depreciation allowances for new rental residential and non-residential structures placed in service after January 1, 1981, with tax lives reduced to 15 years with no phase in. Depreciation on new rental residential and non-residential structures should be on a straight line basis.

-- Allow current expensing of construction period interest and taxes, rather than requiring that these be amortized over 10 years as under current law.

-- Eliminate the $10,000 limitation on investment interest deductability for individuals.

• For personal tax relief,

-- Increase the amount of interest and dividend income excludable from federal taxable income from the $200 ($400 for joint returns) provided under current law to $500 ($1,000 for joint returns) so as to provide individuals with tax relief and encourage an increase in savings and ~~the supply of investable funds.~~

-- Lower personal income tax rates so as to provide individuals with $12 billion in tax relief in 1981 to offset the off-set of "bracket creep" on effective rates of personal income taxes.

The total cost of this revenue package is given in Table 6 on pages 24 and 25.

While this proposed package provides a simple and effective means of stimulating savings and investment, fighting inflation and raising living standards, it must be recognized that many other tax initiatives will be necessary over the next 5 years to help address this country's economic problems. We have included as an Appendix a list of several additional tax policy proposals that we recommend be considered by this Committee when more time for adequate evaluation of these measures is available.

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TABLE 6

REVENUE CHANGES FROM THE REALTORS® TAX PACKAGE
REDUCTIONS IN FEDERAL RECEIPTS ($ BILLION)

	1981	1982	1983	1984	1985
Business Portion of Package					
15 Year Straight Line Write-Off New Non-Residential and Rental Residential Structures, excluding feedback effects					
Gross Tax Change (current prices)	1.1	2.4	4.0	5.9	8.1
Gross Tax Change (constant 1980 prices)	1.0	2.1	3.2	4.3	5.5
Current Expensing of Construction Period Interest, excluding feed-back effects					
Gross Tax Change (current prices)	0.8	0.9	1.0	0.8	0.8
Gross Tax Change (constant 1980 prices)	0.7	0.8	0.8	0.6	0.5
5 Year Write-Off of New Equipment (with Phase in), excluding feed-back effects					
Gross Tax Change (current prices)	3.2	8.9	21.6	28.2	31.4
Gross Tax Change (constant 1980 prices)	2.9	8.2	18.3	20.7	21.4
Sub Total: Gross Change in Tax Receipts for Business Portion Tax Relief Package, excluding feedback effects					
(current prices)	5.1	12.2	26.6	34.9	40.3
(constant 1980 prices)	4.7	11.1	22.3	25.6	27.5

TABLE 6
(Continued)

REVENUE CHANGES FROM THE REALTORS® TAX PACKAGE
REDUCTIONS IN FEDERAL RECEIPTS ($ BILLION)

	1981	1982	1983	1984	1985
Individual Portion of Package					
Change in Personal Income Tax Rate, excluding feedback effects					
Current Prices	12.0	13.6	15.2	17.0	18.8
(Constant 1980 Prices)	11.0	11.3	11.7	12.1	12.4
Tax Incentive for Savers, excluding feedback effects					
Current Prices	5.5	5.5	5.8	6.0	6.3
(Constant 1980 Prices)	5.1	4.6	4.6	4.4	4.3
Total: Gross Change in Federal Tax Receipts from REALTORS® Tax Relief Package (Individual and Business), excluding feedback effects					
Current Prices	22.6	31.3	47.6	57.9	65.4
(Constant 1980 Prices)	20.8	27.0	38.6	42.1	44.2
As a Share of Federal Tax Receipts	3.7	4.4	6.0	6.4	6.5
Total: Net Change in Revenues (including feedback effects)					
Current Prices	21.5	24.0	30.3	40.0	50.3
(Constant 1980 Prices)	19.8	20.3	23.8	29.3	34.3
As a Share of Federal Tax Receipts	3.5	3.4	3.8	4.4	5.0

Tax Relief for Individuals

The real earnings of wage earners over the recent past have seriously declined as a result of the high rate of inflation, slow productivity growth and unlegislated increases in effective tax rates on individuals. Even though wage earners may have received higher gross incomes, the decline in the value of the dollar as a result of inflation has caused real incomes to decline.

To add insult to injury, any wage increases received to reduce the effects of inflation have forced these workers into higher tax brackets, resulting in automatic tax increases despite the fact that real incomes may have declined. In order to offset these automatic tax increases, we propose that the tax rate schedule be adjusted so as to prevent inflation from forcing taxpayers into higher income tax brackets this year. Specifically, the income tax rates in each bracket should be adjusted downward so as to reduce Federal personal income tax receipts by $12 billion in 1981, the first full year of operation. This tax relief should be made effective October 1, 1980.

In addition to tax rate schedule adjustment, and in keeping with our view that tax relief must be non-inflationary and encourage investment and economic growth, we strongly support legislation that would exclude from gross income the first $500 in interest or dividend income received by a single taxpayer and $1,000 for taxpayers filing a joint return.

We appreciate the legislation recently passed by the Congress and signed into law that would exclude the first $200

($400 for a joint return) of such income from tax for an individual. However, the amount of this exclusion is too small to provide an adequate stimulus to savings. Consequently, a higher level of exclusion is needed and economic analysis indicates that the $500/$1,000 level is an appropriate start.

The legislation we propose would encourage savings, and thus reduce current consumption. Even though this would be tax relief for individuals, it would not add to aggregate demand or thereby to inflationary pressures. It would have the opposite effect of reducing consumption spending and providing funds for investment in productivity-increasing and inflation-reducing investment in new structures and equipment and more adequate housing -- which enhances the quality of life for home dwellers everywhere.

In addition, while encouraging an increase in savings, the legislation we propose would give back to taxpayers a small portion of the income that inflation has taken away. In fact, this would be particularly helpful to the elderly, whose interest income comprises approximately one-quarter of all income they receive in any given taxable year. Contrary to popular belief, tax incentives for savers would also benefit lower and middle-income earners proportionately more than upper income levels.

The NATIONAL ASSOCIATION OF REALTORS® also supports an increased level of tax incentives for savers because of the beneficial effects such legislation would have on our economy. The increased level of savings brought about by the legislation would serve to help control inflation because individuals would save rather than spend a greater proportion of their disposable income and would allow larger increases in investment.

Tax Relief for Boosting Investment

The real estate industry has been particularly hard hit by the current recession. New single-family housing starts this year will be in the range of only 1.3 million units and the construction of non-government-assisted multi-family residential rental units is at a standstill. At the same time, construction of productivity-increasing factories, warehouses, office buildings and other commercial realty has fallen off because of inflation-induced cost increases, high government-induced cost increases due to straightjacketing regulations and high government-induced interest rates. Consequently, unemployment in the construction industry is rampant while the shortage of additional housing and commercial realty is becoming more and more acute.

To help counteract the effects of the current recession and the high rate of inflation, the NATIONAL ASSOCIATION OF REALTORS® proposes a revision of the current depreciation laws and repeal of two onerous provisions that deter individuals from real estate investment: the requirement that construction period interest and taxes be capitalized and the limitation on investment indebtedness.

Revision of some of the depreciation laws in the Internal Revenue Code is long overdue. The "useful life" concept has been shown to be problematic for a number of reasons, including inconsistent IRS audit practices, rising interest rates, and the high rate of inflation we have experienced over the years. Double-digit inflation has been especially harmful to capital formation because new buildings and equipment double or triple in cost by the time that businesses are able to recover their investment in older buildings and equipment.

Depreciation revision is desirable to eliminate the needless complexity of the present system and to allow taxpayers a reasonable measure of certainty in this area. At present, certainty may never be achieved, even after numerous depreciation audits with the Internal Revenue Service and the expenditures of time and money required by litigation.

We applaud Senator Harrison Williams (D-NJ) for introducing a bill, S. 2969, that provides a 20-year straight-line depreciable life for real property. This bill also contains a number of other vitally needed real estate tax provisions and we appreciate the leadership displayed by Senator Williams in introducing this bill, entitled the "Real Estate Construction and Rehabilitation Tax Incentives Act of 1980."

The NATIONAL ASSOCIATION OF REALTORS® strongly supports the stand taken by the Williams bill in recognizing that depreciation revision must be extended to all real estate and that the depreciable life must be significantly reduced without at the same time resulting in excessive revenue impacts. Although S. 2969 would allow a 20-year depreciable life, we estimate that even if a 15-year straight-line depreciable life were enacted, the revenue impact would still be only a fraction of that for the accelerated 10-year depreciation plan currently proposed as part of the so-called "10-5-3" proposal. A 15-year life would lead to increased construction and rehabilitation activity and ultimately give a much-needed stimulus to our nation's depressed real estate industry.

Consequently, in order to achieve certainty with respect to an allowable depreciation period, and, more improtantly, to help spur construction of housing and productivity-increasing structures, the NATIONAL ASSOCIATION OF REALTORS® proposes a 15-year straight-line depreciable life for all real estate and a phase-in 5 year accelerated depreciation period for equipment (other than light trucks and cars). By eliminating accelerated depreciation and providing a fixed statutory life, the bill would simplify the tax laws and ease the burden of tax administration. It would do away entirely with the necessity for the present complicated recapture and minimum tax provisions insofar as they involve real property. It would also end most audit disputes between taxpayers and the Internal Revenue Service conserning useful life. Finally, it would provide for a more realistic and far less costly 15-year depreciation period for real estate than the accelerated 10-year depreciation plan currently proposed as part of 10-5-3.

Despite the general benefits of increased simplicity and economic effectiveness which would result from the enactment of 10-5-3, the current bills embodying the 10-5-3 approach contain substantial deficiencies insofar as real estate investment is concerned. In the first place, they do not apply 10-5-3 to residential real estate, thereby omitting from the reforms a substantial and important segment of the economy. Second, in regard to the real estate they cover, the current bills would apply depreciation "recapture" rules previously established for short-lived personal property which are totally inappropriate for real estate and which would, in effect, transform into ordinary income amounts that are treated as capital gains under current law.

In addition, the 10-5-3 proposal has been subject to substantial criticism on the ground that a 10-year depreciable life for real estate would result in too great a revenue loss to the Treasury in relation to the benefit received.

The accelerated 5-year depreciation period for equipment is necessary to increase productivity, to establish our competitiveness in the world marketplace and to stimulate the kind of economic growth that will make large inroads into the high rate of unemployment. Because of their short period of use, cars and light trucks would be depreciated over a three-year period.

Currently, American business is at a serious disadvantage when compared with the depreciation laws of most other industrialized countries because these countries allow equipment to be depreciated over a far shorter period than is allowed under U.S. law. This decreases the competitiveness of U.S. goods in world markets and in the U.S.

The NATIONAL ASSOCIATION OF REALTORS® proposes that the 5-year depreciation period be phased-in over a three-year period in order to provide an orderly and non-inflationary boost to investment demand. During the first year after enactment the depreciation period would be the lesser of nine years or two years below the taxpayer's current practice; in the second year, the lesser of seven years or four years below current practice, and five years in the third year. In no event during the first and second years could the depreciation period fall below five years. We would also anticipate amendments in the investment tax credit area to reflect these changes and to prevent any abuses that may arise as a result.

Although the shortened tax lives for equipment are to be phased in, our calculations show that there will be no adverse postponement of investment decisions during the phase in period, a commonly encountered criticism. In an effort to further increase the ability of investors and businesspeople to form capital, we propose that the Committee repeal two provisions of the Code that seriously impair capital formation activities and unjustly discriminate against the small businessperson. These provisions are the limitation of interest deductions on investment indebtedness (Code Section 163(d)) and the construction period interest and tax provision (Code Section 189).

Specifically, the limitation on investment interest provision provides that an individual is denied a deduction of more than $10,000 plus the amount of any net investment income in the case of investment indebtedness. In practical terms during this time of high interest rates, an individual can borrow no more than $80,000 for investment purposes without facing this discriminatory ban on the allowance of any further deduction. It is discriminatory because no such limitation is imposed on corporate taxpayers. It is unfair because the wealthy investor may in fact have no limit because of other investment income. This provision seriously impairs the capital formation activities of the small businessperson. We urge this Committee to correct this obvious inequity and vote to repeal this limitation.

A similarly onerous provision is the requirement that construction period interest and taxes be amortized over a 10-year period instead of being deductible in the year actually paid and incurred. Interest and taxes are deductible in all other instances by all other taxpayers. It is only when construction activity is undertaken that these otherwise deductible expenses somehow lose their deductible status and fall under this discriminatory rule that is only applicable to the real estate industry.

Repeal of this provision would equalize the treatment of interest and taxes between real estate and all other industries and would also eliminate a disincentive for investors to construct badly-needed residential housing units and productivity-increasing commercial realty. Repeal would also remove the discrimination against individuals and in favor of corporations that construct real estate.

Finally, in order to remove a cloud that has been hanging over the business community and disrupting business relationships for a number of years, we urge this Committee to resolve the tax status to independent contractors. Many groups within the business community, the NATIONAL ASSOCIATION OF REALTORS® among them, have worked with the Congress in attempting to establish reasonable legislation standards for determining independent contractor status. Bills have been introduced in both the House and Senate to provide such standards and the House bill is presently before the Ways and Means Committee.

Now is the time to finally resolve the independent contractor question. The House bill, H.R. 5460, has not been scheduled for Committee action because of the controversy concerning a provision in the bill that would impose a withholding requirement on independent contractors. Withholding is neither desirable nor necessary since it would be far more costly to the real estate industry than any increase in tax revenues that could be derived as a result of withholding. It is necessary, however, to focus now on reasonable long-term legislative standards because the interim relief provision that has protected workers from unjustified IRS harassment activity on this issue will expire at the end of this year. We urge this Committee to resolve the independent contractor issue as soon as possible this year, whether in the context of a tax relief bill or other legislation.

THE ECONOMIC IMPACTS OF THE REALTORS® TAX RELIEF PACKAGE

The REALTORS® proposal for tax relief offers the prospect of substantial economic gains over the next 5 years (see Table 7). If accompanied by a modest slowdown in federal spending and appropriate monetary policy, our proposed tax relief would result in a $600 increase in average spendable income per household per year by 1985 and would cause consumer prices to be nearly 2 percent lower. About 500,000 additional jobs would be created and an additional 250,000 new homes built each year. A breakdown of these economic impacts by state is given in Table 8.

TABLE 7

ECONOMIC IMPACTS OF REALTORS® TAX PACKAGE
Changes in Levels
U.S. Billions, 1980 Prices

	1981	1982	1983	1984	1985
With Offsetting Reduction in Federal Spending Growth 1/					
Gross National Product	10.4	21.0	42.0	50.0	65.0
Percentage Change	0.4	0.8	1.5	1.8	2.3
Personal Disposable Income per Household ($)	275	320	400	470	600
Employment (New Jobs)	60,000	150,000	450,000	550,000	470,000
Consumer Prices (% Difference in Level)	-0.1	-0.5	-1.1	-1.4	-1.9
Investment in New Equipment	4.7	12.8	25.3	39.6	48.6
Percentage Change	3.0	8.0	15.0	22.0	25.0
Investment in New Commercial and Industrial Structures	2.7	6.9	11.2	15.0	16.7
Percentage Change	3.4	9.4	15.2	18.9	18.5
New Housing Starts ('000 Units)	104	250	240	240	254
Percentage Change	6.4	13.0	11.0	10.0	11.0

1/ Includes also modest accommodating changes in monetary policy.

Source: Estimates by Dr. Jack Carlson using model developed by Data Resources, Inc. and the NATIONAL ASSOCIATION OF REALTORS®.

TABLE 8

Impact Of REALTORS tax Package
In 1985 By State

State	Increase in Employment (Jobs)	Increase in Family Income ($ 1980 prices)	Additional New Housing Starts
Alabama	6,990	484	4,155
Alaska	934	830	851
Arizona	5,552	565	6,349
Arkansas	3,934	468	2,820
California	51,623	682	30,270
Colorado	7,066	621	5,700
Connecticut	7,316	682	1,870
Delaware	1,278	653	393
Florida	19,321	580	24,384
Georgia	11,047	519	6,524
Hawaii	2,047	648	1,368
Idaho	1,892	541	2,274
Illinois	24,656	679	8,701
Indiana	11,482	590	5,724
Iowa	5,894	601	2,652
Kansas	5,162	600	2,742
Kentucky	6,652	505	3,406
Louisiana	7,604	516	4,891
Maine	2,133	483	1,372
Maryland	8,497	639	3,637
Massachusetts	12,936	607	2,665
Michigan	18,333	650	6,727
Minnesota	9,273	605	4,747
Mississippi	4,330	427	2,456
Missouri	9,946	558	4,380
Montana	1,767	529	1,124
Nebraska	3,226	577	1,920
Nevada	2,265	718	3,524
New Hampshire	2,189	565	1,397
New Jersey	15,092	672	3,852
New Mexico	2,818	505	2,009
New York	33,775	630	4,444
North Carolina	12,300	508	8,375
North Dakota	1,336	569	1,172
Ohio	22,862	601	7,649
Oklahoma	6,062	545	4,673
Oregon	5,955	618	5,417
Pennsylvania	22,955	593	5,782
Rhode Island	2,031	570	681
South Carolina	6,100	482	4,060
South Dakota	1,255	504	1,151
Tennessee	8,893	502	4,946
Texas	32,833	593	24,252
Utah	3,270	505	3,249
Vermont	1,070	505	1,087
Virginia	11,444	591	5,997
Washington	9,694	655	9,018
West Virginia	3,243	507	874
Wisconsin	10,342	576	5,221
Wyoming	1,329	665	1,068

Source: Modelling and Assumptions by NATIONAL ASSOCIATION OF REALTORS®.

The need for a slowdown in federal spending growth to accompany this tax relief is critical. Without a slowdown in spending growth virtually no improvement in inflation will occur, despite an increase in investment in new plant and equipment. Interest rates are also forced up, with particular harm done to housing and small business. In fact, without an offsetting reduc- in federal spending growth the impact of rising interest rates on housing starts will almost entirely negate any positive impact on housing activity due to accelerated depreciation on rental residential property, as shown in Table 9. Only when accompanied by slower spending growth can the full beneficial effects of tax relief on housing be attained.

TABLE 9

IMPACT OF REALTORS® TAX PACKAGE
ON NEW HOUSING STARTS
(Thousands Units)

	1981	1982	1983	1984	1985
With Slowdown in In Federal Spending	104	250	237	240	254
Without Slowdown in Federal Spending	70	200	170	75	40
Difference	34	50	67	165	214

Only modest slowdowns in government spending accommodate the REALTORS® tax relief package so as to avoid these harmful impacts on housing and small business and allow the full benefits of increased productivity to be reflected in lower prices. A slowdown of less than 1 percentage point in federal spending growth would be sufficient.

However, the NATIONAL ASSOCIATION OF REALTORS® strongly urges that federal spending growth be slowed more than this minimum desirable figure.

Specifically, REALTORS® recommend that Congress:

- reduce planned spending growth by two percentage points in FY 1981 from the double digit increases currently proposed by the Administration and Congress; and
- after FY 1981, growth in federal spending be restricted to 2 percentage points less than the growth in people's incomes.

Even a modest slowing of spending growth of this size would make room for even larger tax relief for increased investment and savings and move the federal budget toward balance. The benefits to the economy and to Americans in general would then be even greater than the already significant gains shown in Table 7.

APPENDIX I

ADDITIONAL TAX POLICY PROPOSALS

A. Mortgage Investment Tax Credit

The NATIONAL ASSOCIATION OF REALTORS® proposes that holders of mortgage loans, on residential properties be entitled to a credit against Federal income taxes on a portion of the interest received from the next increase in such mortgage holdings. The result would be more available funds for mortgages, with possibly lower mortgage rates to homebuyers.

Individuals and institutional investors with 20 percent or less of their assets in 1-4 family mortgages would be entitled to a tax credit of 5 percent. The credit would increase by 1/10 of a percentage point for each percentage point increase in the mortgage/assets ratio. Institutions with 70 percent or more of assets in residential mortgages would qualify for the maximum tax credit of 10 percent. The credit would apply to interest paid during the first 10 years of the mortgage. To be eligible for a tax credit the original amount of the mortgage must be no greater than one and one-half times the average price of new homes in the preceding year. Advantages of this proposal are:

1. Provides an inducement for any lender to invest in residential mortgages.
2. Provides an inducement to savings and loan associations and mutual savings banks to continue to invest heavily in mortgage loans. Because only new mortgages are covered, previous high investment in mortgages, while establishing the base, cannot be

used to guarantee significant credits without continued investment.

3. Possibly makes mortgage loans available to homebuyers at interest rates less than the rate would be without the tax credit, enabling more people to achieve homeownership.

All residential mortgage loans regardless of when they were originated would be used to compute the mortgage/asset ratio. However, the credit would only apply to the interest received from qualified mortgages.

B. Rental of Property to Relatives as Principal Residence

A technical correction is needed to the Internal Revenue Code provision meant to place limitations on deductions relating to vacation homes. This provision inadvertently also limited deductions on the rental of property to a taxpayer's relative for use as a principal residence at a fair market rental. For example, if a taxpayer rents residential property to a stranger he is entitled to deductions for repairs, depreciation, etc. If he rents this same residence to a relative at the same rental, he should be entitled to, but is denied under current law, to the same deductions. If a fair market rental is paid the same rules should apply.

C. Ordinary and Necessary Business Expenses Paid or Incurred Prior to Realization of Current Income.

The Internal Revenue Service has adopted the policy, in the case of real estate activities involving the construction and operation of a property, of disallowing the deduction of otherwise deductible ordinary and necessary business expenses paid or incurred by the owner of the property prior to the actual realization of income. Existing law should be clarified to clearly provide that these ordinary and necessary business expenses are currently deductible.

D. Extension of Provision for Rapid Amortization of Rehabilitation Expenses to All Residential Rental Property.

In order to encourage the maintenance of the nation's existing housing stock, the current provisions which allow a 60-month amortization of rehabilitation expenses for low-income housing should be extended to all residential rental property. In addition, to keep pace with inflation, the maximum amount of rehabilitation expenditures subject to this amortization schedule should be increased from $20,000 to $30,000 per unit and the minimum from $3,000 to $5,000 per unit.

E. Capital Gains Treatment for Gains from Sale to Tenants; Tax-Deferred Rollover of Reinvested Gain.

Under current law, if a landlord wishes to dispose of his residential rental property, he is virtually forced to sell this to an outside professional converter rather than to his tenants in order to receive capital gains treatment on the proceeds of the sale. This extra layer of profit drives up prices for tenants. This proposal would encourage a landlord to sell directly to tenants and individuals instead of to a third-party converter by allowing capital gains treatment on such a sale to these tenants and individuals. Further, to encourage continued investment in residential rental property a landlord should be allowed to defer the tax on gain from the sale of rental property for the portion of the proceeds which are reinvested in residential rental property.

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STATEMENT

SENATE FINANCE COMMITTEE

on

ADVISABILITY OF A TAX CUT

July 30, 1980

SUMMARY OF PRINCIPAL POINTS

- N.A.H.B. favors a Targeted Tax Cut, structured to avoid inflationary pressures and directed toward improving productivity and creating jobs.
- For the housing industry, a tax cut should be structured to accomplish two results:
  - (1) Provide a stable source of single family home financing at interest rates families can afford; and
  - (2) Stimulate the production of multifamily housing.
- Current Housing Downturn
  - oo Housing Starts:

    78 - June 1978 - 2,093,000
    79 - June 1979 - 1,910,000
    80 - June 1980 - 1,190,000
  - oo Unemployment in Construction Trades: 17.5%
  - oo Impact on economy of loss of 800,000 starts;
    - Loss of 1.35 million jobs
    - Loss of $23 billion in wages
    - Loss of over $4.7 billion in federal tax revenues
- Obstacles housing industry faces
  - oo Record demand for housing in 80's --

    41 million Americans reach prime home buying age, compared with 31 million in thr 70's

- oo Obstacle to single family housing --

  much higher mortgage interest rates in the future
- oo Various obstacles to apartment construction

N.A.H.B. RECOMMENDATIONS

Incentives for Single Family Mortgage Finance

- o Tax Incentives for Savers

  N.A.H.B. supports Senator Nelson's bill (S. 2560) and Senator Doles's bill (S. 2745).

- o Tax-Exempt Revenue Bonds

  N.A.H.B. supports Senator Williams bill (S. 2064) with the Randolph/Byrd amendment and Senator Hart's bill (S. 2746).

Incentives for Rental Housing

- o Depreciation Reform

  N.A.H.B. supports the 20 year/15 year straight line depreciation schedule of Senator Williams bill (S. 2969).

- o Construction Period Interest and Taxes

  N.A.H.B. urges repeal of I.R.C. §189, so that construction period interest and taxes can be deducted in the year payments are made.

- o Interest on Investment Indebtedness

  N.A.H.B. urges repeal of I.R.C. §163.

- o Removal of Existing Expiration Dates for Rehabilitation, Historic Preservation and Barriers for Handicapped

  N.A.H.B. favors making provisions permanent.

- o Capital Gains Treatment for Gains from Sale to Tenants

  N.A.H.B. favors capital gains treatment for sales to individual tenants.

Other Tax Proposals

- o Withholding on Independent Contractors

  N.A.H.B. strongly opposes withholding on independent contractors.

- o Withholding on Interest and Dividends

  N.A.H.B. strongly opposes withholding on interest and dividends.

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STATEMENT OF

THE NATIONAL ASSOCIATION OF HOME BUILDERS

before the

SENATE FINANCE COMMITTEE

on

Advisability of a Tax Cut in 1980

JULY 30, 1980

Good morning, Mr. Chairman and Members of the Committee.

My name is Herman J. Smith and I am First Vice President of the National Association of Home Builders, the trade association of the home building industry. Our association represents over 124,000 members, who in turn employ over 3 million people in the residential construction industry. Members of NAHB are responsible for over two-thirds of all residential construction in this country. Accompanying me today are Robert D Bannister, Senior Staff Vice President of Governmental Affairs, Gary Paul Kane, Associate Legislative Counsel, Leonard Silverstein, of the firm Silverstein & Mullens, and Michael Sumichrast, NAHB's Chief Economist.

I appreciate the opportunity to appear here today to present the views of the home building industry on the advisability of a tax cut to be enacted in 1980. Tax policy has a significant effect on the housing sector of the American economy. It provides incentives and disincentives affecting the volume and character of housing construction and can have a significant impact on the cost and availability of mortgage funds.

Concerning the advisability of a tax cut this year, we agree with the comments Senator Bentsen made on these hearings last week. Any tax cut must be targeted and structured in a way to avoid inflationary pressures. The tax cut should be directed toward improving industrial productivity and creating jobs.

For the housing industry, a tax cut should be structured to accomplish two results: to stimulate the production of multi-family housing, and to provide a stable source of single family home financing at interest rates which families can afford. Accomplishing these objectives will create employment and moderate inflationary pressures on home prices by allowing the production of housing to better meet demand.

THE CURRENT HOUSING DOWNTURN

We commend the Chairman and this Committee for its recognition of the present crisis in the housing industry through the near unanimous passage of the Chairman's Resolution (S. Res. 435), that the Senate would not impose restrictions on the use of revenue bonds to finance housing through the end of 1980. This should facilitate the release of mortgage funds at interest rates families can afford, and help the housing industry get back to building houses and construction workers get back to their jobs.

There is some evidence which indicates that the housing crisis may be easing. The Commerce Department reported that housing starts in June were up 30% from May's figures. But it would be erroneous to conclude from this that the housing industry has recovered. Housing starts in May stood at 920,000, on a seasonally adjusted annual basis, the third lowest month since World War II. The 30% improvement only bought starts to 1,190,000. This compares with starts of 1,910,000 in June of 1979 and starts of 2,093,000 in June of 1978. In that perspective, this June's figures represent only 62% of June 1979 and 57% of June 1978. If the housing industry is recovering, we believe that the recovery will be slow, and the economic effects of the current downturn will continue to be felt for several years.

Let me briefly summarize the current condition of the housing industry. We predict housing production for 1980 will not exceed 1.2 million starts. Housing starts for 1981 are only expected to be 1.55 million. Just two years ago, production was over 2 million units.

- Housing production nationally is down more than 40%.
- Nationally, unemployment is up to 7.8 percent, with more than half the recent layoffs concentrated in the housing and auto industries.
- Unemployment in the construction trades reached 17.5% in May. NAHB's Economics Division predicts that unemployment will soar to 22-24 percent in the construction trades by October 1980.
- Consumer confidence is low because of the recession. Buyers are likely to remain reluctant to purchase homes and cars until they perceive that interest rates have stabilized and the economic recovery is clearly underway.
- The inventory of unsold homes on the market is about 350,000--or about a 8 month's supply at today's sales rate.

The loss of 800,000 housing units in 1980--the difference between the NAHB forecast for 1980 and the 2 million starts recorded annually during 1977 and 1978--would result in a net loss of $95 billion in economic activity. More specifically, this level of activity is having a catastrophic impact on the national economy. The aggregate impact will be:

--the loss of 1.35 million jobs;

--the loss of $23 billion in wages;

--the loss of over $4.7 billion in federal tax revenues and $6.1 billion i combined federal, state, and local revenues.

This represents the equivalent of letting four Chrysler Corporations go bankrupt.

But much more is at stake here. Our inability to produce housing to meet the demands of the American people could well upset the social fabric of our country. Without a doubt, the result will be highly inflated housing costs when this industry recovers during the early 1980's. Thousands of skilled craftsmen will seek employment elsewhere and never return. A new work force will have to be trained when economic conditions improve. Building product manufacturers will delay indefinitely plans to expand their production capacities. Consequently, serious shortages of building materials will occur when starts rebound during the recovery. This will make the inflationary increases in housing prices during the mid 70's, after the last housing decline, look mild by comparison.

STRUCTURAL PROBLEMS IN THE HOUSING INDUSTRY

There has been a great deal of discussion at these hearings about structural weaknesses in the manufacturing and industrial sectors of the American economy and about modifying the tax laws to stimulate correction of some of those deficiencies. In the housing industry, there are two significant structural weaknesses which exist now and will continue even beyond housing's recovery from the current recession. These are the very serious lack of new apartment construction, and the establishment of long term mortgage interest rates at levels well above the affordability of millions of American families.

The Demand for Housing in the Decade of the 80's

The underlying demand for housing--both single family and apartments--is very strong and will grow substantially through the decade of the 1980's. Projections indicate that during the 1980's, 41 million Americans will reach the prime home buying age of 30. This compares with about 31 million who reached the age of 30 during the 1970's. The rate of new household formation will be 25% higher in the 1980's than during the last decade.

This increased rate of family formation is largely the result of the post-war baby boom and the number of increased single person households. When combined with the number of families currently occupying substandard housing and the number of housing units removed from the market each year by demolition, disaster or other means, an additional 23 million housing units would be needed during this decade. This means that there will need to be at least 2.3 million new housing units constructed during each year of the decade of the 80's. Any lower production levels will almost certainly result in increased upward pressure on home prices due to the simple facts of supply and demand.

Gap in Apartment Construction

Apartment vacancy rates in many parts of the country are at very low levels. According to figures gathered by the National Association of Realtors from selected HUD area offices, the following are vacancy rates in several cities (see Table I for a more complete list):

Chicago, Illinois	-	1.0
Raleigh, North Carolina	-	2.3
Detroit, Michigan	-	8.7
Baltimore, Maryland	-	3.3
Los Angeles, California	-	1.0
Burlington, Vermont	-	0.6
Baton Rouge, Louisiana	-	2.87

There are various reasons why new multifamily rental projects are not being built despite the low vacancy rates and the substantial need for housing. Probably the most important factor is that it is simply not economically feasible to build apartments anymore. Rents have not kept pace with rapidly escalating construction costs. And incentives in the Tax Code to encourage multifamily construction are no longer sufficient to eliminate the gap. In addition, several provisions added to the 1976 Tax Reform Act are major disincentives to the development of new multifamily, rental housing.

A substantial number of the new multifamily units which are being produced are being constructed under the Federal subsidy programs. This serves the needs of only one small segment of the income spectrum. Few apartment buildings are being constructed for individuals and families whose incomes are above the level required for admission into the federal programs.

Many individuals and families prefer apartments to home ownership. Apartment rents are generally lower than the monthly mortgage payments and someone else is responsible for maintaining and caring for the apartment building. In addition, some people feel the need for an additional degree of freedom and mobility of not being tied down to an owned home.

In order to provide flexibility and choice to American families and to provide units with monthly payments less than monthly mortgage payments, incentives must be given to encourage the development of multifamily housing.

Much Higher Mortgage Interest Rates in the Future

The second area where structural change is necessary is the area of housing finance. Major changes are occuring in the cost and availability of mortgage finance. In the past, financial institutions had a pool of 5% and 5-1/4% savings deposits upon which they could draw to finance mortgage loans. This provided mortgage financing at the lowest possible interest rates to home buyers. However, the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980 will bring on a new era in mortgage finance. Regulation Q, which prescribed the 5% and 5-1/4% interest rate ceiling is to be phased out within six years. At that time there will be no ceilings on the interest rates financial institutions may pay for their savings deposits. To be competative and to attract savings, financial institutions will be required to pay prevailing market interest rates. If market interest rates are, for example, 9 1/2%, then it will not be possible for financial institutions to make mortgage loans at interest rates below 11% or 11 1/2%. These will be minimum interest rates. Mortgage rates will climb from there.

What this means is that despite the overwhelming need and demand for housing, increasingly fewer families will be able to afford housing. Table II shows the effects of higher interest rates on housing affordability. Assuming a $65,000 house, with a 5% down payment, and a 30-year fixed rate mortgage period at 9% interest, the monthly principal and interest payment would be $497 and the annual income necessary to afford the house would be just over $34,000. At 12% interest, the principal and interest payment jumps $138 a month, to $635, and the annual income needed to afford the house increases to $40,800. Assuming the same $65,000 house with a 5% down payment, the increase in interest rate from 9% to 12% eliminates more than 4 million households from the ability to purchase that home.

RECOMMENDED PROVISIONS FOR INCLUSION IN TAX CUT BILL

As I indicated earlier, we believe that a tax cut can and should be structured as to avoid inflationary pressures on the economy, and to increase productivity and stimulate the creation of jobs. A tax cut which accomplishes these objectives could very well moderate long-term inflationary pressures.

To provide the greatest assistance to the housing industry, a tax cut program should do two things: (1) provide mortgage financing at interest rates families can afford; and (2) provide incentives for the development of apartment projects.

Incentives for Single Family Mortgage Finance

1. Tax Incentives for Savers

NAHB strongly supports Senator Nelson's bill, S. 2560, which provides a tax exemption for interest on savings deposits used by financial institutions to make mortgage loans, and Senator Dole's bill, S. 2745, which establishes tax-exempt Housing Savings Accounts to encourage families to accumulate funds to purchase a home.

Much attention has been given to the low savings rates in the United States and the impact of that rate on capital investment and productivity. And proposals have come forward to provide incentives to increase the rate of savings in order to assist this nation's industrial base. However, as I mentioned, mortgage finance is presently undergoing a revolution of its own. And without some incentives to provide mortgage loans at interest rates families can afford, in the next few years many millions of American families will be priced out of the housing market by high interest rates.

The personal savings rate in this country is now below 5% of aftertax income, the lowest among all industrialized nations. Since the 1950's, the long run savings rate in this country has ranged in the area of 6% to 6 1/2%-exceeding 8% in the mid 1960's. However, since the middle of the 1970's, the savings rate has declined precipitously. It appears to us that unless some very firm positive steps are taken immediately, the savings rate will continue to decline throughout the decade of the 1980's.

A continued low savings rate is detrimental both to the nation's economy and to the home building sector of that economy. Lower savings will mean higher relative interest rates, and shortage of capital formation, thereby perpetuating the slow growth in the U.S. productivity. And shortages of funds will continue to prevent families from buying homes.

The present income tax structure discourages savings and encourages consumption. Interest on savings accounts, which already is significantly below the rate of inflation, is subject to tax. The aftertax yield on a savings deposit at a commercial bank or thrift institution may be as little as 3% to 4%. Given the present rate of inflation, this is hardly an incentive to save.

Mortgage interest rates are beginning to ease up, but we do not believe they will ever return to the low rates which typified the 1960's and 70's. For the foreseeable future, without some incentive such as that contained in Senator Nelson's bill, mortgage interest rates should remain at double digit levels, preventing many millions of American families from affording homes.

Senator Dole's bill addresses the problem of families accumulating the downpyment required to make the purchase of a home. S. 2745 provides both the incentive and the means to accumulate a sufficient downpayment

2. Tax-Exempt Revenue Bonds

In the long term, NAHL believes that revenue bonds offer one of the tools which should be used to provide mortgage financing at affordable interest rates. Revenue bonds provide cities, counties and states the opportunity of tailoring mortgage financing to the needs and demands of those individual jurisdictions. And we believe no one is in a better position to assess the needs and demands of local communities than the state or local government.

We would recommend that a tax cut bill include a provision permitting the issuance of tax-exempt revenue bonds after December 31, 1980. We would support either Senator Williams' bill

(S. 2064) with the amendment introduced by Senators Randolph and Byrd (of West Virginia), or the bill introduced by Senator Hart (S. 2746). Both the Williams bill and the Hart bill recognize that state housing finance agencies are responsible entities, strictly and carefully supervised by their state legislatures. Both bills recognize that the lending programs of state housing finance agencies generally are subject to income and mortgage limits worked out as a compromise among the competing interests within each state. These limits are carefully drawn out to the needs of each state and clearly more representative of the needs in that state than any restrictions prescribed by the federal government.

If restrictions are to be placed on cities or counties, then we would support either the Randolph/Byrd amendment to the Williams bill or the approach taken in Senator Hart's bill. The Randolph/ Byrd approach provides that revenue bond financing can only be provided to families with incomes which do not exceed 45% of the average new one family housing cost for the state in which the residence is located. The advantage of this approach is that it ties income levels to the actual cost of housing within each individual state. It does not set some arbitrary income level for the entire country which may or may not work in individual states.

Senator Hart's bill requires that families have an income not exceeding 150% of the median income for the statistical area in which the residence is located. If a fixed income limit is to be used, Senator Hart's approach is a good one. With housing costs as high as they now are, this type of income limit permits the sale of some of the least expensive newly constructed homes, in addition to existing homes. A lower limit would almost surely prevent the sale of newly constructed houses.

3. Tax Credits for Purchase of a Home.

NAHB supports a tax credit of 5% of the purchase price of a newly constructed home, up to the maximum amount of $4000, for the sales of such a home within twelve months of the effective date of such legislation. This provision is modeled after the 5% tax credit which helped stimulate sales during the housing downturn of 1974-75.

Incentives for Rental Housing

1. Depreciation Reform

Accelerated depreciation for business is at the top of many lists for necessary tax reform. Various depreciation reform proposals have been mentioned as a means to stimulate capital investment and increase productivity in U.S. business.

However, we are very concerned that many of these proposals overlook the housing industry. The 10-5-3 proposal, for example, is actually detrimental to the housing sector of the economy. Multifamily housing is not included in the depreciation reforms contained in 10-5-3. Thus, the effect of passage of the present 10-5-3 proposal would be a further shift of capital investment away from housing and into other sectors of the economy. The result would be an even greater reduction in the number of apartments being built and a lower vacancy rate.

NAHB believes that if depreciation reform is to be included as part of a tax cut proposal, that it should be expanded to include multifamily rental housing. We strongly support Senator Williams bill, S. 2969, which provides twenty-year straight line depreciation for all Section 1250 property (with 15-year straight line depreciation for low-income housing). We would urge that the 20-year/15-year depreciation schedule is a better approach than the ten-year component of the 10-5-3 proposal.

The adoption of the Williams proposal would greatly simplify the computation of depreciation. All existing accelerated depreciation formulas would be eliminated with respect to Section 1250 property. There would be a certainty in the useful lives of depreciable real property which would benefit both the businessman and the IRS auditor. The frequent audits of apartment properties and the inconsistency in useful lives prescribed by various I.R.S. auditors discourage builders from becoming involved in the development of multifamily housing. And substitution of the 20 year/15 year useful life for the 10 year component of 10-5-3 would involve substantial savings in revenue to the Federal treasury.

N.A.H.B.'s economists estimate that the 20 year/15 year depreciation provision will increase multifamily starts by 105,000 units. This in term would generate $1.47 billion in wages, and $310 million in additional federal personal and corporate tax.

Finally, I would like to note that as part of the Williams proposal, the recapture rules presently applicable to Section 1250 property would remain. The recapture rules currently contained in 10-5-3 proposal establish mass asset accounts, which are more suitable in manufacturing enterprises where the companies own a great many machines or vehicles and are acquiring or disposing of them frequently. Section 1250 property generally consists of discreet units of real estate, such as an apartment building or a shopping center. These items are developed and sold on an individual basis and do not really lend themselves to the mass asset type of accounts.

2. Current Deduction of Construction Period Interest and Taxes.

NAHB urges that Section 189 of the Internal Revenue Code be repealed, and that construction period interest and taxes be be allowed as deductions in the year in which the payments were made. Section 189 has been a major impediment to the development of rental housing.

We can see no justification for capitalizing construction period interest and taxes. These items are akin to current expenses. So long as there is no attempt to avoid legitimate taxes by prepaying interest attributable to other periods, interest and tax deductions should be allowed in the year in which payments are made.

Taxes are a recurrent expense: tax bills come out yearly, and are paid as they are issued. In other businesses, a deduction is allowed for taxes in the year in which they are paid. It is discriminatory to the real estate industry not to allow the deduction in the year in which construction period tax payments are made.

A similar argument can be made for construction period interest payments. Construction interest is attributable to a construction loan which exists only during the twelve to twenty-four month period when a multifamily housing project is under construction. When construction is complete, the construction loan is paid off, a new permanent take-out loan is issued and a new, recurring interest charge begins. Construction period interest is clearly an expense of the short construction term, and should be allowed as a deduction during that period.

3. Interest on Investment Indebtedness.

NAHB urges repeal of the provision in Internal Revenue Code Section 163 which limits the deduction for investment interest by non-corporate taxpayers to $10,000 plus net investment income. This provision was added as part of the 1976 Tax Reform Act. But its impact is greatest on small taxpayers and it acts as a further impediment to the development of multifamily housing.

The taxpayers most affected by this provision are those not wealthy enough to have other investment income. Taxpayers who have considerable wealth and considerable other investment income, find the $10,000 limitation of no significance. Only those taxpayers without other investment income, the small investors, are limited by this provision.

With the construction interest rate running 2% over prime, the interest costs in developing multifamily housing are extremely high. Thus, a month or so ago when the prime rate was 20%, the construction interest rate was 22%. On a multifamily apartment building costing $4 million to $5 million, a 20% or 22% construction interest rate can mean a substantial cash payout period. (The construction interest cost for such a building could be over $1 million at a 20% interest rate.) This is not an insignificant item. The $10,000 limit is easily reached and surpassed. The result is the discouragement of the investment by small and medium sized individuals in multifamily housing.

4. Removal of Existing Expiration Dates for Rehabilitation, Historic Preservation and Barriers for Handicapped.

NAHB urges that the expiration dates for rapid amortization of expenditures for rehabilitation of low-income housing, historic preservation, and removal of barriers for the handicapped and elderly be removed, and those provisions be extended indefinately. When these provisions were enacted, expiration dates were included to provide time to see whether or not these tax incentives would actively encourage these three objectives and to provide time to develop alternative non-tax incentives. The tax incentives have accomplished their objectives, and there are no non-tax incentives which now could be used as substitutes. Removal of the expiration dates for each of these activities would avoid the uncertainty in the building industry as each expiration date compes up, and permit better long-term planning.

5. Capital Gains Treatment for Gains from the Sale to Tenants.

Included in Mr. Williams' proposal is a provision which would permit capital gains treatment to an apartment owner when individual units are sold to tenants. Under current law, in order to qualify for capital gains treatment, the landlord must sell the entire building either to a tenant's association or to a condominium convertor. In either case, this sometimes means an additional layer of profit which must be passed on in the form of a higher price to the purchasing tenants. By providing the same tax treatment whether the apartments are sold as a block or individually, the apartment house owner would be encouraged to sell individual units to individual tenants, thereby avoiding an extra layer of profit and passing the cost savings onto the tenant.

We believe that the provision in S. 2969 requiring approval of the terms and conditions of sale by a tenant's organization is unnecessary and may work to the detriment of the tenants. The reason for allowing capital gains treatment on the sale of units directly from the apartment owner to individual tenants is to avoid the extra cost necessitated by negotiation and sale to a middleman. We believe that if individual tenants can reach an agreement on price with the landlord, they should be able to take advantage of that bargain without having the sale approved or ratified by a tenant's organization. Negotiations with the tenant's organization, whether for the purpose of sale to the tenant's organization or for the purpose of agreeing to terms under which units will be sold to the tenants, is a long and cumbersome process. It involves a great deal of the apartment owner's time and a great deal of the time of his professional representatives (accountants, lawyers, and real estate agents). All of this adds unnecessary cost to the purchase price of each unit, which must necessarily be born by the purchaser. We believe that the least costly and most efficient means to get the units to individual tenants at the lowest possible cost is by simply allowing the direct sale by the landlord to the tenants and allowing capital gains treatment on that sale.

Other Tax Proposals Detrimental to the Housing Industry

1. Withholding on Independent Contractors

NAHB strongly objects to the provision requiring withholding on independent contractors contained in a House bill, H.R. 5460. Withholding is simply one more burdensome and costly requirement which would make it more difficult for a small businessman or businesswoman to conduct his or her business. At a time when there is general recognition that the regulatory requirements placed on small business already stifle production and inhibit innovation, this is simply one more major burden to be placed by government on the operation of business.

From the perspective of our industry, two-thirds of our single family builders construct 25 or fewer homes per year. Most of these builders may employ only 2 or 3 persons but utilize 12 to 15 subcontractors. Requiring withholding for subcontractors will impact significantly on the small home builders. The burden is simply unfair and will be reflected in even higher home prices to the housing consumer.

We do not believe that the Internal Revenue Service should be alllowed to shift its responsibility for enforcing compliance to the private small businessman or businesswoman. Present law requires that a general contractor report the income paid to his subcontractor for the work that person performs. We belive it is the responsiblity of the Internal Revenue Service to match that information with information provided by the taxpayers, and to seek to enforce any discrepancy.

2. Withholding on Interest and Dividends.

For similar reasons, NAHB also strongly opposes the proposals in S. 47, S. 1565, and H.R. 1040, which provide for withholding on interest on savings deposits and dividends from stock. These proposals fly in the face of action taken by Congress this year to encourage increased savings and increased investment in stock. As part of the Windfall Profits Tax Act, beginning in 1981, a single taxpayer will be allowed to exclude $200 ($400 for a married couple) in interest and dividend income on his or her return. This increased exclusion was intended to encourage greater savings and greater investment in corporate stock.

Whatever incentive is provided by the increased exclusion, may be more than offset by the withholding requirements. Instead of receiving the full return on their savings or corporate stock, taxpayers will see that return only after withholding has been taken from it. Lower income taxpayers will not have the use of the funds to meet current expenses. More affluent taxpayers will not have the opportunity to reinvest the interest or dividend income pending final payment of their taxes.

Again, we believe the Internal Revenue Service, is attempting to shift the burden of compliance from itself to small taxpayers. We believe that each taxpayer should pay his or her fair amount of tax. And we believe that all earned income should be reported to the Internal Revenue Service. But we beleive that the responsibility for enforcing compliance of the existing tax rules is the responsibility of the Service and not of individual taxpayers or small businessmen and businesswomen.

CONCLUSION

N.A.H.B. supports a targeted tax cut, structured to be non-inflationary. With respect to the housing industry, such a tax cut should help stimulate apartment development and provide more affordable interest rates for single family houses. If properly structured, we believe a tax cut could moderate long-term inflationary pressures in home prices.

I appreciate this opportunity to appear before you and I would be pleased to answer any questions you may have

Table I

Selected Vacancy Rates
[In percent]

ILLINIOS	
Chicago	1
Rockford	3.6
Springfield	6.1
NORTH CAROLINA	
Raleigh	2.3
Durham	2.0
Greensboro	2.5
Charlotte	2.5
MICHIGAN	
Detroit	8.7
Ann Arbor	1.57
Grand Rapids	3
MARYLAND	
Baltimore	3.3
Montgomery County	3.1
Annapolis	2.8
ALABAMA	
Montgomery	2
MASSACHUSETTS	
Boston (city; 3.0 area)	5.3
Springfield	3.3
SOUTH CAROLINA	
Columbia	5.1
Charleston	3.5
GEORGIA	
Atlanta	3.4
LOUISIANA	
Baton Rouge	2.87
NEBRASKA	
Lincoln	2.1
Omaha	5
COLORADO	
Denver	2.3
TEXAS	
Corpus Christi	1.7
Houston	10.0
CALIFORNIA	
Los Angeles (down from 1.8 in Dec. 1979	1
San Francisco	2
San Diego	2.9
MINNESOTA	
Minneapolis:	
Rental housing (down from 7 in Dec. 1979)	4.5
All housing	2.0
VERMONT	
Burlington (1978)	0.6
Montpelier (1979)	1.6

SOURCE—National Association of Relators survey of HUD area offices. Most data is from Q4, 1979. Rates should be less today than that shown above.

Table II

HOUSING AFFORDABILITY

$65,000 house
$61,750 mortgage amount (5% down)
30-year term

Interest Rate	Monthly Payment	Related Housing Expenses[1]	Annual Income Needed To Afford[2]	Number of Households Who Can Afford (in thousands)	Percent of Households Who Can Afford	Number of Families Priced Out (in thousands)
7 1/2%	$432	$215	$31,056	13,274	23.2%	—
8 %	453	215	32,064	12,645	22.1	629
8 1/2%	475	215	33,120	12,015	21.0	630
9 %	497	215	34,176	11,386	19.9	629
9 1/2%	519	215	35,232	10,756	18.8	630
10 %	542	215	36,336	10,070	17.6	686
10 1/2%	565	215	37,440	9,440	16.5	630
11 %	588	215	38,544	8,754	15.3	686
11 1/2%	612	215	39,696	8,067	14.1	687
12 %	635	215	40,800	7,381	12.9	686
12 1/2%	659	215	41,952	6,694	11.7	687
13 %	683	215	43,104	6,008	10.5	686
13 1/2%	707	215	44,256	5,321	9.3	687
14 %	732	215	45,456	4,577	8.0	744

1. Real estate taxes, hazard insurance, utilities, maintenance and repairs.
2. Assumes one-fourth of income goes to housing expenses and constant underwriting criteria.

Source: National Association of Home Builders

NATIONAL REALTY COMMITTEE

2033 M STREET, N.W. • WASHINGTON, D.C. 20036 • 202/785-0808

STATEMENT OF THE
NATIONAL REALTY COMMITTEE ON
1980 TAX CUT PROPOSALS

SUBMITTED TO
SENATE COMMITTEE ON FINANCE

JULY 30, 1980

NATIONAL REALTY COMMITTEE

2033 M STREET, N.W. • WASHINGTON, D.C. 20036 • 202/785-0808

National Realty Committee Statement on 1980 Tax Cut Proposals

SUMMARY

The most widely discussed possibility for encouraging greater productive investment in real property is depreciation reform. The NRC testimony reviews various depreciation reform proposals, including S 1435, the Capital Cost Recovery Act and reaches the following conclusions:

The National Realty Committee is opposed to any change in the depreciation rules which would impose full depreciation recapture at ordinary income rates to real property.

The National Realty Committee is in favor of:

1. The availability of fixed capital cost recovery periods for real property investments,
2. Substantially shorter capital cost recovery periods than those currently available under Treasury guidelines, and
3. Including residential rental property in any depreciation reform ultimately adopted.

Statement of the National Realty Committee

The National Realty Committee, Inc., a non-profit business league whose membership includes owners, operators and developers of all types of real estate throughout the United States, offers the following statement, regarding the possibility of 1980 tax cut legislation, for consideration and action by the Senate Finance Committee.

There are a very large number of tax revisions which could be enacted which would serve to set the course of tax policy in the right direction. Among such possible revisions, depreciation reform is certainly a major concern. Several proposals have been advanced for drastically revising and improving the present unrealistic depreciation provisions. By comparison with those provided in virtually every other industrial nation's tax systems, the Federal income tax laws are obsolete. No other major industrial nation insists on determining "useful lives" and basing capital recovery on so ambiguous a notion. Neither should the U.S. tax system. The concern, instead, should be with making the income tax as neutral as possible with respect to the choice between consumption, on the one hand, and saving and investment, on the other, as well as in its effect among differing types of capital.

Among the more widely discussed proposals for depreciation reform is the so-called 10-5-3 proposal, which would provide, after a phase-in, a 10-year capital cost recovery period for all real property other than residential rental property. The exclusion of residential rental property is particularly unfortunate since residential rental property has grown far more slowly during the period from 1950 through 1979 than any of the other broad types of capital, and in the entire decade of the 1970s, there has been very little growth at all in residential rental property. An alternative suggestion for depreciation reform is included in H.R. 7015 introduced by the Chairman of the House Ways and Means Committee. Under H.R. 7015, taxpayers could elect to use audit proof class lives for determining depreciation with respect to all buildings, including residential rental buildings. The class lives under H.R. 7015 would be at least 35% shorter than the applicable useful lives for buildings under existing Internal Revenue Service guidelines.

A vital distinction between the 10-5-3 proposal and the proposal contained in H.R. 7015 is the difference in depreciation recapture rules provided under each proposal. Presumably as consideration for the very rapid accelerated recovery of capital cost relating to buildings under the 10-5-3 proposal, that proposal would change the existing rules relating to depreciation recapture for real property and would impose full depreciation recapture at ordinary income rates upon all real property to which the 10-5-3 proposal would be applicable.

On the other hand, under H.R. 7015 the existing depreciation recapture rules applicable to real estate, which impose recapture only upon accelerated depreciation, are retained.

The National Realty Committee strongly opposes any change in the depreciation recapture rules which would have the effect of applying full recapture at ordinary income rates to real property depreciated under the straight-line method.

While we believe that the scheduled lives proposed for real property under H.R. 7015 do not reflect current actual practices, as contrasted with current Treasury guidelines, and are therefore too long to accomplish the purpose of encouraging taxpayers to utilize the system to its fullest extent,* our primary concern is maintaining the viability of the real estate investment market by preserving the current depreciation recapture rules applicable to real property irrespective of the capital cost recovery period ultimately chosen.

Full depreciation recapture at ordinary income rates when applied to individuals would have the effect of virtually eliminating voluntary sales since the profits from such sales, even if attributable solely to inflation, would be subject to Federal income tax rates of up to 70%. While industrial concerns rarely dispose of depreciable personal property for amounts substantially in excess of salvage value, the value of real property held for investment over many years may substantially appreciate due to inflation, changes in interest rates and

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* Statistics compiled by the Treasury Department's Office of Industrial Economics indicate that lives claimed by taxpayers with respect to new buildings average approximately 20% shorter than the Treasury's 1962 Guidelines (Office of Industrial Economics, Department of the Treasury, Business Building Statistics, GPO, Washington, 1975). As a consequence, although reducing personal property ADR lives by 35% results in a real increase in current depreciation allowances, a commensurate real increase in depreciation allowances accorded to real property would require lives 35% shorter than the average useful lives currently in actual use. On this premise, a comparable reduction in depreciable lives for real property would result in capital cost recovery periods for real property in the range of 20 to 25 years.

other miscellaneous factors. Imposing draconian tax penalties upon the sale of such assets will not produce tax revenue and will not inhibit initial investment but those penalties will severely limit subsequent voluntary sales. The net result will inevitably be an increasingly inefficient allocation of capital resources throughout the real estate sector of the economy.

These results may be illustrated by comparing the following two examples involving the hypothetical purchase of depreciable real property for $10 million, $2 million paid in cash and $8 million by execution of a mortgage note bearing interest at 10% and providing for 1% amortization per annum.

The first example illustrates the effect of a sale at original cost after 5 year under the 10-5-3 proposal. The $4,900,000 in tax liability, resulting from a sale which produces only $2,400,000 in cash before tax, graphically illustrates the impossible market conditions that would result from 10-5-3 with full depreciation recapture.

The second example assumes a 20-year straight-line depreciable life with no applicable depreciation recapture. In this example a sale after 5 years at original cost is eminently viable.

EXAMPLES

1.	Depreciable real property - cost	$10,000,000
	10-5-3 depreciation for 5 years	7,000,000
	Adjusted basis	3,000,000
	Sales price	10,000,000
	Gain	7,000,000
	Tax at 70%	4,900,000
	Cash from sale before tax	2,400,000
	Cash from sale after tax	(2,500,000)
2.	Depreciable real property - cost	$10,000,000
	Depreciation for 5 years	2,500,000
	Adjusted basis	7,500,000
	Sales price	10,000,000
	Gain	2,500,000
	Tax at 28%	700,000
	Cash from sale before tax	2,400,000
	Cash from sale after tax	1,700,000

In summary, the National Realty Committee is opposed to any change in the depreciation rules which would impose full depreciation recapture at ordinary income rates to real property.

The National Realty Committee is in favor of:

1. The availability of fixed capital cost recovery periods for real property investments.

2. Substantially shorter capital cost recovery periods than those currently available under Treasury guidelines.

3. Including residential rental property in any depreciation reform ultimately adopted.

STATEMENT OF

THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS

ON

THE TAX CUT PROPOSALS

PRESENTED BY

MYLES H. TANENBAUM

SUBMITTED TO

THE COMMITTEE ON FINANCE

OF THE

UNITED STATES SENATE

JULY 30, 1980

The International Council of Shopping Centers
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Table of Contents

SUMMARY OF STATEMENT

ICSC members believe the most pressing issue facing our nation is the building of a healthy economy for the 1980s with emphasis on growth and reduced inflation, interest rates and unemployment. A tax cut is in furtherance of this goal, but it must provide impetus to increased capital investment and development in the severely depressed real estate industry to ensure that industry's critical contribution to a healthy economy. It is time now to provide such an impetus by enacting the following changes:

A. Depreciation reform. The current depreciation rules should be revised to provide for a set, audit-proof depreciation recovery period of reasonable length with no change in the current section 1250 depreciation recapture rule.

B. Current deductibility of construction period interest and taxes. The bill should provide for the current deductibility by individuals of construction period interest and taxes by repealing present section 189 of the Internal Revenue Code which requires the amortization over a 10-year period of all construction period interest and taxes involved in the construction of real property by individuals.

C. Interest on real estate invetsment indebtedness. Section 163(d) should be repealed to the extent that it limits the deduction of interest on real estate investment indebtedness.

D. Ordinary and necessary business expenses paid or incurred prior to realization of current income. At the present time, the IRS disallows current deductions for ordinary business expenses incurred prior to realization of income. The Code should be amended to assure the current deductibility of these expenses.

STATEMENT OF
THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS
ON
THE TAX CUT PROPOSALS
PRESENTED BY
MYLES H. TANENBAUM
TO
THE COMMITTEE ON FINANCE
OF THE
UNITED STATES SENATE
JULY 30, 1980

STATEMENT

I. INTRODUCTION

My name is Myles H. Tanenbaum of Kravco, Inc., King of Prussia, Pennsylvania. I am a member of the Tax Subcommittee of the Government Affairs Committee of the International Council of Shopping Centers (ICSC), and I appear today on behalf of the members of the International Council of Shopping Centers.

The ICSC is a business association of more than 9,000 members consisting of shopping center developers, owners, operators, tenants, lenders and related enterprises. ICSC represents a majority of the shopping centers in the United States.

Shopping center development in the United States involves an annual investment of $6.2 to $7.2 billion for structures, fixtures and equipment. It is estimated that more than 5.5 million people are regularly employed in shopping centers and that several hundred thousand more are annually engaged in new construction. The rippling effect of shopping center development on employment in related businesses, including display advertising, maintenance and cleaning, legal and accounting, and the manufacture of goods sold in the centers, is considerable.

At one time, retail trade in the United States was concentrated in individual stores and central business districts. It is estimated that in 1979 shopping centers accounted for 40.2 percent of total U.S. retail sales. In 1980, the figure is expected to equal 42.4 percent. By the beginning of the next decade (1990) the shopping center share will likely range between 48 percent and 53 percent. In current dollar value, U.S. shopping center retail sales reached a level of $356.2 billion in 1979, up from an estimated $305.1 billion in 1978. Because of the uncertainty of consumer expenditure during the current recessionary period, it is difficult to predict 1980 shopping center retail sales at this time.

In 1977, an estimated 43.4 percent of all new U.S. retail space construction took place in planned shopping centers. By 1979, the proportion had risen to 53.9 percent. The figure is even higher among certain retail sectors. For instance, over the next three years, an estimated 80 percent to 85 percent of new department store square footage will form the basis for new or expanded shopping center development space (ICSC Research Department surveys).

In 1978, retail store (free-standing) and shopping center construction represented an estimated 21.6 percent of the total U.S. contracts for commercial and industrial buildings floor space. (F.W. Dodge, Division of McGraw-Hill Information Company). In 1979, retail store (free-standing) and shopping center construction accounted for 21.2 percent of the total U.S. contracts for commercial and industrial buildings' floor space. (F.W. Dodge, Division of McGraw-Hill Information Company).

In short, the retail store and shopping center industry has a significant influence on the total United States economy.

II. ECONOMIC ISSUES

The members of ICSC believe that the most pressing domestic issue facing the United States is the building of a healthy economy for the 1980's: an economy based on growth, with reduced inflation, interest and unemployment rates. Such a growing economy is the basis for the fulfillment of all the domestic hopes and plans of our people, and, indeed, of our strength and reputation around the world. The achievement of the goal of a healthy, stable and productive economy requires the enactment of a tax cut this year to be effective January 1, 1981. The adoption of a tax cut this year effective on the first of next year will allow individuals and business to order and plan their economic affairs in a productive manner.

Any tax cut adopted this year must be addressed to reducing the current high inflation, interest and unemployment rates by increasing investment incentives and capital for the productive, elements of the economy.

One sector of the economy that should have a high priority in a tax cut is the real estate industry. Inflation and high interest rates have had a dramatic and negative effect on employment and activity in this vital industry.

The real estate industry is composed almost totally of small firms. Sixty percent of all construction firms and eighty percent of all real estate service firms have four or fewer employees. This makes the industry unusually susceptible to changes in economic conditions, financial climate, the tax code and other public policies. During the past, those factors have combined to retard the growth rate of all areas of real estate.

The recent dismal figures on contruction activity during the first half of 1980 indicates that the decline during this period is much greater than during the 1974-75 recession. 4.5 to 6 percent of total employment in the U.S. economy is in the real estate construction and development sector. Currently, unemployment in this sector is 16.5 percent (June 1980, up from 10.0% in June, 1979).

The residential rental housing market has collapsed and new and planned activity in the single family residential housing and commercial segments of the industry are down.

Rising interest rates, contractions in the availability of mortgage financing, falling retail sales, and major reductions in the level of housing starts have resulted in a significant downturn in the square footage of shopping center construction plans, clearly influencing the level of starts nine to fourteen months from now.

Building permits for new stores and other mercantile buildings - affecting the value of construction in the more immediate future - likewise, have been negatively affected.

Shopping center construction starts - for the first quarter of 1980 - were at an annualized level of 91.3 million to 95.6 million square feet, off by nearly one-quarter of the level recorded in 1979. By year-end, assuming no major change in government policy toward stimulating the economy, the total square footage of shopping center construction starts will have likely fallen to a level of 79.1 million.

At this level of starts, the shopping center industry's development sector will have experienced a contraction equal to a decline of 28.7 percent over the average level of construction starts during the 1978/79 period. Current projections for 1981, (again assuming no bold governmental pro-capital investment initiatives) place the level of shopping center construction starts at 67.1 million square feet, down 39.5 percent from the 1978/79 average annual level, and off by 15.2 percent from the already depressed levels expected for 1980.

It appears that the shopping center industry's development sector may be moving into a protracted period of economic decline.

The decline of construction and planned development in the real estate industry is not just a temporary problem resulting from the ebb and flow of the economic cycle. The real estate industry in general is faced with a serious shortage of investment capital when the futures needs of the American people are considered. During the decade of the 1980's there will be a dramatic growth in the establishment of new households and families. According to the Bureau of the Census, during the period of 1980-1989 there will be created 15.46 million new households, an increase of 19.39 percent over the previous decade.

If these new demands are to be met, the real estate industry will have to find the capital to finance the construction and rehabilitation of the facilities necessary for these new households and families to be housed, to have places to buy goods and services, and to have office buildings and industrial plants in which to work.

The various sectors of the real estate industry are interrelated and have a symbiotic relationship with each other. For example, shopping center development and rehabilitation follow very closely new housing starts and rehabilitation, and the development and location of housing and job-related real estate such as office buildings, retail stores, and industrial facilities continually interact with one another. In a recent study conducted by the ICSC Research Department, total square footage of U.S. annual shopping center construction starts (1970 to 1979) were correlated with U.S. annual housing starts (1969 to 1979). Results indicated that 95% of the variation in shopping center construction starts could be statistically "explained" by changes in the level of housing starts.

This interrelationship has been recognized in recent federal policy designed to revitalize and rehabilitate the economically depressed areas in our urban centers. Thus, the federal government has funded the Urban Development Action Grant, Community Development Block Grant, and Economic Development Administration programs which provide funds to assist in the development and rehabilitation of shopping centers, retail stores, office buildings and other job related facilities in economically depressed areas.

Also, shopping center developers and retailers recently have begun new development in urban centers and in-fill locations in areas close to the urban fringe on their own and without federal assistance. In fact, between 22% to 25% of the ICSC developer member firms who were actively planning development in 1979 were projecting shopping center openings at urban in-fill locations, quite near traditional downtown central business districts.

One lesson that these developer have learned is that such urban development is expensive, time consuming, and risky. It is clear that it is not desirable, nor will it be possible, for the federal government directly to provide the capital and incentives necessary to continue and increase such urban and in-fill development and redevelopment, and that the necessary capital will have to come from the private sector.

All the elements of the real estate industry are suffering from the current bias and penalties in the federal tax code against real estate rehabilitation and construction which discourage capital formation and investment.

What is needed as a part of this years tax cut is a comprehensive reworking of the current federal tax policy regarding real estate to eliminate the inhibitions against capital formation and investment, and to enact provisions that will encourage and allow all of the sectors of the real estate industry to produce the strutures and facilities necessary to provide the housing, retail facilities and job sites that will be needed in the 1980's.

III. THE CAPITAL DRAIN RESULTING FROM PAST TAX LEGISLATION

Since the health of the real estate industry is predicated upon a delicate balance of many factors, it is crucial that the Internal Revenue Code contain provisions which encourage capital investment and productivity in the industry. Unfortunately, tax laws enacted over the last two decades have had a dampening effect on capital investment and productivity.

A comparison of the tax provisions in effect seventeen years ago with the provisions presently in effect will, we believe, dramatically indicate how the tax laws have both reduced the supply of and increased the demand for investment capital in real estate.

Seventeen years ago a commercial real estate developer operated under the following rules: Construction period interest and real estate taxes were currently deductible in their entirety. Upon completion of the project, all interest and taxes continued to be currently deductible. Moreover, a variety of accelerated methods of depreciation were available including the double declining balance method. Upon the sale of the project, all gain was taxable at the capital gains rate which, under the alternative tax, could not exceed 25 percent. A combination of those provisions gave developers a positive incentive to construct commercial and other real estate by reducing the amount of investment capital required and increasing the ability to attract this capital.

Those provisions, which significantly contributed to the strength of the commercial and other segments of the real estate industry, have, over the years, been eliminated or substantially eroded. In addition, new provisions have been enacted which have increased the drain on investment capital even more.

In stark contrast to the tax provisions described above, the commercial real estate industry is now faced with the following rules: non-corporate construction period interest and taxes must be capitalized and amortized over a prescribed number of years. Also, many shopping center and other real estate owners and developers have substantial limitations on the amount of mortgage interest that may be currently deducted once the project is placed in service. Although accelerated depreciation has not been entirely eliminated, present rules limit the maximum rate to the 150 percent declining balance method, and the accelerated portion is subject to a tax preference surtax of 15%. In addition, cumulative depreciation deductions in excess of straight-line are again taxable upon the sale of the project at the highest ordinary income rates to the extent of gain, regardless of the holding period. Moreover, the rules regarding the taxation of capital gains have undergone substantial change, and even with the recent reduction there has been an increase in the effective tax rate.

In addition, capital flow in the real estate industry has suffered from the unfair and unrealistic treatment by the Treasury and the IRS of the depreciation and component depreciation lives taken by the industry, and by the less advantageous depreciation methods made available to real estate as compared to the methods made available to other kinds of property. For example, investment in personal property is fostered by the investment tax credit and more rapid depreciation methods. For such property depreciation lives are more realistically scheduled and the ADR system provides shorter optional lives which permit rapid write-offs. The law, on the other hand, provides different standards for real estate.

It is also very disconcerting to note that the depreciation periods for retail buildings advocated by the Treasury and the IRS significantly exceed the depreciable lives which have been established by shopping center industry studies. A representative sample group of 89 shopping centers owned by ICSC members established a median initial tax life of 26 years and a mean initial tax life of 27 years for shopping centers.[1/] This is significantly lower than the 50 year life which IRS Revenue Procedure 62-21 requires for retail buildings, and the 35 years suggested by the Treasury in 1976 for retail buildings having 50,000 or more square feet of indoor floor space on contiguous parcels of land.

By reason of the guidelines for depreciation advocated by the Government, we find that our members are spending an increasing amount of time and effort fighting against unreasonable calculations of useful lives in the IRS audit process. This involves the unnecessary expenditure of great amounts of unproductive time by both taxpayers and revenue agents. This results in increased costs of operation and lost opportunities for the taxpayer and inefficient use of IRS personnel.

IV. TAX CUT PROPOSALS AND COMMENTS

Any tax cut legislation enacted this year to eliminate the penalties and bias against real estate investment and to provide reasonable inducements for investment

[1/] Touche Ross & Co., DEPRECIABLE LIVES OF SHOPPING CENTERS, The International Council of Shopping Centers, 1973.

and capital formation in the real estate industry should contain the following significant changes in the current tax treatment of real estate:

A. Depreciation reform. The current depreciation rules should be revised to provide for a set, audit-proof depreciation recovery period of reasonable length with no change in the current section 1250 depreciation recapture rule.

B. Current deductibility of construction period interest and taxes. The bill should provide for the current deductibility by individuals of construction period interest and taxes by repealing present section 189 of the Internal Revenue Code which requires the amortization over a 10-year period of all construction period interest and taxes involved in the construction of real property by individuals.

C. Interest on real estate investment indebtedness. Section 163(d) should be repealed to the extent that it limits the deduction of interest on real estate investment indebtedness.

D. Ordinary and necessary business expenses paid or incurred prior to realization of current income. At the present time, the IRS seeks to disallow current deductions for ordinary business expenses incurred prior to realization of income. The Code should be amended to assure the current deductibility of these expenses.

A. Depreciation Reform

In order to make more equitable the treatment of depreciation for the real estate industry, we favor a system that would reform the present depreciation system as follows:

1. Establish a set capital cost recovery period for depreciation for all real property in place of the current system of requiring the establishment of a useful life by the facts and circumstances test, except in those cases where the economic life is obviously shorter than the set life.

2. Set the recovery period for depreciation at a reasonable length which is shorter than currently provided for under Treasury quidelines and currently established in the industry.

3. Make no change in the current section 1250 recapture rules for real estate.

Such a system would simplify the tax code and greatly reduce the costs of its administration. It would insure consistency and predictability and eliminate audit disputes between taxpayers and the Internal Revenue Service concerning the useful life of real property, except in rare cases of unusually short lives. This would free revenue agents to work on higher priority matters.

A set recovery period of reasonable length will encourage capital formation and investment, and create economic growth through enhanced activity and the modernization of the nations capital plant.

ICSC strongly supports the continuance in the law of the current section 1250 depreciation recapture rules for real estate. Section 1250 provides for the recapture (the taxation at ordinary, rather than capital gain, rates) of the accelerated portion of depreciation over straight line on the sale of real estate. Under section 1250, if real estate has been depreciated by the straight-line method it is not subject to recapture on sale.

The elimination of the present depreciation recapture rules for real estate and the application of the section 1245 full depreciation recapture rules to real estate as proposed in the "10-5-3" bill, would have a disastrous effect on development and sales in the real estate industry.

Since, under full recapture of depreciation, individuals would be faced with paying ordinary income tax rates of up to 70 percent on the profits realized on the sale of real property, the number of voluntary sales of real property would fall dramatically. As real estate sales and development fall, so will the revenues the government realizes from such activities.

This "lock in" effect will be compcunded by inflation, and the efficiency, growth, and productivity of the economy will suffer as more and more capital is "locked in".

Full recapture of depreciation on the sale of real property would effectively destroy any incentive for real estate investment that Congress might intend in this legislation. Since the tax rates on ordinary income are lower for a corporation than an individual, this provision would tend to force real estate investment to the corporate form, a very substantial change in the real estate industry as it exists in the United States today.

B. Current Deductions of Construction Period Interest and Taxes - Section 189

Section 189 of the Internal Revenue Code, enacted by the Tax Reform Act of 1976, requires that taxpayers other than a corporation which is not a subchapter S corporation or a personal holding company capitalize real property construction period interest and taxes. The amount capitalized may be amortized over a period which began with 4 years in 1976 and will be extended to 10 years when the provision is fully phased in. Since the amortization is phased in over a 7-year period, the full 10-year amortization period will not be fully effective in the case of commercial real estate until 1982, and will not begin to apply to low-income housing until 1982. Thus, although this provision has already had an adverse effect upon the real estate industry, the full impact of the provision has not yet been fully felt.

This provision has the effect of draining capital from the real estate industry since interest and taxes are real, out-of-pocket expenses which have to be paid whenever due. By forcing individuals who develop real estate to capitalize these costs rather than allowing them to deduct them currently as others are allowed to do, section 189 diminishes the capital available for the development of real estate.

In light of the adverse consequences which section 189 now has on most real estate development and will have on low-income housing, we support the repeal of section 189 retroactive to the its original effective date. Repeal of section 189 will equalize the treatment of interest and taxes, which are actual out-of-pocket expenses, between real property construction and other industries. Repeal also would remove the discrimination against individuals and in favor of corporations which construct real property created by the section.

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C. Deductibility of Investment Interest

The Tax Reform Act of 1969 added Section 163(d) to the Internal Revenue Code which provided an exception to the general rule that a taxpayer itemizing his deductions may deduct all interest paid or accrued within the taxable year on his indebtedness. Section 163(d) was amended further by the Tax Reform Act of 1976 to impose more significant limitations on the deductibility of interest on investment indebtedness by non-corporate taxpayers by limiting such deductions to $10,000, plus the amount of net investment income.

Section 163(d) works harshly in the case of shopping centers since they are one of the properties as to which the rather contorted rule most often operates to deny a deduction for a cash outlay for an unquestionably bona fide business expense, i.e., interest. Application of this rule, therefore, produces a "paper gain" which is taxed. Although few really foresaw the effect that the enactment of this section would have on shopping centers, the fact remains that shopping centers have borne a disporportionately large share of its brunt. This is one example of how tax legislation, regardless of intended effect, produces a drain on capital in our industry.

This provision is discriminatory in that it applies to individuals, but not to corporations, moreover, wealthy individuals who have large amount's of passive income derived from investments can avoid its impact.

In addition, the investment interest limitation is difficult to understand and even more difficult to administer.

We believe that this unfair, complicated, and difficult-to-administer rule should be repealed as it applies to real estate.

D. Ordinary and Necessary Business Expenses Paid or Incurred Prior to Realization of Current Income

It is generally held that trade or business expenses are currently deductible under section 162 of the Internal Revenue Code only after a business has started to perform the ultimate activities for which it was organized. Prior to that time, the activity or business is not considered a trade or business. With regard to shopping center and other real estate developers and partnerships, the IRS has taken the unfair position that the ultimate activities are not begun until the premises are occupied by retail tenants or otherwise until regular rentals come in.

Therefore, this rule generally precludes the current deductibility of many otherwise deductible expenses incurred during the investigatory and start-up stages prior to the commencement of regular rental income.

This rule is patently unfair in that it disregards the most risky business period of development which is necessarily a major part of the business purpose of a developer of rental income property. The rule also discriminates in favor of corporations, which are deemed to commence business upon commencement of corporate activity.

We urge that section 162 be amended to provide that a taxpayer would be able to deduct currently amounts paid or incurred in connection with, or during the period of, the acquisition, development, construction or erection of all real property, unless it should be properly capitalized.

The costs incurred are actual, not paper, expenses and as such should properly be deductible. The IRS position that a trade or business does not begin until gross income is realized from the property is particularly harsh with regard to shopping center developers since much of their activity occurs before rents are received from center tenants. Clearly, the "trade or business" of a developer begins prior to the time he realizes income. Indeed, the "trade or business" of a real estate developer is the development of real estate.

V. The Real Estate Construction and Rehabilitation Tax Incentives Act of 1980 (S.2969).

There have been numerous proposals advanced by members of Congress, business groups and individuals regarding changes in the tax laws for real estate. The most comprehensive attempt to eliminate the penalties and biases against real estate investment in the current tax code and to provide reasonable inducements for investment and capital formation in the real estate industry is the Real Estate Construction and Rehabilitation Tax Incentives Act of 1980, S.2969, introduced by Senator Harrison A. Williams Jr. (D.-N.J.) and Co-sponsored by Senators Donald W. Steward (D. Ala.) and Thad Cochran (R. Miss.)

As Senator Williams indicated in his statement introducing the bill, "virtually every group involved in the construction of new realty supports the overall thrust of this measure, including both private market and subsidized residential rental property developers, as well as those active in rehabilitation." The International Council of Shopping Centers agrees with this assessment of the general reaction of the real estate industry.

The bill addresses in a responsibile way many of the concerns that ICSC has about current tax policy, and, generally deals with these concerns in a manner that ICSC can support.

Thus, of our four proposals for inclusion in a tax cut this year, S.2969 and ICSC are in total agreement on two: the complete repeal of section 189 (the amortization of construction period interest and taxes), and the repeal of section 163(d) (limitations on the deductability of interest) as it applies to real estate.

On the other two ICSC proposals - depreciation reform and the allowance of current deductions for ordinary and necessary business expenses prior to the realization of income - S.2969 and ICSC are in basic agreement in principal, if not in total agreement as to specific details and solutions.

For example, in regard to depreciation, S.2969 and ICSC are in agreement on the basic elements of depreciation reform - the establishment of a set recovery period for depreciation for all real estate of reasonable length and the continuation of the current section 1250 depreciation recapture rule for real estate. However, ICSC is continuing to explore with its members additional proposals and/or modifications which would improve the depreciation proposals of S.2969 and make this aspect of the legislation more attractive to those elements of business and industry who believe that such reform should provide greater benefits for real estate.

ICSC is in agreement with the provision in S.2969 which provides for the current deductions of ordinary and necessary business expenses paid or incurred prior to the realization of current income, except as it limits such deductions to a period 24 months prior to the receipt of such income. ICSC feels that the 24 month limitation is arbitrary in light of the long lead times involved in major projects and that all such proper deductions should be allowed without regard to a time limit.

In addition, S.2969 contains a number of provisions which deal solely with rental residential real estate, and we understand from representatives of that important segment of our industry that many of these provisions will be helpful in solving some of their problems. Without having expertise in that part of the industry, we urge that the Committee consider these proposals in a positive manner.

VI. Conclusion

Considering the time and fiscal restraints that Congress currently faces, ICSC believes that its proposals represent a responsible and modest step toward improving incentives and capital formation for the total real estate industry, and we urge that the Committee adopt them as part of a tax cut to be enacted this year effective January 1, 1981.

Thank you for your consideration.

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STATEMENT OF

BUILDING OWNERS AND MANAGERS ASSOCIATION INTERNATIONAL

ON

PROPOSED TAX CUTS

BY

GARDNER McBRIDE

TO

THE SENATE FINANCE COMMITTEE

JULY 30, 1980

TABLE OF CONTENTS

SUMMARY

Our nation's current economic problems, especially recession and unemployment, have a significant effect on the commercial and residential segments of the real estate industry which now suffer from reduced capital investment. In turn, the economic situation worsens when the real estate industry declines.

The office building industry in particular has suffered the consequences of rising operating costs despite high office occupancy rates. There will be a continuing increase in the need for office space in the coming years, particularly in the government and service sectors of our economy. However, present provisions in the Internal Revenue code act as a disincentive to capital investment in the real estate industry.

While a general tax cut would prove beneficial to the general economic situation, it should be coupled with legislation that remedies the specific problems of the real estate industry. S.2969 would accomplish this through four major changes:

1. Depreciation Reform. The bill would replace the present requirement of establishing, through facts and circumstances, the real property's useful life with a set recovery period of 20 years for all real property. Depreciation would be calculated on a straight-line basis thereby eliminating any depreciation recapture on sale. There would be no change in the section 1250 depreciation recapture rule for real estate.

2. Construction Period Deductions. A taxpayer would not have to capitalize and amortize construction period interest and taxes over a prescribed number of years as currently provided, but would be able to deduct them against current income.

3. Investment Interest. Under present law with regard to investment interest, an individual may deduct such interest in the amount of $10,000 plus the amount of net investment income. The bill would eliminate the investment interest limitation as it applies to real estate.

4. Pre-Opening Expenses. At the present time, the IRS disallows current deductions prior to realization of income for ordinary and necessary business expenses incurred in the selection or creation of a rental income property. The bill would clarify the code to assure the current deductibility of those expenses.

In addition, S.2969:

- is reasonable in cost and considerably less expensive to the Treasury than the other proposals before Congress;
- enjoys wide support through virtually every group involved in the construction of new realty; and
- is a modest and realistic proposal that will have a substantial benefit not only to the U.S. real estate industry, but to the entire economy.

Statement of
The Building Owners and Managers Association International
on
Proposed Tax Cuts
by
Gardner McBride
to
The Senate Finance Committee
July 30, 1980

STATEMENT

I. INTRODUCTION

My name is Gardner McBride; I am Executive Vice President of the Building Owners and Managers Association International (BOMA). BOMA is an association of owners and managers of commercial office buildings, comprising nearly one billion square feet of space. In addition, our members own or manage residential rental property as well as other types of nonresidential real estate.

I welcome the opportunity to appear before you today to urge the adoption of an investment oriented tax cut this year to be effective on January 1, 1981.

II. THE STATE OF THE ECONOMY AND THE OFFICE BUILDING INDUSTRY

The United States is experiencing a period of high inflation and interest rates along with a deepening recession. This has produced high unemployment and reduced capital investment in the commercial and residential segments of the real estate industry.

The office building industry in particular has suffered the consequences of rising operating costs even though at the present time, office occupancy rates are high relative to their levels of pre-1978.

I should note that about seventy percent of office space in the United States is concentrated in central cities.*/ Office buildings therefore play a crucial role in the health and vitality of downtown areas, providing places of employment for central city residents as well as suburbanites. Therefore, continued construction of office buildings is vital.

Over the last twenty years, while employment in manufacturing industries in central cities remained relatively constant, employment in the government and service sectors increased dramatically. Government and service workers are office-space-oriented. Employment growth in the government and service sectors is a major determinant of office building construction. It has also been largely responsible for the total growth of new jobs in central cities.

We project that in the coming years, there will be a continuing increase in employment in these sectors, and that unless adequate new office building construction is started soon, there will be a lack of adequate office space to accomodate these new jobs.

BOMA is concerned that unless those provisions in the Internal Revenue Code which are a disincentive to capital investment in the real estate industry are repealed and unless new measures providing for added incentives are enacted, needed construction of both new and replacement office buildings will be retarded.

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*/Bennett Harrison. Urban Economic Development. Washington, D. C.: Urban Institute. 1974; p. 13.

Since much office building construction occurs in the downtown areas, incentive given to construction will contribute to the revitalization of our urban cores and work to further some of this nation's important urban and social goals. If increased incentives for real estate are not adopted, we are concerned that new office building construction proposals may be rejected in favor of competitive investments. This situation takes considerable time to correct itself in the office building industry since the amount of new office space proposed is often just a fraction of the total office space market with only a modest influence on the market rents for office space services. Eventually, of course, rents will rise high enough to favor office building investment, but in the intervening period cities will lose tax revenue and may need to reduce some vital municipal services. The members of the service-dependent urban population will pay part of the cost of these problems.

III. TAX CUT PROPOSALS

It is our opinion that many of the provisions of The Real Estate Construction and Rehabilitation Incentives Act of 1980, S. 2969, which was introduced by Senator Harrison A. Williams and co-sponsored by Senator Donald A. Stewart and Senator Thad Cochran, should be a part of any general tax cut.

S.2969 will provide needed impetus to investment in the real estate industry through reform of the outmoded real estate depreciation rules and other provisions of the tax code. In addition, the bill will help simplify the Internal Revenue Code, one of the goals of tax reform.

The major provisions of the bill will repeal entirely two very complex provisions, section 189 (Amortization of Real Property Construction Period Interest and Taxes) and section 163(d), (Limitation on Interest on Investment Indebtedness) and replace the present complicated depreciation rules for real property with a simplified system providing for the establishment of a 20 year straight-line depreciation recovery system for all real property, except for new low-income housing which would get a 15 year recovery period. The new system would be less complex and easier to administer by the IRS.

Not only will S.2969 have a beneficial impact on all elements of the real estate industry, but it will do so at a reasonable cost to the Treasury, especially when compared to the high cost of other proposals before the Congress.

The National Association of Realtors has calculated on a static and conservative basis that the combined cost to the Treasury of the 20 year straight-line depreciation recovery period and the repeal of section 189 (the amortization of construction period interest and taxes) for all real estate (including rental housing) would be $2 billion in 1981, $3.3 billion in 1982, $4.8 billion in 1983, and $6.2 billion in 1984. If the feedback effects of the changes are calculated the cost would be even less.

Also, the National Association of Realtors has calculated that for nonresidential real estate such changes in the tax code would result in increases in investment of $5 billion (0.7 percent) in 1981, $1.9 billion (2.4 percent) in 1982, $2.3 billion (2.7

percent) in 1983, $2.6 billion (2.8 percent) in 1984, and $3 billion (2.9 percent) in 1985.

For rental residential real estate such changes in the tax code would result in an increase of 15,000 units in 1981, 35,000 units in 1982, and 60,000 in 1983.

A. General Provisions

The major provisions of S. 2969 will have an impact on all the aspects of the real estate industry and will provide:

1. Depreciation Reform. The bill would replace the present requirement of establishing, through facts and circumstances, the real property's useful life with a set recovery period of 20 years for all real property. Depreciation would be calculated on a straight-line basis thereby eliminating any depreciation recapture on sale. There would be no change in the section 1250 depreciation recapture rule for real estate.

2. Construction Period Deductions. A taxpayer would not have to capitalize and amortize construction period interest and taxes over a prescribed number of years as currently provided, but would be able to deduct them against current income.

3. Investment Interest. Under present law with regard to investment interest, an individual may deduct such interest in the amount of $10,000 plus the amount of net investment income. The bill would eliminate the investment interest limitation as it applies to real estate.

4. Pre-Opening Expenses. At the present time, the IRS disallows current deductions prior to realization of income for ordinary and necessary business expenses incurred in the selection or creation of a rental income property. The bill would clarify the code to assure the current deductibility of those expenses.

1. Depreciation Reform

Under current law, a taxpayer generally must compute depreciation on real property over a useful life established by the facts and circumstances. This complicated method often leads to disputes and inequities. As a replacement, we favor a system, as provided by S. 2969, under which a taxpayer would use a set recovery period for depreciation for real property. The bill provides for a 20 year recovery period for all real property except for new low-income housing which is entitled to a 15 year recovery period. The real property would be depreciated on a straight-line basis with no depreciation recapture on sale.

In our opinion, the 20 year recovery period proposed in S. 2969 is justifiable on economic grounds and is a sufficiently short depreciation period to encourage economic growth and development. The concept of a set recovery period is superior to the present depreciation system. It will greatly simplify the depreciation rules and ease administration of the tax laws by doing away with the necessity for the present complicated recapture and minimum tax provisions insofar as they involve real property. It also would eliminate audit disputes between taxpayers and the Internal Revenue Service concerning the useful life of real property.

Because of the restraints on rents in low-income housing and in order to equalize the rate of return on investment on this type of housing with that on other types of housing, it is necessary to have a more advantageous depreciation schedule for low-income housing. If the rates of return were not equalized, there would exist a disincentive to production of vitally needed low-income housing. Therefore, S. 2969 provides a 15 year recovery period for low-income housing.

BOMA strongly supports the continuance of the current depreciation recapture rules contained in section 1250, and strongly opposes the imposition of full recapture on real estate contained in the Capital Cost Recovery Act (the 10-5-3 bill).

2. Current Deductions of Construction Period Interest and Taxes - Section 189

Under section 189, taxpayers other than a corporation which is not a subchapter S corporation or a personal holding company are required to capitalize real property construction period interest and taxes. The amount capitalized may be amortized over a period which began in 1976 with 4 years, and will be 9 to 10 years when the provision is fully phased in. Since the amortization is phased in over a 7-year period, the full 10-year amortization period will not be effective in the case of commercial real estate until 1982. For low income housing the provision will not apply until 1982.

This provision discriminates against individuals and in favor of corporations who develop real estate and draws capital from real estate investment.

BOMA supports repeal of this section.

3. Deductibility of Investment Interest

Section 163(d) of the Internal Revenue Code as added by the Tax Reform Act of 1969, provides an exception to the general rule that a taxpayer itemizing his deductions may deduct all interest paid or accrued within the taxable year on his indebtedness. Section 163(d) was amended further by the Tax Reform Act of 1976 to impose more significant limitations on the deductibility of interest on investment indebtedness.

Section 163(d) discriminates against individual real estate developers since they are limited in their deductions for a legitimate business expense--interest--while corporate developers of real estate face no such limitations.

Because of this unfair treatment investment in real estate is discouraged. BOMA supports the repeal of this section contained in S.2969.

4. Ordinary and Necessary Business Expenses Paid or Incurred Prior to Realization of Current Income

The general rule is that trade or business expenses can be deducted currently under section 162 of the Internal Revenue Code after a business has started to perform the ultimate activities for which it was organized, but prior to that time the activity or business is not considered a trade or business. The Internal Revenue Service has adopted the policy, in the case of real estate development and construction, of not allowing the deduction of otherwise deductible ordinary and necessary business expenses of the owner of the property until the actual receipt of income.

S. 2969 would amend section 162 to provide that a taxpayer could deduct currently amounts paid or incurred in connection with, or during the period of, the acquisition, development, construction or erection of all real property unless those expenditures should properly be capitalized. No amount will be deductible if it is paid or incurred more than 24 months before the realization of gross income from the property, unless a longer period is appropriate for the particular real estate under development and such longer period is approved by the Commissioner of the IRS.

We also support the language of S. 2969 which clarifies existing law.

B. Residential Real Estate Provisions

In addition to the general provisions discussed above which have an impact on all aspects of real estate construction and development, The Real Estate Construction and Rehabilitation Incentives Act of 1980, contains a number of provisions which apply only to residential rental housing. BOMA members build, own, and manage residential rental real estate and support many of these provisions.

However, BOMA is currently studying the provisions dealing with condominium and cooperative conversion, and has no position on these sections at this time.

IV. CONCLUSION

BOMA urges the adoption of S. 2969. As part of a tax cut, this bill would provide much needed assistance to the commercial and residential segments of the real estate industry and would have a beneficial effect on the entire economy.

STATEMENT OF MARSHALL McDONALD, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, FLORIDA POWER & LIGHT CO., CHAIRMAN OF THE BOARD, EDISON ELECTRIC INSTITUTE

Mr. McDONALD. Mr. Chairman, and members of the committee. I am Marshall McDonald, chairman of the Florida Power & Light Co., and currently serving also as chairman of the Edison Electric Institute.

EEI is a national association of investor-owned electric power companies in the United States. Its members serve 77 percent of all electricity users in this country, and produce 76 percent of the total generation of electricity. On behalf of our membership, I thank you for this opportunity to appear before you.

The regulated investor-owned electric utility is a conduit for the funds of our customers. Benefits or costs all flow to our customers, ultimately. We are the most capital intensive industry. This amplifies the poblem of having to replace facilities with vastly inflated dollars. As matters of national policy, we are being forced to incur huge capital expenditures to convert generation of electricity from oil and natural gas to coal, to add environmental equipment to coal fired plants, and to retrofit nuclear plants. These capital requirements are in addition to the normal capital expenditures dictated by growth.

As a result of this recognized need for capital in an unfavorable regulatory environment, almost all of our members have common stock selling considerably below book value. Our regulated earnings are insufficient to permit continued issuance of debt capital without periodic issuance of common stock. Both our customers and existing stockholders suffer when we have to sell new issues of common stock below its book value.

The greatest concern of our industry is the generation of capital, both through generation of new capital and through recovery of invested capital. In recent years tax law changes have been beneficial with the prior passage of the asset depreciation range and increases in the rate of investment tax credit.

Nevertheless, the financial markets have been heavily discounting the common stock offerings of most of our members for over 6 years. Currently, electric utilities' common stock averages selling approximately 20 percent under book value.

As public utilities with an obligation to serve the demand, we have to make our investment in facilities as needed, not waiting until the financial climate is favorable. This has resulted in sales of common stock at a substantial discount to its book value thus decreasing the value of the investment of previous purchasers of stock.

Selling stock below book value weakens the financial integrity of the industry. Those who provide the capital see the weakened condition and demand a higher return, if they will invest at all. The higher return requires translates into higher rates for all customers.

Our recommendations as to the nature of any tax cut fall in three general areas: providing new sources of capital, accelerating capital recovery, and lowering of individual tax rates.

In this area of new capital generation, we first suggest tax deferred dividend reinvestment because this would make equity investments more attractive in a period when high interest income has siphoned so much capital out of equities and into debt instruments.

Next, with regard to investment tax credit and TRASOP's, we recommend: One, increase in rate of either or both; two, make TASOP's permanent; and three, maintain present normalization requirements.

Additionally, we suggest that rate relief granted by regulatory agencies for the costs of spent nuclear fuel and nuclear decommissioning and required to be accounted for by the utility to specifically meet the obligation not be subject to tax.

In the second area, capital recovery, we recommend accelerated recovery of invested capital through an increase in depreciation rates for tax purposes as included in the Capital Cost Recovery Act or increasing the range under the present asset depreciation range. We further suggest the maintenance of normalization requirements on any increase in capital recovery.

In the third area, individual tax reduction, we feel that our employees are our most valued asset and a vital influence on our ability to meet our responsibility to provide electric service in an efficient manner. Increases in salaries over recent years due to inflation have placed these employees in higher tax brackets, thus increasing their effective tax rate and reducing their real spendable income.

To help provide relief to these workers, we recommend widening of the individual tax brackets and lowering of the corresponding rates.

Thank you very much, Mr. Chairman.

Senator BRADLEY. Thank you very much, Mr. McDonald. Mr. Curtis.

STATEMENT OF JOHN J. CURTIS, DIRECTOR OF TAXES, PACIFIC LIGHTING CORP., ON BEHALF OF THE AMERICAN GAS ASSOCIATION

Mr. CURTIS. Thank you very much, Mr. Chairman. My name is John Curtis. I am director of taxes for Pacific Lighting Corp., and chairman of the American Gas Association's Tax Committee.

I am testifying today on behalf of the American Gas Association, and I hope that our written statement, which I have filed for the record, will be accepted.

While the nature of these hearings is general, our testimony addresses four recommendations which I think answer the specific needs of our industry.

Again, as EEI has stressed, the foremost challenge of our industry is also capital formation. We project over the next 20 years a tremendous need in this area. Our four reform proposals, we think, go a long way to achieve this goal.

First AGA believes that the current tax depreciation system should be liberalized. Two measures now before Congress can accomplish this. One is the class life ADR variance change from 20 percent to 35 percent. This would help generate capital through more liberal depreciation without abandoning the depreciation system which has been in place and working for a number of years.

On the other hand the popular 10-5-3 proposal departs from historical useful life concept, and completely restructures the tax depreciation system. It, too, would significantly improve internally generated capital. However, because our industry is regulated, we have particular concerns with 10-5-3 which we think should be addressed.

The 10-5-3 proposal does not incorporate the present normalization requirements of section 167 of the code. These requirements should be incorporated within 10-5-3 for the same policy reasons they were originally placed in section 167, and that is ensure that the liberal depreciation allowances are effective as a capital formation mechanism within the utility industry.

Also 10-5-3 for sound economic reasons provides that a taxpayer may use less than his maximum allowance in any given tax year. However, the proposal contains no language prohibiting a State regulatory commission from imputing in rates more of the allowance than the utility actually obtained on its tax return in a particular year.

Similar to the normalization issue, this potential imputation problem could defeat the proposal's capital formation purpose for regulated utilities. Imputation should, therefore, be specifically addressed in the proposal.

Second, AGA believes that the double-taxation of dividends should be eliminated in whole or in part. Relieving the tax burden on dividends would make equity investment more attractive, thereby stimulating internally generated capital for American industry.

This can best be accomplished in one of two ways; significantly increasing the annual exclusion for dividends received by individuals, or providing a tax deferral for dividends reinvested under a qualified plan.

Third, AGA believes the current deduction should be provided for certain pre-operating expenses for new domestic energy facilities. This would include feasibility and environmental studies, certification, startup and training expenses. Such a deduction would go far to encourage the development of necessary new domestic energy facilities and supplies.

Fourth, AGA believes that the investment tax credit rate should be permanently increased from 10 percent to 12 percent. Taxpayers should be permitted to offset 100 percent of their tax liability with the tax credit, and the credit should become refundable at some point.

In conclusion, AGA urges this committee to develop effective capital formation incentives to help American industry, including the regulated natural gas industry, to meet its tremendous capital formation requirements over the next 20 years.

Thank you.

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

Let me just ask one question of Mr. McDonald. What was the point you made about the nuclear waste issue?

Mr. MCDONALD. There are State public commissions who are considering giving rate relief which means some amount of money to utilities that have nuclear plants at the present time in anticipation of their decommissioning at some later time. Unless these are freed from tax, they would have to give us twice the amount in order to net out the tax.

Senator BRADLEY. How many State commissions are about to do that?

Mr. McDONALD. You never can tell.

Senator BRADLEY. Is Florida?

Mr. McDONALD. Yes. It is one that I know very definitely is. They talk among themselves, and according to information that I understand, there are some number who are talking about this.

Senator BRADLEY. I would like to ask each of you a great deal more questions. Unfortunately, we are in a time bind. Let me just ask each of you. Have either of you heard of the residential energy efficiency plan?

Mr. McDONALD. There are a number of things that would be classed under that coming out of the DOE and out of various State regulatory commissions.

Senator BRADLEY. That is my bill, and it just went through in the Synthetic Fuel Act. I know that Florida Power and Light has an interest in that, and I would encourage you to take a look at it, as an alternate source to these increasing problems that your industry is going to face in the next decade, particularly the capital requirements that you are trying to address here.

I have talked to a lot of utility executives, and frankly I don't see the situation getting dramatically better. So I want to help you do something, and these are interesting suggestions, but I think you would agree that they are kind of tinkering with some of the fundamental problems. The tax deferral on dividend reinvestment is a particularly important concept, I think.

Mr. CURTIS. We will appreciate the opportunity to get back to you on your bill

Senator BRADLEY. Please do. It is law now.

[The prepared statements of Messrs. McDonald and Curtis follow:]

STATEMENT OF MARSHALL MCDONALD, CHAIRMAN OF THE BOARD OF FLORIDA POWER & LIGHT COMPANY, ON BEHALF OF EDISON ELECTRIC INSTITUTE REGARDING PROPOSAL FOR TAX CHANGES

(Committee on Ways and Means of the United States and Committee on Finance of the United States Senate)

These comments are submitted by the Edison Electric Institute (EEI) with respect to tax cut proposals. EEI is the national association of investor-owned electric power companies in the United States. Its customers comprise 99 percent of the customers of the investor-owned segment of the industry and serve 77 percent of all electricity users in the country.

The electric utility industry today faces the most complex and critical problems in its history. It is the most capital intensive, major industry in the nation today and one of the largest single industry consumers of oil. Thus, it is at present in the position of no other industry, facing the abnormal effects of inflation in the cost of building new generating facilities with sky high financing costs, while at the same time, trying to adjust to the tremendous increases in the cost of oil and other fuels used for the generation of electricity. In the future, as National policy requires conversion of generating facilities from oil and gas to coal or other fuel sources; requires multiplying the cost of coal fired plants by adding environmental equipment, and requires extensive retrofitting of nuclear plants, we are faced with an even more critical situation because construction costs are at an all time high and competition for capital from the financial community is greater than ever.

We have to be concerned that adequate sources of capital will be available at any reasonable rate. Most of our member companies are regulated by both the Federal Energy Regulatory Commission and state commissions, and lack the flexibility of other companies in financing. As public utilities with an obligation to serve the demand, we have to make our investment in facilities as needed - not waiting until the financial climate is favorable. The aforementioned increases in building costs and fuel costs have necessitated the filing of requests for rate relief from the regulatory commissions at a record pace since the early 1970's, resulting in a significant increase in our rates to cover these costs. Due to these past increases in rates, pressures upon regulatory commissions to deny or decrease company requests for rate relief have made it harder to achieve the adequate rate relief so necessary to maintain a financially healthy industry, thus making acquisition of needed capital more costly and harder to secure.

Therefore, the greatest concern of our industry today is the generation of capital, both through generation of new capital and through recovery of invested capital. In recent years, tax law changes have shown that they can be a great assistance in this area with the prior passage of the Asset Depreciation Range (ADR) and increases in the rate of investment tax credit. Nevertheless, the financial markets have been heavily discounting the common stock of most electric utilities for over six years.

Our recommendations as to the nature of any tax cut fall in three general areas: Providing new sources of capital, accelerating capital recovery and lowering of individual tax rates.

New Capital Generation

Tax Deferred Dividend Reinvestment Plans. We recommend the deferral of tax on any dividends reinvested in the same corporation until final disposition of the stock. Tax-deferred dividend reinvestment offers an important means of raising capital by making equity investments more attractive. With present individual rates on dividend income as high as 70 percent, deferral of current tax would encourage investment by individuals in higher brackets, as well as provide more available funds for reinvestment by existing investors.

Investment Tax Credit. Both the regular investment tax credit and the TRASOP credit in recent years have provided much needed capital to the industry, and we recommend the following in this area:

(a) Make TRASOP credit permanent,

(b) Increase the rate of credit on either or both the regular or TRASOP credit, and

(c) Maintain present normalization requirements on this credit for regulated utilities to ensure capital source is maintained by preventing regulatory agencies from forcing immediate transfer of these amounts generated to the customer with no benefit to the utility.

Spent Nuclear Fuel and Nuclear Decommissioning Costs. Our industry today faces the financial obligation to store spent nuclear fuel and to decommission existing nuclear plants. In order to better provide for this obligation, we recommend:

(a) Provide a tax deduction currently for this anticipated cost that can reasonably be expected to be incurred, and/or

(b) Provide that rate relief granted by regulatory agencies and required to be accounted for by the company to specifically meet the obligation not be subject to tax.

Capital Recovery

Capital Cost Recovery Act (CCRA). We also recommend accelerated recovery of invested capital through an increase in depreciation rates for tax purposes as included in the Capital Cost Recovery Act (CCRA) or increasing the range under the present Asset Depreciation Range (ADR). In the context of the recovery of invested capital, adoption of either of these recommendations would prove to be an important step in providing replacement capital and improving the overall financial condition of America's business in general, and particularly the electric utility industry.

The electric utility industry supports CCRA, but recommends three modifications to ensure the Act provides the maximum source of capital to the industry:

(a) Investment tax credit should be applied before the CCRA allowance so as not to nullify the intended benefit of investment credit to the industry or deny the employees the benefit of TRASOP.

(b) If an electric utility company is precluded from the application of CCRA due to regulatory denial of normalization accounting, the depreciation deduction for tax purposes should be based on the lives and methods used for rate making purposes.

(c) Any allowance based on "construction expenditures" should be available only to the degree these expenditures are included in rate base for rate making purposes.

All these modifications help ensure that the benefits of CCRA provide needed capital for the companies as intended by the Act and all would reduce the revenue loss estimated by the Treasury.

Increase in Asset Depreciation Range. We recommend increasing the life variance permissible under ADR from 20 percent to 35 or 40 percent. Since most EEI member companies already employ the ADR system, this approach has particular appeal to our industry. Not only are we familiar with this system but, more importantly, it has been an effective method of capital recovery.

Mandatory Normalization Recovery. Mandatory normalization for regulated companies places these entities on a basis similar to that required by the accounting profession for non-regulated industries. Normalization, as previously recognized by the Congress in legislation dealing with accelerated depreciation, is important because it protects the ratepayers' interests by ensuring the proper allocation of tax benefits to the ratepayer using the utility service and by giving him the better and less costly service that a financially healthy utility company can provide. Normalization contributes to the financial health of a regulated utility by providing:

1. Improved debt coverage,
2. Improved quality of earnings,
3. Improved cash flow,
4. Reduced external capital requirements, and
5. Lower costs of financing.

These financial benefits have the ultimate effect of reducing cost of service and benefiting all ratepayers. Mandatory normalization should be a feature of any capital recovery measure that the Congress may consider.

Individual Tax Rates

Just as our member companies have been adversely impacted by the effects of inflation, so have our employees. Our employees are one of our most valued assets and a vital influence on our ability to meet our responsibility to provide electric service in an efficient manner. Increases in salaries over recent years due to inflation have placed these employees in higher tax brackets, thus increasing their effective tax rates and reducing their real spendable income.

To help provide relief to these workers, we recommend widening of the individual tax brackets and lowering of the corresponding rates.

STATEMENT OF

Marshall McDonald
Chairman of the Board of
Florida Power and Light Company
on behalf of
The Edison Electric Institute

Committee on Finance
July 30, 1980

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To help provide relief to these workers, we recommend widening of the individual tax brackets and lowering of the corresponding rates.

TESTIMONY

OF

JOHN J. CURTIS,

CHAIRMAN OF THE

TAXATION COMMITTEE

OF THE

AMERICAN GAS ASSOCIATION

AND

DIRECTOR OF TAXES FOR

PACIFIC LIGHTING CORPORATION

ON BEHALF OF

THE AMERICAN GAS ASSOCIATION

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON

1980 TAX CUT PROPOSALS

July 30, 1980

SUMMARY OF THE PRINCIPAL POINTS
OF THE
AMERICAN GAS ASSOCIATION
BEFORE THE
SENATE COMMITTEE ON FINANCE
ON
1980 TAX CUT PROPOSALS
July 30, 1980

I. A.G.A. believes that any tax reform proposals should be designed to encourage capital formation.

II. A.G.A. believes that depreciation reform should take the form of a capital cost recovery allowance (similar to the "10-5-3" proposal with certain modifications) or an increase in the variance under the class life ADR system.

III. A.G.A. believes that the burden of double taxation of corporate dividends should be relieved either by a greater exclusion of a certain amount of dividends from an individual's gross income, or by a dividend reinvestment program.

IV. A.G.A. believes that a current deduction should be provided for certain pre-operating expenses associated with new domestic energy facilities.

V. A.G.A. believes that the investment tax credit should be increased from 10% to 12% on a permanent basis, should be permitted to offset 100% of tax liability and should be refundable.

Mr. Chairman and Members of the Committee:

My name is John J. Curtis, Director of Taxes for Pacific Lighting Corporation and Chairman of the American Gas Association Taxation Committee. I am testifying today on behalf of the American Gas Association.

The American Gas Association (A.G.A.) is a national trade association representing over 300 natural gas transmission and distribution companies located in all 50 states. A.G.A. member companies serve over 160 million customers and deliver approximately 85% of all natural gas sold by utilities in the nation.

Tax Rate Cut or Reduction

A tax rate cut or reduction *per se* will not benefit the regulated gas utility industry except on a temporary basis. However, generally reducing tax liability through reform of the tax policy regarding certain other tax provisions would help our industry.

Capital Formation Requirements

The foremost concern of the A.G.A. member companies regarding any tax legislation package is that it include provisions which will have a significant, positive effect on capital formation and which will go far to rectify the capital investment dilemma currently facing American industry. The challenge of forming new capital is particularly acute for capital intensive industries such as the energy utility industry.

The A.G.A. estimates that the regulated natural gas industry alone will need additional capital of more than $300 billion through the year 2000 just to finance and maintain the industry's present level of supply (stated in terms of 1978 dollars). This $300 billion figure is particularly significant when compared to the regulated natural gas industry's total capitalization of less than $60 billion as of December 31, 1978. The $300 billion needed is approximately five times the industry's current level of capitalization. In short, over the next two decades, stimulating capital formation may be the most fundamental challenge facing the regulated natural gas industry and the nation.

Indeed, the importance of stimulating capital formation cannot be overemphasized if our nation is to develop our domestic energy supplies in order to reduce our dependence on imported oil. For this reason, A.G.A. has set forth several tax reform recommendations which will stimulate investment in productive assets and improve the tax code as a capital formation mechanism.

Depreciation System Reform

Under current law, "a reasonable allowance for the exhaustion, wear and tear (including .. . obsolescence)" of eligible assets is permitted through a depreciation deduction. This "reasonable allowance" is a deduction determined on the basis of the "facts and circumstances" test, the Asset Depreciation Range (ADR) system for certain assets, or the class life system for pre-1971 profit.

However, without a substantial modification or total reform of this existing system of depreciation, U.S. industry will simply not be able to regain a competitive posture in world markets. Moreover, without such reform U.S. productivity will continue to decline causing further deterioration of the dollar in world money markets and an increase in domestic economic problems as our nation imports more and exports less.

A.G.A. recognizes two alternatives to achieve the necessary depreciation reform. The first takes the form of a modification in the existing class life ADR system. This modification would simply entail increasing the variance under this system to 35% from the current 20% variance. This modification is proposed for the treatment of public utility property in Section 213 of H.R. 7015, introduced by Congressman Ullman (D-OR).

The other alternative is the establishment of a capital cost recovery allowance (CCRA) mechanism such as that provided by H.R. 4646 and S. 1435. This bill would divorce the capital recovery period from the concept of the useful life of assets. The amount of the allowance would vary according to the class of investment. H.R. 4646 creates three such capital investment classes: 10 years depreciation for buildings; 5 years for equipment; and, 3 years for automobiles and light trucks. However, for the regulated natural gas utility industry there are certain problems with this proposal and they would have to be rectified.

Increasing the ADR variance to 35% would essentially liberalize depreciation benefits allowable under the current class life depreciation system. This liberalization, while not a total revamping of the depreciation system, would go far to provide additional capital to meet the growing requirements of the regulated natural gas utility industry.

Revision of the existing depreciation system has certain other benefits. The present ADR system has been in place and working for a long time, therefore, it is a "known commodity". The variance modification could be accomplished simply and become effective immediately without engaging a cumbersome regulatory process to promulgate numerous complex implementing rules and regulations. Moreover, a simple ADR variance increase would not have to undergo the "debugging" which also accompanies a new system.

It must be noted however that any increase in the ADR variance should be accompanied by a reiteration of the Congressional intent underlying the modification, that being that the increased depreciation allowance is meant as a capital formation mechanism for the industry and should not be used to immediately reduce a utility's rates set by regulatory commissions. To accomplish this Congressional intent, the existing normalization features under Section 167 of the Internal Revenue Code should be continued.

Depreciation system reform can also take the form of providing a capital cost recovery system with a specified allowance (CCRA) to replace the current concept of useful lives for determining the allowable depreciation allowance.

The CCRA is an attempt to stimulate investment and productivity by modernizing and simplifying the capital cost recovery mechanism. The proposal should stimulate investment insofar as more capital will be available for plant modernization and equipment replacement because of the more rapid recovery of capital invested in productive assets. Modernization and simplification will be achieved by replacing the current complex array of depreciation useful life schedules with a simple set of standardized recovery periods.

While these characteristics and achievements are desirable, A.G.A. believes that there are three distinct problems with the CCRA proposal as introduced which are particularly troublesome for the regulated natural gas utility industry.

First, the CCRA is an elective deduction and a taxpayer can use less of the allowance than he is otherwise entitled to. There is no explicit language in the proposal, however, which would prohibit a utility's regulatory commission from imputing to that utility in its cost of service calculation more of the CCRA than the utility actually utilized.

Specifically, the problem would arise in the following manner. If a utility chose to use less of the CCRA than was actually allowable, a state commission would not be prohibited, under the present bill's language, from imputing the total amount of the CCRA allowable to the utility when calculating the utility's tax liability for cost of service and ratemaking purposes. Subject to such imputation, a utility therefore would recover less from its ratepayers than it actually should because the tax liability component of the utility's cost of service was deemed by the regulatory commission to be lower than it actually was. A.G.A.. believes that this potential "imputation" must be removed under any CCRA proposal.

Second, the CCRA proposal creates an entirely new capital cost recovery system to replace the existing depreciation provisions and, therfore, also creates the potential for unfavorable Treasury regulations with respect to "normalization" of the CCRA.

The bill establishes no requirements that the "normalization" method enlisted for CCRA purposes would embrace the same safeguards that the present "normalization" provisions provide under Section 167, i.e., anti-flow through provisions. It is conceivable that the IRS could develop such unfavorable regulations pursuant to a CCRA proposal. Therefore, A.G.A. believes that any CCRA proposal must have "normalization" safeguards similar to existing ones.

There is an additional general concern of A.G.A. that no depreciation reform proposal should be accompanied by "trade-offs" in, or the loss of, any currently available capital formation mechanism such as the investment tax credit. To create such a "trade-off" would only operate to frustrate the goal of enhancing capital formation.

Moreover, any depreciation reform proposal should retain as an alternative the use of the "facts and circumstances" test for determining what the reasonable depreciation is. This would permit taxpayers greater flexibility.

Elimination of the Double Taxation of Corporate Dividends

The double taxation of corporate dividends should be rectified in whole or in part by providing relief at the shareholder level through two possible vehicles, the exclusion from gross income of an amount of corporate dividends received by shareholders or a tax deferral for reinvested dividends. This relief should be simple, straightforward and implemented without complex rules and regulations.

One such remedy would simply be to provide an annual exclusion from the taxpayer's gross income of a selected amount of dividends received. This ammount could be determined by Congress on the basis of Treasury statistics.

The second mechanism is incorporated in H.R. 654, introduced by Congressman Pickle (D-TX) and in S. 1543, introduced by Senator Nelson (D-WI

This bill provides an exclusion from shareholders' gross income of dividends reinvested in a qualifying dividend reinvestment program.

Currently, corporate cash and property dividends are taxed twice, first as part of the corporation's earnings, and then again when received by the corporate shareholders and included in their gross income.

This tax policy of double taxation of dividends increases the cost of capital in three ways. First, it encourages an over-reliance on debt financing as opposed to equity financing. Second, it weakens the company's capital structure by raising the debt-equity ratio and reducing the interest coverage ratio (the ratio of a utility's earnings to its interest on debt). These two ratios are critical to the bond rating which the company receives from the bond rating services. Consequently, the utility's bond rating is lower and its debt instruments must yield higher interest rates resulting in increased capital costs to both the company and its ratepayers. These higher interest rates must ultimately be borne by the ratepayer. Finally, current tax policy raises the cost of equity capital. The over-reliance on debt financing increases the financial risks assumed by the equity investor, thus lowering the price he is willing to pay for common stock.

A.G.A. strongly urges that relief from double taxation be provided at the shareholder level. If treated otherwise, the benefits would simply be reflected in a reduction of the utility's cost of service set by regulatory commissions. Moreover, if relief were provided at the corporate level, the resulting cost of service reduction would effectively pass-through the tax benefit to the consumers in the form of reduced rates and, therefore, would provide no stimulus for additional investment. This would impede the formation of equity capital by, and discriminate against the regulated natural gas utility industry in favor of other, nonregulated industries. We submit that this unique problem facing regulated industries must be recognized in national tax policy which should be formulated to provide relief for capital intensive industries and their shareholders.

In elaborating on the first alternative, A.G.A. recommends that shareholders be granted an additional significant exclusion from gross income of dividends received. With such an exclusion, equity shares in general would be perceived by investors as a much more desirable and attractive investment. This would in turn stimulate equity capital formation.

With respect to the second alternative, H.R. 654 and S. 1543, A.G.A. notes that these bills provide that shareholders participating in a qualified dividend reinvestment plan may elect to receive dividends in the form of common stock of the issuing corporation rather than in cash. The effect of this election would be to defer the shareholder's Federal income tax liability on the amount of the reinvested dividends to the time of disposition of the acquired stock. The bill would, therefore, effectively convert the tax on the reinvested dividends from ordinary income to capital gain. The attractiveness of dividend reinvestment is thereby enhanced which, in turn, directly stimulates equity capital formation.

In addition to providing a significant stimulus for equity capital formation, this proposal also provides a more equitable tax treatment for shareholders generally. Shareholders who receive a conventional stock dividend at present enjoy a tax benefit similar to that proposed in H.R. 654 and S. 1543 for reinvested dividends, that being deferral of taxable gain to a later date. The inequity lies in the fact that when a corporation decides to issue a dividend, the individual shareholder receives either a conventional stock dividend, with the accompanying tax deferral benefits, <u>or</u> a cash dividend with no such benefits. The shareholder has no control over the type of dividend distributed and therefore is dependent on corporate management as to the tax treatment of his dividends. H.R. 654 and S. 1543 eliminate this inequity by permitting corporations which adopt a qualified dividend reinvestment plan to provide their shareholders a choice. Thus, when a dividend is declared, shareholders may elect to receive a cash dividend, taxed immediately as ordinary income, or, they may reinvest these cash dividends in common stock in the same corporation.

A.G.A. believes that as the above two alternatives, the dividend exclusion and the dividend reinvestment plan, hold many benefits for the gas utility industry's shareholders, customers and the nation. However, while the majority of the A.G.A. member companies have supported H.R. 654 and S. 1543, some division of opinion exists among A.G.A. member companies as to whether a dividend reinvestment program should include both original issue stock and that which is acquired in the open market. Therefore, A.G.A. requests the opportunity to file a written statement in the future on behalf of the A.G.A., if necessary, addressing this issue.

A Current Deduction For Certain Pre-Operating Expenses

Because new domestic energy facilities are of crucial importance to the nation, we recommend a current tax deduction be specifically provided for feasibility and environmental studies, certification, start-up programs, and pre-operating expenses (including training costs) related to their development.

Under current law, these types of pre-operating expenses are often treated by the IRS as an integral part of the energy facility, to be capitalized over the life of the plant. Such capitalization, of course, does not afford as rapid a recovery of these costs as would making them currently deductible. Indeed, current law discourages such investment.

Liquefied natural gas plants and coal gasification plants can make valuable contributions toward the prevention of energy supply shortfalls. However, these plants are, like most energy projects, capital-intensive ventures. The deductibility, as current expenses, of the costs associated with the establishment of these new domestic energy facilities would enable companies to internally generate the money for financing the actual construction of these projects. Without such a deduction, the gas utility industry must now incur the costs of increased debt capital in conventional financing markets.

Denying a deduction for these expenses and permitting only capitalization creates delays in the generation of internal capital and detracts from the utility's ability to finance further construction of essential projects.

On the other hand, expressly permitting the current tax deduction of pre-operating expenses would promote the development of supplemental gas supply projects, which is entirely consistent with the recently passed synthetic fuels legislation (The Energy Security Act of 1980, Pub. L. 96-294) designed to develop domestic unconventional energy resources, such as coal gasification and liquefaction.

A.G.A. believes that providing a current deduction for these pre-operating expenses associated with the establishment of new domestic energy facilities would help provide much-needed internal financing for the construction of these facilities.

Investment Tax Credit

The investment tax credit rate should be increased from 10% to 12% on a permanent basis. The investment credit limitation should be removed so that companies can fully utilize the credit offsetting 100% of their tax liability. A.G.A. also supports any modifications which broaden the classes of property qualifying for the investment tax credit.

While Congress has recently enacted appropriately needed tax credits designed to stimulate specific new energy technologies, A.G.A. believes that what is urgently needed now is an expansion of the general investment tax credit to help form new capital in the regulated utility industry. This expansion cannot be overemphasized because this industry now has, and will continue to have for a very long time, the primary responsibility of supplying the energy needs of our nation's homes and industries.

To this end, A.G.A. urges that the investment tax credit be made refundable to permit maximum use of this capital formation benefit within the industry.

A refundable investment tax credit would enable a company or individual to get a cash payment from the Treasury for the amount of the credit that exceeds the taxpayer's Federal income tax liability. This excess amount would be treated as an overpayment of tax, and refunded to the taxpayer.

An essential element of any tax credit, or for that matter any tax benefit designed to stimulate capital formation, is that Congress provide that the tax benefits flowing from the U.S. Treasury not be used to immediately reduce the utility's rates set by regulatory commissions. Rather, these benefits must be used to achieve Congress' intended purpose of stimulating capital formation. Indeed, the incremental sharing provisions under Section 46(f) of the Internal Revenue Code should be continued to achieve this Congressional intent.

For an increased (from 10 to 12%) refundable investment credit to achieve maximum effect, it must take on the permanent nature of the present 10% credit and not be provided as an intermittent incentive such as we have experienced in the past. A permanent credit will provide the long-term stability and assurance to the financial community and will provide planning capability for the gas industry to meet the industry's energy requirements.

Also, the limitation must be revised to permit full use of the credit up to 100% of tax liability. Under current law, the 100% utilization is not available to gas utilities (distribution or transmission companies) or to those entities engaged in developing supplemental gas supply sources, such as synthetic natural gas or other supply projects including gas from Devonian shale, occluded coal seams or geopressured brine. These sources hold the potential to make significant contributions to our domestic natural gas supplies. However, these projects will necessarily demand the great amounts of capital in the very near future.

While most companies within the regulated natural gas utility industry are generally able to use the full amount of their investment credits, to the extent that some are unable to, these credits should be refundable. This will help meet the gas industry's capital requirements. Moreover, refundability will accomplish the Congressional intent underlying the investment tax credit: to provide internally generated capital for purposes of reinvestment in plant and equipment with a goal of increasing production capability. It is important to note, however, that in order to obtain the maximum capital formation incentive possible, there should be no "trade-offs" in other areas such as depreciation or corporate tax rates. These "trade-offs" would counteract any benefits received by investment tax credit reform.

If enacted, the proposed changes in the investment tax credit will create a stable and positive investment environment for the gas industry. Such an atmosphere will engender investment decisions by the financial community to fund supplemental gas supply projects for the future good of both the gas utility industry's customers and the nation.

Conclusion

A.G.A. believes for the foregoing reasons that the proposals outlined above would be effective capital formation incentives. In particular, these proposals would help the regulated natural gas utility industry meet its capital requirements over the next two decades, a task which is essential if this industry is to continue to provide gas energy to our nation's homes and industries.

65-969 O - 80 - 36 (pt.3)

Senator. BRADLEY. Unfortunately, as a junior member of the Finance Committee, I find myself here at 1:05 with at least five other panels to give testimony, and no other Senator here to hear this important testimony. As a freshman Senator, I am also called upon to preside over the Senate at 1 o'clock. As you can see, I am delinquent in my prime responsibility to the Senate, although I am fulfilling my responsibility to the Finance Committee.

With this dilemma in mind, and considering that tomorrow we have a witness list that is just as auspicious, and important, and lengthy as this one, I wonder if the witnesses would accept my apology for not hearing their testimony. I ask them to submit their testimony in full for the record, so that it will be made a part of the hearing record. You will simply not have the benefit of my penetrating questions after the testimony.

If you do not mind, I would like to proceed that way, and I apologize to you for your having waited around here for 3 hours, and not getting getting an opportunity to speak. But I assume that we have Mr. Dempsey here, Mr. Ignatius, Mr. Burbage, Mr. Seibert, Mr. Godfrey, Mr. Steenberg, and Mr. Flowers. Am I correct in that?

All of you will submit your testimony, then, for the record, and I thank you very much for your patience, and your interest in this issue, which I think we are all interested in and we are going to find an answer to.

Thank you very much.

[The following witnesses could not be heard by Senator Bradley because of time schedule, their prepared statements follow:]

July 30, 1980

SUMMARY OF TESTIMONY OF
ASSOCIATION OF AMERICAN RAILROADS
BEFORE THE
SENATE FINANCE COMMITTEE

1. The railroad industry supports reform of the depreciation rules to eliminate the "useful life" concept of measuring depreciation and the adoption of new proposals for capital cost recovery over shorter periods of time.

2. In support of national goals of energy conservation and conversion of energy sources from oil to coal, the railroad industry encourages adoption of energy tax credits for investment in energy-related railroad transportation rolling stock and equipment.

3. Railroads have invested heavily in property eligible for investment credit, but some railroads have been unable to utilize the credit due to low earnings and, consequently, low or negligible tax liabilities. The incentives afforded by the tax credit are thus deferred for many years or extinguished. A "refundable" credit would enable the marginal railroads to invest in needed equipment in much the same way as taxpaying railroads.

STATEMENT OF

THE ASSOCIATION OF AMERICAN RAILROADS
ON PROPOSALS FOR TAX REDUCTION

BEFORE THE

FINANCE COMMITTEE
OF THE UNITED STATES SENATE

July 30, 1980

Mr. Chairman and members of the Committee, I appreciate this opportunity to present to you the views of the Association on the need for early action to reduce taxes and stimulate investment in the American economy. The Association of American Railroads represents members owning 92% of the line haul mileage of the Class I Railroads in the United States and 97% of the freight revenue of all railroads in the United States.

As members of Congress, you have seen that the railroad industry is presently engaged in a tremendous effort to consolidate the nation's railroads into national systems of transportation to compete and perform effectively for the public benefit. While our efforts to achieve these important goals must be pursued, the railroad industry continues to suffer from the lack of adequate capital growth. Compared with the average 11% return on net investment which the Interstate Commerce Commission has said is necessary to sustain adequate rail service, the railroad industry earned a return of only 1.6% in 1978 and 2.6% in 1979.

The railroad industry is highly capital intensive, requiring three times as much investment per dollar of gross revenues as the average manufacturing industry! We rely heavily on internally generated capital to meet our needs. In our view, a continued improvement in the tax laws to stimulate capital investment by further acceleration of depreciation allowances, a narrowly defined expansion of the energy tax credit, and the full utilization of the existing investment tax credit through refundability is necessary to our continuing effort to improve our plant and equipment.

As noted, the railroad industry is one of the most capital intensive industries in the country. It is also an industry in which the unmet demand for capital is increasing. The industry, the Interstate Commerce Commission, and the Department of Transportation have all analyzed the railroad industry's capital needs and have determined them to be in the neighborhood of $4 billion per year. Actual investment, however, has been running about $2.5 to 2.6 billion per year. The result of these recurring shortfalls has been service inadequacies, lower productivity, and reduced ability to modernize the industry to take advantage of its fuel efficiency.

Capital outlays have exceeded internally generated funds (income plus depreciation) in each of the years 1973 through 1979. The accumulated deficiency in the last three years alone amounts to $4.5 billion, a pattern that can not long continue. Since existing railroad mortgages preclude debt financing for track and most road projects, the industry has had to rely on its internally generated cash flow or federal assistance for these investments.

The railroads presently face two challenges which intensify the need for capital and demonstrate the public interest in assisting to generate the necessary cash flow.

First, the major thrust of our national energy policy is to promote the conversion from oil and gas to coal wherever possible. It has been estimated that coal production in the next ten years will double. The railroads, which now carry about 2/3rds of the coal traffic, expect to carry at least that percentage, and more likely even a greater percentage, of the incremental coal traffic. A 1977 DOT study estimated that investments of $4 1/2 to 6 billion will be required over an eight year period for the railroads to meet the coal production goal of 1.1 billion tons per year by 1985. We have the basic facilities and the ability to manufacture the needed new equipment, but the enormous amount of capital required gives the industry a serious problem.

The second challenge facing the industry that also requires a large infusion of capital is the need to maintain and improve existing plant. Railroads, as the only transportation mode owning their own rights-of-way, must invest very large amounts to maintain their track and equipment each year. This maintenance effort is necessary to assure safe and efficient operation. When capital is insufficient, plant declines, service deteriorates, hazards and delays increase, and business is lost. Clearly, railroads must be able to assure the integrity of their systems in order to operate and compete. Our aim is to accelerate the acquisition of new and better equipment and to maintain and improve our track and bridge structures.

The proposals which have been advanced by Chairman Ullman and other leaders of both tax-writing committees are certainly aimed in the direction of stimulation of capital investment through changes in the depreciation structure of the tax law, and the railroad industry strongly supports these efforts. The so-called "10-5-3" bill to restructure the depreciation allowances into a simplified capital cost recovery allowance has been supported by this Association from the early days of its announcement in May of 1979. Since that time numerous proposals have been advanced by other members of Congress in reasonable eforts to achieve equity for all businesses.

To the extent that more favorable depreciation allowances are enacted, the cash flow resulting from tax savings could provide capital to the railroads to rehabilitate and modernize railway plant and equipment. Added to this, an expansion of the energy tax credit applicable to qualified energy transportation property, and provisions for refundability of the existing investment credit will mean continued improvement in railroad rights-of-way and equipment. The nation is being called upon to convert from oil to coal as a primary energy source. The railroads will play a vital role in this conversion process. The increased capital provided by favorable depreciation allowances, expansion of the energy tax credit, and refundability of the existing investment tax credit will enable the railroads to fulfill their role.

Improvements in Accelerated Depreciation

We appear here today to encourage the Congress to adopt a modern capital cost recovery tax system to meet the needs of this nation's economy, which is falling far behind its ability to meet the international challenge in trade and commerce. As you know, many studies have been presented to this Committee demonstrating the effect on the economy of our major world competitors whose present laws provide much more favorable depreciation allowances than our own system of taxation. Japan, West Germany, France, Australia, and Canada provide capital cost allowances permitting the write-off of investments at a rate 2 to 10 times faster than our present law. Most of these countries also provide greater flexibility to industries in the election of timing of these allowances to coincide with current needs.

The railroad industry is affected dramatically by the recovery of its investment through accelerated depreciation. A reform of existing law to eliminate the useful life concept of measuring depreciation and substituting shorter capital recovery periods would be helpful to the railroad industry. The continued need for heavy investment in modern railroad rolling stock depends on a healthy cash flow. The shorter recovery periods envisioned by the "10-5-3" bill or the four category recovery periods proposed in the Ullman bill would in different ways provide additional cash flow to aid the industry in continuing its major investment programs. As the railroad industry heads into the 1980's with a growing demand for major intercity rail service, modernized depreciation laws are necessary.

Since the investment tax credit is such an important capital formation mechanism, we urge that the availability of the present 10% investment credit not be jeopardized by a capital recovery period which is shorter than the useful life of the asset to the taxpayer.

It would be counter-productive to require that a taxpayer elect its capital recovery period in the taxable year in which the asset is placed in service. If the proposed capital formation changes are indeed effective, a taxpayer in a marginal or loss situation could find his tax picture substantially changed during the life of the asset. To require an election of the recovery period in the taxable year in which the asset is placed in service would prevent such taxpayer from taking advantage of the shorter recovery period if its situation warranted such election. To this end we urge that whatever depreciation reform is adopted, taxpayers be able to elect appropriate allowances annually without needlessly using up basis in loss or marginal years.

Additional Energy Credit

During the years of its existence, the investment tax credit has proven to be an important tool in the railroads' effort to raise capital for the purchase of rolling stock. In March of last year, the AAR submitted testimony to the Ways and Means Oversight Subcommittee showing the effectiveness of the investment tax credit in encouraging freight car purchases.

Exhibit "A" tracks the history of the credit since its enactment in 1962, including the six-month suspension in 1966 and 1967 and the two-year repeal in 1970 and 1971. Exhibit "B" shows the monthly car orders before and during the six-month suspension. Taken together, these exhibits show the dramatic drop-off in orders during the period without the credit, and sharp increases when the credit was reinstated. Not only the railroad industry, but the entire economy is responsive to the tax credit as an effective, targeted incentive for investment in the specific kinds of assets the Congress intended.

To aid the railroad industry and the nation in their goals of more productive plant and equipment and greater use of coal, we urge the Committee to consider an additional credit for investment in railroad transportation property. The additional credit, up to a maximum of 10%, could be based upon the percentage of coal carried during the previous year.

The Energy Tax Act of 1978 provided for an additional 10% investment tax credit for energy property as a stimulus for business to convert from the use of oil and gas to alternate fuels. Examples of property covered by the 1978 Act included solar, wind, or geothermal property, ocean thermal property, hydroelectric electric generating property, qualified intercity buses, and biomass property. However, during Congressional consideration of the Act, rail transportation was not defined as "energy property", a serious omission if the national energy program is to be effective.

The House and Senate reports leading to the 1978 Act emphasized both conversion and conservation. The energy-efficient operating characteristics of railroads clearly place them in a unique position to aid the nation's conversion and conservation efforts. The emphasis today, however, is on supply and production, as evidenced by Title I of the Windfall Profits Tax Act, providing for phased deregulation of oil prices, and Title II, providing tax credits to promote synthetic fuels projects. The same can be said for the Energy Security Corporation legislation (loans and loan guarantees for synthetic fuels projects). Moreover, this is consistent with the Joint Economic Committee's 1980 recommendations that a comprehensive set of policies be designed to enhance the production side, i.e., the supply side, of the economy.

Although equipment for the transportation of coal was not made eligible for the additional tax credit in the Energy Tax Act of 1978, we believe an additional credit for equipment for the transportation of coal is imperative. Such a credit would be consistent with the Congress' present interest in addressing supply side problems and would open the way for the rail industry to fulfill its coal transport role -- coal to be used for direct consumption and as an essential feedstock for increasing the supply of synthetic fuels transported by the most energy efficient mode available.

Refundable Investment Tax Credit

One of the weaknesses in the existing law is that the amount of investment tax credit which may be used is limited to a percentage of the income tax liability. Thus, new companies which are starting up as well as older companies with lower earnings which do not have sufficient tax liabilities cannot fully enjoy the benefit of the credit, and for them the intended inducement to invest is not available. This weakness in the credit is particularly harmful to the railroad industry because the earnings of many campanies are meager if not non-existent, and its capital needs are great. Marginal companies as well as those that enjoy moderate earnings get little or no benefit from the credit. Companies with strong earnings, on the other hand, may realize the full benefit of the credit.

Congress has recognized this discrimination based upon earnings and has taken some steps in the past to alleviate it. The Tax Reform Act of 1976 allowed utilities, airlines, and railroads to use the credit to the full extent of their tax liabilities beginning in 1977 (instead of 50% as was the case with other taxpayers). The increase, however, was for a limited period (2 years) and was gradually phased back down to the 50% limitation. In 1978, Congress increased the amount of credit as measured by tax liability that could be used by all taxpayers by phasing it in from 50% to 90% over a period of 4 years. These changes, however, were of only limited usefulness to taxpayers with depressed earnings and limited tax liability. Even in the case of companies with moderate income, the investment credit was little inducement because the large amounts of unused credit built up in years when a more restricted percentage of tax liability prevailed had to be used before current credit could be used.

The real solution to the problem is to allow a payment of investment tax credit to taxpayers whose tax liability was not sufficient to use the credit. With such a refundable tax credit, marginal taxpayers can get a benefit equal to that of other companies, including competitors that enjoy higher earnings. In the case of railroads, a refundable credit would go a long way toward filling the gap between the actual investment and the investment which is estimated to be necessary to give the industry and the nation the track system and equipment fleets it needs to meet the energy challenges of the future. Marginal railroads now leasing equipment would be better able to purchase needed equipment and thereby attain equity in these investments.

Congress is being asked to consider various methods of encouraging investments. A refundable investment tax credit is a proper complement to other incentives to investment in order to reach the taxpayers with reduced earnings. Such legislation we believe, will go far toward avoiding the necessity for direct, massive assistance to companies which do fail for lack of available capital to maintain efficient and competitive operations. Two recent examples are the failures of the Milwaukee and Rock Island Railroads, which have required over $200 million each in Federal assistance so far. This $400 million total aid for two railroads is equal to a substantial percentage of the assistance to all railroads that a fully refundable tax credit would provide.

In summary. we applaud the Members of Congress of both parties for their recognition of the need for tax reduction as a significant incentive to investment to modernize the American industrial plant and increase productivity. The Association of American Railroads will be pleased to render whatever assistance is necessary to achieve these goals.

Exhibit "A"

NEW & REBUILT
FREIGHT TRAIN CAR ORDERS, DELIVERIES AND BACKLOG
1960-1978

	ORDERED	DELIVERED	ON ORDER 12-31
1960	37,953	58,322	21,445
1961	33.085	34.231	16,046
1962[1]	40,054	39,822	16,568
1963	71.311	48,255	38,632
1964	91,403	83,266	39,426
1965	106,784	89.653	57,249
1966	112,898	106,048	65,998
1967[2]	70,551	100,181	33.655
1968	71.663	68.836	36,359
1969[3]	90,151	75,972	50,337
1970[4]	58.346	75.440	29.936
1971	57,470	60,918	24.007
1972	50,379	50,197	22.834
1973	106.077	59.388	67,965
1974	99,034	67,649	90.876
1975[5]	35.370	74.345	40,755
1976	38,024	53.849	24.704
1977[6]	68,515	53,907	37,186
1978	129.341	68,774	96,342

1. Initial year of credit application
2. Reduction due to suspension of the credit
3. Increase from reinstatement of the credit
4. Low orders in '70-'72 reflect bankruptcy of Penn Central and other Eastern roads
5. Low orders in '75-'76 reflect natioal economic recession
6. Increase reflects railroads percentage utilization provided by 1976 Act, as well as economic turnaround

Exhibit "B"

FREIGHT TRAIN CAR MONTHLY ORDERS DURING 5-MONTH PERIOD PRIOR TO SUSPENSION OF CREDIT ANDD DURING THE PERIOD COMMENCING WITH SUSPENSION AND TERMINATING WITH ITS RETROACTIVE RESTORATION

Orders During 5-Month Period Prior to Suspension		Orders During Period Commencing With Suspension and Terminating With Its Retroactive Restoration	
June, 1966	7,538	November, 1966	6,258
July, 1966	6,353	December, 1966	9,863
August, 1966	8,678	January, 1967	4,364
September, 1966	13,045	February, 1967	4,041
October, 1966	6,720[1]	March, 1967	5,909
		April, 1967	1,728[2]
		May, 1967	7,677
		June, 1967	11,449[3]

1. Month suspension effective.

2. Month restoration effective.

3. Month restoration retroactively enacted.

Summary
Statement of Paul R. Ignatius
President and Chief Executive Officer
Air Transport Association of America
Before the Committee on Finance
United States Senate
July 30, 1980

1. The airlines of the United States believe that Congress should promptly enact effective capital recovery and investment incentive legislation to spur economic activity through greater investment, to increase productivity, and to create employment.

2. The airlines face an enormous capital investment requirement for new technology replacement aircraft — demands amounting to $87 billion during the 1980's. This investment is needed to accommodate growth and to obtain the essential benefits of more fuel efficient, quieter aircraft.

3. Airline industry earnings, while expected to improve over their present depressed state, are dependent upon a turnaround in the national economy. An effective capital recovery system, such as proposed in S. 1435, is needed to bring about this turnaround.

4. Enactment of S. 1435 will do much to help solve the serious capital recovery problems facing all American businesses. However, it does little to meet the current needs of unprofitable or marginal businesses having the greatest need for an investment stimulant — businesses which cannot receive the benefits of the investment tax credit program.

5. A complete and fully effective capital recovery system can only be achieved by assuring that the benefits of the investment tax credit are made available to all American businesses. The refundability of earned but unused credits, as proposed in S. 2157, would provide that assurance.

STATEMENT OF

PAUL R. IGNATIUS

PRESIDENT AND CHIEF EXECUTIVE OFFICER

AIR TRANSPORT ASSOCIATION OF AMERICA

ON THE NEED FOR CAPITAL RECOVERY AND INVESTMENT INCENTIVE LEGISLATION

BEFORE THE

FINANCE COMMITTEE

UNITED STATES SENATE

JULY 30, 1980

Statement of Paul R. Ignatius
President and Chief Executive Officer
Air Transport Association of America
Before the Finance Committee
United States Senate
On the Need for Capital Recovery and Investment Incentive Legislation
July 30, 1980

My name is Paul R. Ignatius. I am President and Chief Executive Officer of the Air Transport Association of America, which represents virtually all of the scheduled airlines of the United States. These hearings, Mr. Chairman, are indeed timely. They are addressing the difficult but important issue of Federal tax policy at a time of national economic distress. The questions you are considering — the timing, nature and long-run structuring of tax legislation — are crucial to the efforts to restore strong economic growth with high employment and stable prices.

I appear on behalf of our membership to inform the Committee of airline investment requirements in the 1980's, to discuss the airline industry's difficulties in meeting those requirements, and to emphasize the importance of, and need for capital recovery and investment incentive legislation.

Like many other segments of American industry, the airlines believe that an improved investment climate is essential to increase productivity, create jobs, improve energy efficiency, reduce inflation, and improve our ability to compete in the international marketplace.

Air transportation is the predominant mode of intercity public transportation to, from, and within the United States. Today, 85 percent of all public travel between U.S. cities in terms of passenger miles is accomplished by air. Last year, U.S. airlines carried 317 million passengers more than 260 billion miles, and accommodated 7 billion ton miles of cargo, including 9 out of every 10 intercity first class letters.

The U.S. air transportation system interacts with the nation it serves on several levels: as a supplier of services that reduces production and distribution costs and stimulates market development; as a supplier of public service that uniquely meets the requirements of the travel market for expedited and reliable transportation; and as a market for the products of U.S. high technology industries, which, in large part, enables the U.S. aircraft industry to maintain a position of supremacy in the world market. This system produces substantial benefits -- benefits that will be lost if the growth and productivity of air transportation is curtailed or reversed. The nation more than ever requires a fast, frequent and reliable air transportation system, and the airlines must invest many billions of dollars to assure that this national need is met.

AIRLINE INVESTMENT REQUIREMENTS IN THE 1980'S

The airlines of the United States face very heavy aircraft investment demands during the next 10 years -- demands reaching $87 billion.

New technology replacement aircraft for the U.S. airline fleet are urgently needed throughout the 1980's. Because of the long lead and delivery times involved, fleet planning decisions should be made now and orders placed as soon as possible if the important benefits of the new technology are to be fully realized during this 10 year period of most urgent need. In view of the huge investment cost and serious questions about the adequacy of available airline industry resources, fleet planning decisions will be deferred, and the level of orders will be sharply reduced unless meaningful capital recovery and investment incentive legislation is enacted soon.

There are four compelling reasons why it is essential for the U.S. airline industry to make an $87 billion investment in new techonolgy aircraft:

- Fuel Efficiency — new technology aircraft will be from 20 to 30 percent more fuel efficient. National fuel efficiency improvement objectives, and the continually increasing price of fuel, give greater aircraft fuel efficiency an overriding priority.
- Aircraft Replacement — the average age of the airline fleet doubled in the past decade. The average age today is nearly 10 years, compared to 5 years in 1970. While the current fleet is completely reliable, it is significantly more costly to maintain and operate an aging fleet than would be the case with new technology aircraft.
- Traffic Growth and Productivity — public demand for air transportation is expected to grow from a record 317 million passengers last year to 500 million passengers by 1990. More productive new technology aircraft are necessary to meet this demand.
- Noise Reduction -- new technology aircraft will be substantially quieter. New technology is the only practical way to achieve the meaningful noise relief sought by airlines, airport operators, public officials and millions of airport neighbors.

The $87 billion cost of the airline industry's capital investment requirement during the 1980's involves $80 billion for passenger aircraft, and $7 billion for freighter aircraft. Of this amount, $22 billion is needed in the 1980-1984 period, and $65 billion for the last half of the decade. The $22 billion needed during the first half of the 1980's exceeds total airline industry investment during the entire decade of the 1970's.

Airline industry investment in new technolcgy will contribute significantly to other essential national policy priorities. It will create thousands of jobs in the aircraft and engine manufacturing and supplier industries. And with enhanced productivity, new technology aircraft will help offset inflationary pressures on the price of air transportation to the airline passengers and shippers.

AIRLINE INDUSTRY RESOURCES

During the period 1970-1979, the airline industry earned a profit margin of only 2.1 cents on each dollar of revenue, compared to 5.1 cents for U.S. industry in general. The average return on total investment (including long-term debt) was only 6.3 percent, compared to 10.2 percent for U.S. industry. In the two most recent years — 1979 and 1980 — the results were particularly discouraging, with net profits of only $400 million in 1979 on record revenues of $27 billion. During the first half of this year, industry losses were approximately $375 million, and the outlook for the balance of the year is not encouraging.

Airline industry earnings over the past decade have been directly affected by changing national economic conditions, resulting in ups and downs in traffic growth, by explosive increases in operating costs, and by an inability to pass through costs dollar for dollar to consumers in periods of inflation and recession. New flexibility made possible by the Airline Deregulation Act, tighter cost controls, and a general industry belt tightening hold the promise for an improvement in the industry's economic posture during the period ahead. However, attaining an airline industry return on investment high enough, and on a consistent basis, to support an $87 billion investment will be exceedingly difficult, particularly in view of the continually increasing cost of fuel.

Airline fuel costs in 1979 amounted to $6.5 billion, compared with $4.2 billion in 1978, and $1.3 billion in 1973 when the fuel price surge began. In 1980, the airline industry fuel bill is expected to be approximately $10 billion. In short, airline fuel costs have risen nearly 800 percent since 1973 while consumption has remained relatively stable.

With the airline fuel bill increasing this year by over $4 billion for the same volume, it is easy to see the impact fuel costs have on airline industry earnings. Now representing over 30 percent of airline cash operating expenses, fuel price escalation is expected to continue, and will impact heavily on airline earnings in the decade of the 1980's.

The airline industry would need an average annual corporate return on investment (ROI) of 13-15 percent to meet the $87 billion in capital requirements from 1980 to 1990. Over the past five years, the airline industry ROI has averaged 8 percent and was only 7 percent last year.

THE NEED FOR EFFECTIVE CAPITAL RECOVERY AND INVESTMENT INCENTIVE LEGISLATION

Significantly improved airline industry earnings are dependent upon a healthy and growing national economy, restored consumer confidence, increased employment and productivity, and lower inflation rates. Immediate, positive tax policy changes are imperative in attaining these goals. The airlines believe there is an urgent need for early enactment of effective capital recovery and investment incentive legislation, both to enhance airline investment capability and to stimulate the national economy.

The proposed Capital Cost Recovery Act, S. 1435, represents such a positive tax policy change. It would provide needed improvements in the capital cost recovery system. The airline industry of the United States endorses this legislative proposal.

Enactment of S. 1435 will do much to help solve the serious capital recovery problems facing all American businesses. However, it does little to meet the current needs of many important business enterprises including marginally profitable companies, companies that intermittently operate at a loss, or newly developing companies. Nor does it meet the needs of industries, like the airline industry, that experience wide cyclical variations in profitability and have very heavy demands for capital investment. An improvement in the investment tax credit program is urgently needed to deal with the problems of these companies and industries.

The investment tax credit program was designed to encourage business to invest in new plant and equipment to enhance productivity and employment. The credit is earned by making an investment. Credits earned are used to reduce taxes. Profitable companies have the cash benefit of the credit paid to them immediately through a current reduction of income tax liabilities. On the other hand, unprofitable or marginal companies do not receive immediate benefit of the credit, and may never receive it under existing law. Such companies need the benefit of the credit to reduce the cost of acquiring capital equipment ever more than profitable companies do. Thus, the current investment tax credit program should be modified in order to make it of greater value to companies who need it most. For example, the airlines stand to lose some $400 million of earned credits as a result of the current earnings outlook of the industry. With investment requirements of $87 billion, the airlines need the ability to use both prior earned credits and new credits as well.

The solution to this problem is to provide for the refundability of earned, but unused investment tax credits, as proposed in S. 2157.

In a May 8, 1978 report entitled "Investment Tax Credit: Unresolved Issues", the Controller General pointed out that the benefits of the credit are reduced or eliminated for businesses that lack profits or that are operated at a loss, and stated that, among other things, the Congress should consider:

> "—Making the investment tax credit available to those firms that are currently making small profits but are growing rapidly. This would enlarge the base to which the credit is applied and, therefore, aid those industries more likely to invest in machinery and equipment. (The administration's proposal to increase the tax credit limit from 50 to 90 percent goes part of the way, but the Congress may wish to make the credit refundable.)"

The investment tax credit is an essential and most effective method of stimulating investment in productive capital assets. But it can, and should be improved. A complete and fully effective capital recovery system can only be achieved by assuring that the benefits of the credit are made available to all American businesses, including those unprofitable or marginal businesses having the greatest need for an investment stimulant. The refundability of earned but unused credits, as proposed in S. 2157, would provide that assurance. The airline industry of the United States strongly endorses S. 2157 and urges its favorable consideration.

CONCLUSION

The airline industry of the United States faces an $87 billion investment need in the 1980's. An investment of this magnitude is essential to maintain an efficient and reliable national air transportation system. Such an investment is entirely consistent with several important national policy objectives, including energy efficiency improvements, greater productivity, meeting environmental concerns, and creating employment. However, the required airline investment will not be possible in the absence of significant improvements in the national economy, airline earnings, and investment incentive opportunties.

The airlines believe that Congress should promptly enact effective capital recovery and investment incentive legislation. S. 1435 represents a substantial step in the right direction, but a more complete and effective capital recovery system should incorporate the provisions of S. 2157 providing for the refund of earned but unused investment tax credits.

ORAL TESTIMONY OF ROGER BURBAGE
O'BOYLE TANK LINES, INC.
ON BEHALF OF THE
AMERICAN TRUCKING ASSOCIATIONS, INC.

COMMITTEE ON FINANCE
UNITED STATES SENATE
July 30, 1980

Thank you, Mr. Chairman and Members of the Committee for the opportunity to appear concerning the advisability of a tax cut and capital formation; more specifically concerning an aspect of great importance to the motor carrier industry.

My name is Roger Burbage. I am here today on behalf of the American Trucking Associations, Inc., (the "ATA") a national federation of motor carriers having affiliated associations in every state and in the District of Columbia. I am also Vice President, Finance and Administration, O'Boyle Tank Lines, Inc. of Rockville, Maryland. My company operates in 36 states and has annual gross revenues of about $25 million.

The motor carrier industry is composed of over 17,000 firms, 13,000 of which have gross revenues of less than $500,000 annually. The industry directly employs over 600,000 persons and the regulated industry's total estimated revenues for 1979 are over $40 billion. I request that my full written statement, as well as my remarks today, be included in the record.

The Motor Carrier Reform Act of 1980 makes substantial changes in the industry. One aspect of this Act threatens our financial stability by making the value of operating rights previously acquired (usually at significant expense) virtually worthless compared to their previous value. As was suggested by Congress when the Act was passed, our situation equitably demands a legislative solution. We support tax relief for the effect of the 1980 legislation on operating rights held by motor carriers and others.

Congress established the previous "rules of the game" when it passed the Interstate Commerce Act in 1935. For 45 years these "rules" provided significant protection from entry and excessive competition. In reliance on these rules, firms made substantial capital investments (by purchase or otherwise) for these operating rights. The 1980 Act, although not totally "deregulating" motor carrier operations, significantly changes the previous rules by providing far easier entry into the industry and allowing expanded authority with far fewer restrictions. The severe reduction in value of operating rights after the 1980 Act impairs capital formation by potentially jeopardizing current loans outstanding, making additional borrowing more difficult, and diminishing access to equity capital.

Mr. Chairman, the decrease in value is clearly demonstrable. A 1979 I.C.C. study clearly shows that operating rights were reflected on the balance sheets as intangible assets and were a very real asset to a carrier. They were included in the value of an enterprise, were used as collateral for borrowing, and are generally similar to a franchise or license values in other industries. Under the 1980 Act, however, instead of purchasing operating rights as before, companies will more than likely go through the application procedures at the I.C.C. to obtain identical rights to those purchased or otherwise obtained at great expense by the existing companies. Why would anyone reasonably buy these rights when the application procedures have been made so simple and inexpensive? In addition, financial publications such as Value Line have recognized the severe reduction in value for operating rights and the accounting profession is considering an accelerated write-off for accounting purposes.

More importantly, Mr. Chairman, the report that accompanied the 1980 Act recognized the new legislation might result in the severe reduction in the value of operating rights and that appropriate tax relief should be considered as soon as possible.

The ease of getting operating rights under the 1980 Act could have a severe competitive impact on us if a tax deduction is not made available. For example, one trucking company has total assets of about $46 million, of which $18 million are operating rights, largely debt financed. As a result of the new Act these assets drop over 1/3 to $28 million. A future competitor, under the new law, with tangible assets of say, $35 million, without debt financed operating rights, would compete more economically against the old company and drive it out of business; and all because the old rules adopted and encouraged by the U.S. Government have now been changed.

Under current law, it is arguable that a deduction is already available in these cases. However, reasonable men differ. Rather than costly and time consuming litigation with uncertain results, we are proposing an <u>ordinary</u> deduction for the effect of the 1980 legislation on operating rights. The legislative process provides the reasoned approach that accounts for industry, public, and fiscal considerations.

There is ample precedent for this legislative solution. Congress has often recognized that severe economic hardships can result when the U.S. Government itself changes the "rules of the game" after taxpayers have expended substantial resources in reliance upon the old rules. In these situations Congress has provided appropriate tax relief. For example, provisions of the tax law provide special relief provisions concerning changes in policy by the F.C.C., distributions in obedience to orders of the S.E.C., and persons impacted by the bank holding company legislation.

In summary Mr. Chairman, the 1980 legislation significantly reduces the value of operating rights held by various companies. Congress anticipated that legislative tax relief may be appropriate. In recognition of this, it is equitable to allow an ordinary deduction for these operating rights. This deduction is crucial to the financial stability and capital formation capability of this vital American industry.

Thank you, Mr. Chairman.

STATEMENT OF ROGER BURBAGE
O'BOYLE TANK LINES, INC.
ON BEHALF OF THE
AMERICAN TRUCKING ASSOCIATIONS, INC.

COMMITTEE ON FINANCE
UNITED STATES SENATE
July 30, 1980

Thank you, Mr. Chairman and Members of the Committee for the opportunity to appear before you concerning the advisability of a tax cut and capital formation; more specifically concerning an aspect of great importance to the motor carrier industry.

My name is Roger Burbage. I am here today on behalf of the American Trucking Associations, Inc., a national federation of motor carriers, with affiliated associations in every state and the District of Columbia, plus thirteen affiliated national conferences. I am also Vice-President, Finance and Administration, O'Boyle Tank Lines, Inc. of Rockville, Maryland. My company operates in 36 states and has annual gross revenues of about $25 million.

The motor carrier industry is composed of over 17,000 firms, 13,000 of which have gross revenues of less than $500,000 annually. The industry directly employs over 600,000 persons and the regulated industry's total estimated revenues for 1979 are over $40 billion.

The Motor Carrier Reform Act of 1980 makes substantial changes in the operation of the motor carrier industry in the United States. This 1980 Act severely reduces the capital formation capability of the industry by making the value of operating rights acquired by motor carriers and others virtually worthless compared to their previous value. As a result of the 1980 Act, it can legitimately be argued that a deductible loss has occurred under current law. The possible prolonged litigation and uncertainty of result from an attempted deduction, without a legislative mandate, will only further adversely affect the industry as well as create administrative problems for the Internal Revenue Service. As was contemplated at the time of enactment of the Act, the situation demands a legislative solution in the interest of sound tax administration. The purpose of this testimony is to discuss the desirability and necessity of a proposed income tax provision relating to the effect of that legislation on operating rights held by firms in various industries.

In 1935, President Roosevelt approved Part II of the Interstate Commerce Act. That legislation provided the basic regulatory framework for U.S. motor carrier operation for almost 50 years. That Act provided for certification of operating rights by the Interstate Commerce Commission upon a showing that additional service is or will be required by the public convenience and necessity. Carriers were obligated to offer nonpreferential and nondiscriminatory service at regulated rates. These "rules of the game" provided significant protection from open entry and excessive competition at the cost of regulated rates. Pursuant to these rules and in reliance thereon, companies have made substantial capital investments in operating rights (many by outright purchase from others), which are listed as intangible assets on the balance sheet. Today, more than 17,000 companies hold these operating rights pursuant to the provisions of the 1935 Act.

The Motor Carrier Reform Act of 1980, signed by President Carter on July 1, 1980, in effect, renders these operating rights virtually worthless compared to their previous value. This severe reduction in value dramatically affects the financial health of the motor carrier industry. Current loans may be jeopardized, additional borrowing will be made more difficult and access to equity capital is greatly diminished. Let me give you a brief example. Among the many complex provisions in a typical revolving credit agreement are many covenants concerning current equity requirements, working capital requirements, dividend restrictions, and debt/equity ratios. As will be explained more fully later, the accounting profession has indicated a write-off may be appropriate. In such a write-off, the companies would be in technical default because covenants would be violated. Legislative relief would provide needed financial stability to be considered in the renegotiation of the loan provisions.

The 1980 Act, while not totally "deregulating" motor carrier operations, makes substantial changes in the way the industry will operate. These changes are designed to substantially increase competition within the motor carrier industry. Among the many changes is easier entry into the industry. Applicants will no longer need to show that service is required under the public convenience and necessity standard. Existing operators protesting a new entrant on a route will bear the considerable burden of showing the proposed service is inconsistent with the public convenience and necessity. In addition, there are limitations on who can oppose applications. The rules for hauling for a corporation under exclusive contract (contract carriage) are vastly liberalized. Further, established truckers may obtain expanded authority with fewer restrictions under the new legislation. Many other areas of truck transportation such as processed foods, agricultural goods, shipments under 100 pounds, government traffic, etc. may now be conducted by carriers simply be demonstrating they are fit, willing and able to provide the service. Finally, certain areas of transportation, for example, highway transportation incidental to air transportation, are totally deregulated.

In short, under the new legislation, the previous significant regulatory restrictions on entry and expansion are almost removed. As will be discussed infra, the new legislation renders operating rights pursuant to the 1935 Act virtually worthless compared to their previous value.

Mr. Chairman, there is uncertainty concerning the proper tax treatment of operating rights after the 1980 legislation. This presents the need for a legislative solution as a matter of fairness, sound and efficient tax administration, and the national interest with regard to a sound motor carrier system.

From a Federal income tax standpoint, the cost of operating rights has historically been capitalized. These operating rights had an indefinite life. However, the 1980 Act has required a reexamination of this treatment. Events have demonstrated that the rights which were considered to be "permanent" now have been eroded by law and in fact, may have a finite life.

There is an old case, decided in 1938, Consolidated Freight Lines, Inc. v. Commissioner, 37 B.T.A. 576 (1938), in which the then Board of Tax Appeals denied the taxpayer a deductible loss where the State of Washington, which had granted a right to a trucking company, repealed the monopolistic characteristics of the law. The Court of Appeals for the Ninth Circuit, 101 F.2d 813, affirmed the Board's decision in 1939, on the ground that the monopoly was not part of the certificate under which it had previously operated. This case has distinguishable features from the present situation and moreover the issue has not been tested in other jurisdictions. Therefore, the case is not persuasive as to the correct treatment following the 1980 legislation.

In other cases involving the proper treatment of intangibles, such as the grant of a cable television franchise, the courts have held a deduction depends on the specific facts and circumstances with regard to whether the life of the rights involved is determinable or has an indefinite life. In the case of a determinable life, a deduction is proper. Chronicle Publishing Co. 67 T.C. 964 (1977); Toledo T.V. Cable Co., 55 T.C. 1107 (1971).

Further, there is authority for the proposition that the enactment of the Motor Carrier Reform Act of 1980 creates a basis for determining the useful life of operating rights. Consequently, deductions based on the determinable life are proper. Gerrit Van de Steeg, 60 T.C. 17 (1973).

In short, the cases indicate that specific facts and circumstances are very important to the determination of a fixed and determinable life that gives rise to a deduction. The facts and circumstances of this industry after the 1980 Act suggest a determinable life and deductions are proper.

However, the determination involved with respect to the deduction of the losses suffered by businesses in the motor carrier industry is a substantial one which, unless another solution is forthcoming, will necessitate costly and time consuming litigation in order to protect vital financial interests. This will create a period of disruption and uncertainty in the financial status of this vital industry. For the interests of all concerned, a legislative solution is advisable. Let me explain why a legislative solution is necessary and equitable.

As stated, many companies have expended substantial sums, by purchase or otherwise, to obtain operating rights under the previous legislation. That legislation better protected these rights from additional entry and excessive competition on a route. In some cases, operating rights represent as much as 50% or more of the total book value of a company. An issue to be considered in a legislative proposal would be to determine if the old operating rights have lost value. It is demonstrable that the value of previous operating rights has been reduced to almost nothing, indeed rendered virtually worthless compared to their previous value.

In October, 1979, the Interstate Commerce Commission's Office of Policy and Anlysis released a study entitled "The Value of Motor Carrier Operating Rights." The study clearly indicated an active marketplace for operating rights, under Commission supervision and with its consent. Of course, prices varied according to the specific rights bought and sold. The study shows that operating rights were a very real asset to a carrier, functioning much as tangible assets do in other industries. That is, operating rights were included in the value of an enterprise and were a source of collateral for borrowing. These operating rights are generally similar to franchise or license values in other, comparable, nontransportation industries.

The vast reduction of this previous value in operating rights by the new legislation severely impairs capital formation. The decrease may jeopardize current loans outstanding and makes additional borrowing very difficult. Because of the decrease in value, access to equity capital, via the stockmarket or otherwise, will be limited. Overall, the availability of capital for this industry is imperiled by the new legislation.

As stated, the previous system provided significant restrictions on the granting of operating rights. These restrictions are no longer present. Therefore, few businesspersons will purchase operating rights after the new legislation. Under the new legislation, entry on or expansion of a certain route will be more easily obtained from the Interstate Commerce Commission by simple application. Therefore, the industry does not expect the marketplace for operating rights to continue after the 1980 legislation.

This ease of obtaining operating rights under the 1980 Act could have a severe competitive impact on us if tax relief is not forthcoming. Let me give you an example. One of the companies in our industry has total assets of around $46 million, of which $18 million is operating rights, largely debt financed. After the

1980 Act, this company's assets drop over 33% from $46 million to $28 million. A future competitor with assets of say, $35 million, without debt financed operating rights, could come in under the new easier entry of the new law and compete more effectively against the old company and drive it out of business. All because the previous rules adopted and encouraged by the U.S. government have now been changed by that same government.

Stock market analysts and economic commentators have recognized the substantial reduction in the value of operating rights. For example, The Value Line Investment Survey of July 11, 1980, page 306, states in its analysis of the trucking industry: "Because of previous I.C.C. regulations, almost all trucking companies have a considerable amount of operating rights, purchased from other companies that are carried on their balance sheets as intangible assets. The current regulatory reform render these rights virtually worthless compared to their previous value."

The legislative history of the Motor Carrier Reform Act of 1980 recognized the new legislation might result in the severe reduction in the value of operating rights and tax relief should be considered. "Should it become apparent that the effect of this legislation has been to substantially erode the value of operating rights, then appropriate relief for such result should be considered as early as possible. Preferably it will be considered by the Committee on Ways and Means." H.R. Rep. No. 96-1069, 96th Congress, 2d Sess. 4,11 (1980).

Consequently, it is clear that the Motor Carrier Reform Act of 1980 has significantly reduced the value of existing operating rights.

Having determined a severe reduction in value, is the appropriate relief via an income tax credit or deduction? The trucking industry's situation after the new legislation is most similar to a loss situation, via expropriation, casualty, or otherwise. Based on established precedent under § 165 of the Internal Revenue Code, an ordinary tax deduction is the appropriate approach. The general concept of § 165 allows an ordinary tax deduction for losses sustained. Section 165(i), prior to its deletion by the "deadwood" provisions of the Tax Reform Act of 1976, provided a special loss deduction for certain property confiscated by the Government of Cuba. In addition, § 165 authorizes a deduction for general casualty losses and other expropriation type losses have been allowed by the courts, U.S. v. White Dental Mfg. Co. of Pennsylvania, 274 U.S. 398 (1927).

There is oth- ample precedent for a reasonable legislative solution to this problem. In these situations, Congress has recognized that severe economic hardships can result when the U.S. government "changes the rules of the game" that were set up by that same government and after taxpayers have expended substantial resources in reliance upon the old rules. In these situations, Congress has provided appropriate tax relief to remedy the governmental action. For example, § 1071 provides a special nonrecognition provision concerning the sale or exchange of property pursuant to a change of policy or a new policy of the Federal Communications Commission. Likewise, § 1081 provides for nonrecognition of gain in an exchange or distribution in obedience to orders of the Securities and Exchange Commission. Finally, §§ 1101-1103 provide special relief provisions for persons impacted by the 1956, 1966, and 1970 bank holding company legislation.

A tax legislative solution providing an ordinary deduction permits a proper analysis of the economic impact of the 1980 legislation on the motor carrier industry.

The general rule for the amount of loss under § 165 is the adjusted basis of the property. I.R.C. of 1954 § 165(b). In the case of any casualty loss, the amount of the loss is the lesser of (1) the fair market value of property immediately before the casualty reduced by the fair market value of property immediately after the casualty or (2) the adjusted basis under § 1011 for determining loss from the sale or other disposition of the property. However, if property used in the trade or business or held for the production of income is totally destroyed by casualty, and the fair market value of the property immediately before the casualty is lower than its adjusted basis, the adjusted basis is treated as the amount of the loss. Treas. Reg. § 1.165-7(b)(1). Therefore, in accordance with the established § 165 rules, it would be appropriate to base any deduction, arising from the effects of the new deregulation legislation, on the adjusted basis of the operating rights.

However, for equitable reasons and due to the unique nature and origin of the rights involved, it might also be appropriate to base the deduction on the higher of (1) adjusted basis or (2) $50,000. This solution recognizes that many small firms, particularly those using independent contractors, have had their most valuable asset, the operating rights, severely impacted by the new legislation. A deduction for only the adjusted basis of the operating rights in no way recognizes their economic loss. These small firms, numbering about 16,000, play a vital role in the trucking industry. These entrepreneurs and smaller business people are often the first to feel the strong hand of government policy and any changes in that policy. The individuals involved in these smaller firms have planned on the value of existing operating rights being their financial underpinning. For these individuals, the effect of the 1980 Act is particularly harsh.

It should be noted that there are no artificial allocation problems in the allocation of price between goodwill and operating rights. Amounts paid for either did not give rise to any tax deduction for depreciation or amortization under current law. There may have been minor "write downs" for book purposes on the operating rights, but there was no significant reason for misallocating or characterizing these items. These allocations have already been made and approved by the Interstate Commerce Commission and are a matter of public record. The amounts paid or expended for operating rights reflect economic reality and do not reflect goodwill. This is particularly true in many purchases of other companies. Many companies purchased were failing or bankrupt companies. In most of these cases, "goodwill" was negative in character and the new companies had to immediately take affirmative action to correct the deficiencies.

The last aspect of the deduction to be discussed is timing. The most desirable, least complex, and most accurate recognition of the effect of the Motor Carrier Reform Act of 1980 would be to allow an immediate deduction. When President Carter signed this legislation on July 1, 1980 the existing operating rights were essentially rendered virtually worthless compared to their previous value. However, to ameliorate any revenue loss impact over a period of time, the Congress may want to spread the deduction over 3 years. Some aspects of the Motor Carrier Reform Act of 1980 are "phased in" over 3 years and it may be reasonable to make the tax provision similar.

Before I conclude, let me briefly discuss the accounting procedures for operating rights and the revenue loss estimates for our proposal. Motor carriers have accounted for operating rights in accordance with the procedures promulgated by the Interstate Commerce Commission under its uniform system of accounts. In addition those carriers which are publicly held and those whose books have been audited by independent public accountants have accounted for operating rights in accordance with generally accepted accounting principles.

Operating rights have been classified in the intangible accounts prescribed by the I.C.C. whether such costs arose from application to the Commission or whether such costs arose as a result of outright purchase or by merger or combination of corporate entities. In all such cases the procedures followed and classifications used for operating rights were based upon pronouncements of the I.C.C. or authorizations granted after proceedings held before the I.C.C.

Under generally accepted accounting principles, operating rights acquired after 1970 have been amortized generally over 40 years. The I.C.C. has not permitted amortization or disposition of carrying costs of operating rights unless there has been impairment or diminution of value. However, in view of current developments contained in the Motor Carrier Act of 1980 and recent Commission decisions, the I.C.C. Bureau of Accounts has approved the issuance of Accounting Series Circular No. 182, Accounting for Intangible Assets. The Director of the Bureau of Accounts indicates that the I.C.C. is now changing its accounting to conform its practices with generally accepted accounting principles because such legislative actions and recent Commission decisions could have impaired or diminished the market value of carrier operating rights.

The impact of the new legislation and recent I.C.C. decisions are currently being evaluated by those concerned with the accounting treatment of operating rights.

Mr. Chairman, the revenue loss for our proposal, assuming there is no deduction under current law would be about $352 million, based on the latest available data. Of course, if these rights are deductible after the 1980 Act under current law, there is no revenue loss.

Based on the latest (1978) I.C.C. figures, the total operating rights have a book value of $748 million. However, about $27 million of that is held by smaller companies with book operating rights of less than $50,000. The effective tax rate for the larger companies is 30 percent. Consequently, the revenue loss for the book value of operating rights for larger companies is about $216 million ($721 x 30%). For smaller companies, the lowest federal income tax rate on corporations is 17 percent. There are about 16,000 smaller companies. Therefore, based on the best available data, the revenue loss for the smaller companies would be about $136 million. ($50,000 x 16,000 x 17%).

In summary, the Motor Carrier Reform Act of 1980 has had a profound effect on the motor carrier industry. One unfortunate effect was to significantly reduce the value of operating rights held by various companies. Congress anticipated that certain tax problems would arise and should be addressed by the tax writing committees. Rather than costly and time consuming litigation with uncertain results to both the industry and government, the proper solution is legislative. The legislative process provides the reasoned approach that accounts for industry, public and fiscal considerations. In recognition of all this, it is appropriate to allow an immediate ordinary income tax deduction for these operating rights. This deduction is crucial to the financial stability and capital formation needs of the industry.

The enactment of the Motor Carrier Reform Act of 1980 anticipated the problem outlined above and invited a legislative solution such as we are seeking.

Thank you, Mr. Chairman.

PREPARED WRITTEN STATEMENT
OF
DONALD V. SEIBERT
CHAIRMAN OF THE BOARD
J. C. PENNEY COMPANY, INC.
BEFORE THE
FINANCE COMMITTEE
U. S. SENATE

July 30, 1980

Summary

1. The function of retailing is distribution, just as the function of manufacturing is production. Both functions are highly interdependent. Inefficiencies in one will offset efficiencies in the other.

   - Retailing seeks a tax cut designed to increase efficiency, investment and overall output in both sectors of the economy.

   - We are interested in placing the U. S. economy on a sound long term financial basis.

     -- Tax cuts should emphasize productivity, capital formation and savings in order to be anti-inflationary.

     -- Fiscal restraint in the governmental sector is essential.

2. Congress should enact substantial business and individual tax reductions of about $25 billion effective January 1, 1981.

   - Congress should act now because

     -- Postponement would lead to continued economic uncertainty.

     -- A new Congress could not be expected to act early enough in 1981 to remove this uncertainty.

     -- Industry requires lead time to make plans for 1981 and future years.

3. Individual tax cuts are needed

   - To offset the effects of increased social security taxes and higher income taxes (the latter caused by inflation placing individuals in higher tax brackets without corresponding gains in disposable

income). We recommend an across the board tax rate reduction for individuals, designed to offset, at least partially, the higher income and social security taxes of recent years.

-- This would be a step towards restoring the individual's ability to save and invest.

-- This would be the least complicated way of reducing the individual tax burden, as contrasted to providing credits for social security tax, or indexing of individual income taxes.

- Over the long term, Congress should consider adoption of tax incentives which would encourage individual savings, including extension of the TRASOP concept to labor intensive industries.

4. Business tax cuts are needed

- To increase productivity and promote sound new investment over the long term.

- To provide cash flow for modernization and expansion programs.

- Business tax cuts should take the form of depreciation reform; i.e., a major increase in capital cost recovery allowances.

-- Congress should enact the 10-5-3 Capital Cost Recovery proposal.

-- These revised depreciation allowances should be available to all businesses, large and small, manufacturing and retailing, on an equal basis to achieve tax neutrality and equity.

5. Inclusion of the ten-year depreciation period for buildings is critical.

- Buildings represent a significant portion of fixed capital investment for retailers (and many other industries).

- Businesses, in general, consist of a particular mix of buildings and equipment designed to achieve maximum productivity. Businesses cannot simply choose to put money in buildings instead of equipment or vice versa.

Both types of capital investments are necessary and the mix is dictated by the requirements of efficiency in a particular business.

- 10-year depreciation is necessary to offset implicit tax increases resulting from depreciation deductions being limited to original cost, while replacement costs are measured in inflated dollars.

  -- The 1980 Economic Report of the President recognized that inflation has a much greater adverse effect on buildings than on equipment, because of the much longer depreciation lives for buildings. The present lives are too long and unrealistic in view of inflation and obsolescence.

6. Retailers need this help to remain efficient and productive.

   - Efficiency in the retail sector is essential for a healthy manufacturing sector.

   - Large numbers of people depend on retailing for employment.

   - Retailing is also important in downtown areas.

     -- 10-5-3 will help make urban redevelopment by retailers more economically feasible.

     -- J. C. Penney's White Plains Galleria is a typical urban project; but economic considerations currently limit this type of project.

PREPARED WRITTEN STATEMENT
OF
DONALD V. SEIBERT
CHAIRMAN OF THE BOARD
J. C. PENNEY COMPANY, INC.
BEFORE THE
FINANCE COMMITTEE
UNITED STATES SENATE

JULY 30, 1980

On Behalf Of American Retail Federation; National Retail Merchants Association and the following companies: Allied Stores Corporation; Associated Dry Goods Corporation; Carter Hawley Hale Stores Inc.; Dayton Hudson Corporation; Federated Department Stores; K mart Corporation; R. H. Macy and Company, Inc.; The May Department Stores; Montgomery Ward & Company; J. C. Penney Company, Inc.: Sears, Roebuck and Co.; and F. W. Woolworth Co.

My name is Donald V. Seibert, and I am Chairman of the Board of J. C. Penney Company, Inc. Insofar as concerns the need for a substantial business tax reduction, basically in the form of the 10-5-3 capital cost recovery proposal, I am also expressing the views of the American Retail Federation, the National Retail Merchants Association and twelve of the largest retail companies. There are nearly 2 million retail establishments throughout the country. Some are large, but most are small businesses. In fact, about half of all small businesses are retailers.

Congress should enact, this year, a substantial business and individual tax cut for 1981. No purpose is served by postponement of the inevitable necessity to at least partly offset the enormous implicit increase in tax burdens as the result of inflation since 1978. Postponing enactment of a tax cut merely perpetuates uncertainty and delays the intended economic recovery which will result from new capital investment and increased output. Business requires a certain amount of lead time to plan capital investments. If, for example, business leaders knew this September that beginning January 1, 1981, substantially increased capital cost recovery allowances would be available, the planning process could begin and we would have a head start of 4 to 6 months or even longer. In effect, the process of economic recovery could begin in 1980, while the tax revenue cost could be delayed until 1981.

Past experience indicates that, if postponed until next year, the tax cut might not be finally enacted, and the veil of uncertainty lifted, until mid-summer of 1981 or later. For more than a year now, there has been almost incessant talk, inside and outside the Congress, about a major increase in capital cost recovery allowances for business. It is time we brought uncertainty to an end.

Postponing enactment of a tax cut until next year could be justified only if, first, it were thought that the reasons for a substantial tax cut would go away between now and next January; or second, it were thought that a tax cut of the type being discussed is inflationary or would be more inflationary if enacted in 1980 to take effect January 1, 1981, than if enacted next year.

As to the first point, neither the Commerce Department data released last week, which show a 9.1 percent annual rate of decline in real output for the second quarter, nor the President's mid-session review of the FY 1981 budget, gives any encouragement that our difficulties will cure themselves. Absent any policy changes, that forecast predicts 8 1/2 percent unemployment and 10 percent inflation in 1981, plus a $30 billion deficit which reflects increased outlays for unemployment compensation and other recession-related costs, as well as less-than-expected receipts as a result of a lower level of economic activity. The compelling reasons for a major tax reduction for 1981 are not short-term, nor do they suggest a counter-cyclical tax reduction to stimulate demand. Rather, the economic trend reflected by declining rates of personal savings, declining capital investment and declining productivity growth rates, both in terms of our own past history and relative to the experience of other countries, is strong evidence of the need to enact tax measures that will have a long-term anti-inflationary effect. These fundamental reasons for a major reduction in tax burdens will definitely not go away between now and next January.

As to the second point, an individual tax reduction to take effect on January 1, 1981, which would offset, in part, the implicit individual tax increase since 1978, and which would not significantly increase spendable income until well into 1981, is not inflationary whether enacted now or enacted early next year. These implicit tax increases have, along with monetary policies, played a role in slowing the economy and producing the presently projected $30 billion deficit for 1981. If a continuation of an already too heavy tax burden merely served to restrain the upward spiral in price levels, that would be desirable and a tax cut might be postponed; but if, instead, these continued heavy tax burdens serve to restrain economic growth, a tax reduction is in order and the result of that tax reduction will be to decrease, not to increase, inflation. Inflation-generated tax increases have pushed personal taxes as a percent of personal income to record levels. This in turn has fueled the growth of a Federal sector whose budget outlays are growing at a faster pace than economic activity generally.

A business tax reduction which increases investment, which increases efficiency and which increases output is not inflationary. Just the opposite is true. The answer to inflation is to enlarge the productive capacity of the economy, thus stimulating economic growth. In that regard, a reduction in presently inflated individual tax burdens does not merely restore to individuals some part of their lost consumption power. Indeed, in current circumstances, that may not even be its principal effect. Such a tax cut also restores to individuals the power to save and invest. In addition, the large number of unincorporated small businesses pay taxes at individual rates, and therefore benefit directly from an individual tax reduction. Thus, within reasonable restraint, an individual income tax cut is very definitely a part of the "supply side" equation and very much a part of the effort to enlarge the economy.

We already have a projected deficit for 1981 of $30 billion due almost entirely to the marked decline in output combined with increased expenditures. A deficit of that variety, which represents government spending out of proportion to the size of the economy, promises only more of our recent experience -- debt financed demand bidding for a constant or declining amount of output. A tax cut would temporarily increase the total accumulated deficit, but at least a deficit of the tax cut variety can be expected to increase productivity and to enhance economic growth over the long term.

In order to enlarge the economy -- more goods and services with any given amount of capital and labor -- we must both produce and distribute more efficiently. Distribution is the function of the retail industry. In effect, production and distribution are the two engines of the economy, at opposite ends of the stream of commerce, which are highly interdependent. Any inefficiencies in the distribution function performed by retailing will impede flows and may offset any efficiencies in the manufacturing; and, vice versa, inefficiency in manufacturing puts great pressure on the retail sector. Therefore, the retail industry is very interested in, and is very much a part of, any tax cut designed to increase investment, efficiency and overall output, having in mind that the distribution function performed by retailing accounts for about 10 percent of GNP.

I have no magic number as to the size of the tax cut, but a total business and individual tax cut for 1981 of about $25 billion as suggested by the recent report of the Joint Economic Committee would seem appropriate for current circumstances. One obvious item to consider is the social security tax. The already heavy burden of payroll taxes on both individuals and businesses will increase in 1981, but a meaningful reduction in social security taxes can only be accomplished in connection with basic structural modifications of the social security system, related to universal coverage, automatic inflation adjustments, and the like. Therefore, without regard to what may ultimately be done to reform the social security system, significant reductions in individual income taxes would appear to be a necessity. Over the long term, Congress should consider adoption of tax incentives which would encourage individual savings, including extension of the TRASOP concept to labor intensive industries.

The business tax cut should include a major increase in capital cost recovery allowances and should be extended to all businesses, large and small, in all sectors of the economy in order to gain the most immediate and greatest response in terms of new capital investment and increased economic output. It would be a mistake to divide the business community into segments, and to provide increased cost recovery allowances for some businesses and not for others. All businesses are interdependent and all businesses must operate in the most productive manner in order that gains in one area not be offset by inefficiencies in another. Also, substantially increased capital cost recovery allowances are necessary for all, not just some part, of every business' fixed capital investments which are required to produce and distribute the greatest amount of goods and services at the lowest cost. From the standpoint of financial reality, I can assure you that the only significant item to a business executive is the total increase or decrease in the after-tax cost of a business' total fixed capital investment; it is not finely-drawn, meaningless distinctions between the different types of capital assets a business may use, and it is not an adequate cost recovery allowance for one asset that would be offset by an inadequate cost recovery allowance for another.

Therefore, the retail industry strongly supports S. 1435, the 10-5-3 capital cost recovery proposal which applies substantially uniform, proportional, cost recovery rates to all types of business fixed capital in depreciable property and which applies in a substantially neutral manner to all types of businesses. Fundamentally, the 10-5-3 proposal will reduce the overall heavy burden of tax on businesses which is an impediment to long-term economic growth. In the near term, a substantial business tax cut will help provide business with the additional after-tax cash flow to maintain critical investment programs for modernization and expansion despite the current pressure on earnings. An update of currently outmoded cost recovery allowances is also justified by the need to offset the enormous implicit increase in business taxes which occurs, as the result of inflation, when depreciation deductions are limited to original cost but income and replacement cost are measured in inflated dollars.

From the standpoint of the retail industry, the 10-year cost recovery period for buildings is critical. About 46 percent of the J. C. Penney Company's annual fixed capital investment is in buildings. Elimination of the 10-year category would reduce by 59 percent the additional capital cost recovery deductions to the J. C. Penney Company. While the retail industry's investments in buildings are unusually large, we are not alone. Buildings are a significant part of fixed capital investment in other industries also. In fact, almost every business consists of a particular mix of buildings and equipment which is designed to achieve maximum productivity. An operating business cannot simply choose to put its money in buildings instead of equipment or vice versa. Both types of capital investments are necessary and the mix is dictated by the requirements of efficiency in that particular business. As Chairman of J. C. Penney Company, I do not think in terms of buildings versus equipment; instead, I think in terms of the total dollar amount of fixed capital investment which is required. I am sure that my colleagues in other industries would agree. The only distinction I or any other business executive makes is the one the present inadequate cost recovery rates for buildings force us to make. We must recognize that inadequate cost recovery allowances for buildings increase our capital costs, which means that at any given level of operation, our companies will have less after-tax cash flow for investment in modern equipment or for investment in the particular mix of modern equipment and modern buildings which is most efficient. This reduced financial capability will, at the margin, translate directly into reduced capital investment at any point in time. Some projects, such as a major modernization of a plant, or the opening of a major new more efficient retail distribution facility, will still be undertaken, but others, where gains in efficiency and output could also be achieved, will be deferred or cancelled.

There is no rational basis for the vast distinction which present depreciation rules make between buildings and equipment. Keep in mind that I am talking primarily about buildings that are used in the active business of producing or distributing goods, and which are integrally related to the equipment and labor components of that business. The 10-5-3 proposal also contains full recapture rules for both buildings and equipment.

There is a definite rationale for the 10-year capital cost recovery period for business buildings and for the relationship of that period to the proposed 5-year cost recovery period for business equipment. A bit of history will assist in understanding that relationship. Back in 1931, buildings and equipment started out with so-called "facts and circumstance" useful lives for tax depreciation which were set forth in an IRS publication called Bulletin F. In Bulletin F, the average depreciation lives for equipment and buildings were, respectively, about

25 years and 50 years. Obviously, there have been enormous structural changes in the economy and in society since that time. In the post-World War II era, those changes occurred rapidly. In 1962, by direct intervention of the Treasury, depreciation lives for equipment were shortened by 40 percent. In 1971, when ADR depreciation was enacted by Congress, the 1962 guideline lives for equipment were shortened by 20 percent. But on each occasion, business buildings were left out of these depreciation reforms. Today, the 1971 ADR equipment depreciation lives should be shortened to 5 years as provided under the 10-5-3 proposal, which means that equipment depreciation lives would now be 80 percent shorter than the old Bulletin F lives which date back to 1931.

The 10-year capital cost recovery period for buildings reflects this same 80 percent reduction in the old Bulletin F lives for buildings. In other words, 10-5-3 would make up the deficit situation in building depreciation lives as a result of buildings having been left out of the depreciation reforms in 1962 and 1971. Also, based on Treasury data, the 10-year period for buildings and the 5-year period for equipment, respectivly, bear the same relationship to the so-called "facts and circumstance" useful lives of buildings and equipment.

There is no reason to believe that all the economic and social changes in the post-World War II era that justified shortening equipment depreciation lives in 1962 and 1971 did not also affect buildings. Obviously, they did. One need only compare older factory buildings with newer ones, or consider the design, size and construction of more modern retail and wholesale distribution facilities, to realize that there is just as much "in place" economic obsolescence with buildings as with equipment. The fact that a building may still exist many years after being built is not the significant point. The question is whether it is wholly or partially obsolete, in the sense that it is a less efficient tool in the production or distribution of goods, and ought to be replaced. Depreciation lives for equipment were shortened in 1962 and 1971 not because the physical lives of that equipment had somehow become shorter, but because the equipment was less efficient and, therefore, obsolete. Some of the less efficient equipment which was replaced as a result of the depreciation changes in 1962 and 1971 is still in use, in some marginally economic way by some other business which acquired the equipment in used condition. Other obsolete equipment is sold for scrap. Buildings, however, cannot readily be converted to scrap. It is a costly process to demolish a building. Therefore, many older buildings still exist and are used in some way although they are in fact obsolete.

There is also no reason to think that buildings are any less affected by the rapid changes of the late 1970's, and what we expect for the 1980's as we continue to adjust to higher energy costs and the accumulated effects of inflation. In the retail area, for example, more and more buildings are becoming obsolete for retail use as the result of new techniques of goods handling, inventory, storage and display, as the result of the need to conserve energy, and as the result of fundamental changes in consumer demands and locations.

As recognized in the 1980 Economic Report Of The President, inflation has a much greater adverse effect on buildings than on equipment, because of the presently much longer depreciation lives for buildings. The President's report also notes with concern that business investment in buildings has continued to account for a smaller portion of real GNP than it did in every year between 1947 and 1974. The President's report correctly attributes this substantial investment distortion to the fact that buildings have been excluded from the investment tax credit and have been denied the depreciation benefits extended to equipment.

As already noted, in order to enlarge the economy we must both produce and distribute more efficiently. The retail industry has a record of efficiency. Over the past 25 years, the Consumer Price Index has risen about 170 percent, but the Department Stores Inventory Price Index has risen only about 100 percent. While the U. S. retail industry is today the world's most efficient distribution system, large and continuing capital investments are necessary to maintain this efficient distribution system. However, the retail industry is taxed at one of the highest effective rates of tax of any sector of the economy. Moreover, the cost of buildings, one of the industry's principal productive tools, has increased much more than the GNP deflator.

Measured in constant 1972 dollars, fixed capital investment in commercial buildings (other than office) actually declined 1973-1979, compared to increases in expenditures for both producers durable goods and industrial construction. The return on invested capital in the retail industry has been lower than in the case of the Fortune 100 companies as a group.

A healthy retail industry is vital to the economy. Instead of being concentrated in a few regional locations, retailing is nationwide, located in every village, town and city. Retailing has a payroll of about $80 billion and currently employs more than 14 million people. One out of every six jobs is in retailing. One out of every five new jobs created in the 1970's was in retailing. A large number of retailing jobs are filled by less skilled, less experienced workers, as well as by mothers with young children, by students and by older persons who seek work but cannot work full-time. In any economic downturn, these types of workers are, as a group, generally the first to become unemployed. Even in a period of stong economic activity, they are a growing portion of the "structurally" unemployed.

The retail industry also plays an important role in alleviating another structural problem; the plight of many downtown areas and older central cities. By definition, retail and other commercial buildings form the economic framework of a town or city. As industrial plants tend less and less to be located in cities because of environmental concerns and other factors, the particular suitability of retail businesses becomes increasingly important. This was recognized in a 1978 study by the Congressional Budget Office. Urban redevelopment often starts with a new, large and modern retail store which serves as the catalyst and anchor for revitalizing the whole area. The additional employment and consumer traffic generated by such a new retail establishment quickly attracts other businesses to the area, and the process of redevelopment goes on.

In Philadelpnia, Boston, White Plains, Stamford, and elsewhere around the country, major retail developments are augmenting and refurbishing the older business areas as places to shop and work.

For example, the Galleria of White Plains in White Plains, New York, is opening this year and will include a large J. C. Penney Company, Inc. store and a large Abraham & Straus store, plus 160 other stores, 22 restaurants and a major theatre complex. This redevelopment, like others, has occurred in an important, previously blighted, urban area which will now be revitalized. About 40,000 people will pass through the Galleria daily. It will employ approximately 2,500 full-time and 1,500 part-time employees. City planners expect that the Galleria will markedly increase both sales tax and property tax revenues. In addition, the catalyst provided by the Galleria has led to additional proposals for construction of office buildings, a civic center, and apartments which will further enlarge the economic base of the city and increase local tax revenues. City planners are projecting new parks and a regeneration of surrounding residential neighborhoods.

Conclusion

In conclusion, from an overall standpoint I believe that there are compelling reasons for a substantial tax reduction to take effect January 1, 1981. We in the retail industry believe that all these sames reasons -- plus the important societal roles played by retailing, as well as plain equity of treatment -- more than justify providing tax relief to the retail industry in the same way provided to other businesses. We reiterate our strong support of the 10-5-3 cost recovery proposal. But we reemphasize the critical importance of the cost recovery period for retail buildings.

I thank the Committee for its attention and will be pleased to answer any questions.

NMRI
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Richard I. Hersh
President

Before the
Committee on Finance
United States Senate

STATEMENT OF

MR. DAVID W. GODFREY

Chief Executive Officer

Hart Stores, Inc.

ON BEHALF OF THE

NATIONAL MASS RETAILING INSTITUTE

July 30, 1980

STATEMENT OF DAVID W. GODFREY

NATIONAL MASS RETAILING INSTITUTE

Summary of Principal Points

1. NMRI believes that it is essential that tax cut legislation be enacted this year, effective not later than January 1, 1981, in order to stimulate capital formulation and increase productivity.

2. NMRI strongly supports S. 1435 , known as the Jones-Conable bill, because this bill is carefully thought out comprehensive legislation which should stimulate major segments of the American economy.

3. NMRI is particularly concerned that the 10-year write off for commercial real estate be enacted. This portion of the Jones-Conable legislation will be of the greatest benefit to our industry because so much of our capital must be invested in retail outlets and storage facilities.

4. NMRI believes that the tax legislation enacted this year should be part of an overall restructuring of our tax system. Basically, the tax burden on the supply side of the economy must be reduced if United States business is to be able to meet foreign competition and if the current high unemployment rate is to be reduced.

STATEMENT OF DAVID W. GODFREY

My name is David W. Godfrey. I am the Chief Executive Officer of Hart Stores, Inc. of Columbus, Ohio. I am also Chairman of the National Mass Retailing Institute, on whose behalf I am testifying today.

NMRI is a trade association consisting of over 110 major retail stores operating in 48 of the 50 states. Annual sales of the member-companies are in excess of $50 billion per year.

I am here to strongly urge the enactment of tax-cut legislation which is designed to meet the most critical problems now facing the American economy. Specifically, I urge that the Congress enact S. 1435, the Senate version of the Jones-Conable bill, adopting all features of that legislation as introduced.

The provision of that bill of greatest importance to the retail trades is the amendment which would provide a more realistic 10-year write off for commercial real estate.

As you must know, the American economy is doing badly. In recent years the United States increase in productivity has been lower than that of every other major Western economy. Even Great Britian has averaged an annual productivity growth rate which is double that of the United States. Investment rates in the United States are also far lower than those in almost any other Western democracy. During 1979, personal savings rates in the United States were so low as to be almost unprecedented.

American businessmen face double-digit inflation and the capital markets for corporations, particularly the bond market, are in total chaos. In the second quarter of this year the nation's economic output plunged 9.1 percent, a rate of decline as bad as any since World War II.

In a statement made on July 18, 1980, Courtenay Slater, Chief Economist for the U.S. Department of Commerce, predicted that unemployment will reach 8.5 or 9 percent. This prediction is consistent with a recent statement by Charles Schultze, Chairman of the Council of Economic Advisers.

This high unemployment is occurring at a time when inflation is still hovering slightly above 10 percent and prime interest rates are ranging between 11 and 12 percent.

It is obvious that strong measures must be taken to stimulate the economy.

It is equally obvious, I hope, that a tax cut must be structured in such a way as to stimulate the supply side of the economy and must be accompanied by other measures, most importantly a reduction in government spending, to prevent the start of yet another inflationary spiral.

The Jones-Conable bill is certainly a critical step in helping to turn our economy around. The legislation will make it possible for many businesses to make investment which will probably not be possible without this legislation. I also feel that enactment of the legislation will send a strong signal to the business community that government is concerned about the problems of business and is ready to provide the stimulus that is necessary to place the American economy on a sound footing once again.

This legislation would greatly simplify the complicated depreciation rules which all businesses must live with under present law. The bill will also help businesses to find the capital necessary to improve and expand their existing facilities by allowing companies to write off the cost of those improvements over a realistic period. One of the problems which all of us face is that the current allowance for depreciation is simply inadequate in light of the fact that the replacement cost of our fixed assets are rising so rapidly because of inflation. The Jones-Conable bill will help to correct this situation.

The Jones-Conable bill will also rectify a situation which places the United States at a serious competitive disadvantage as compared to businessmen operating abroad. The United States has an average business cost recovery period of about 15 years. Most foreign governments allow cost recovery of capital assets within a time period of no more than 10 years.

The part of the legislation which is of the most importance to the retail trades is the provision which will permit a 10-year write off for commercial real estate. Much of our investment is in retail outlets, warehouses and similar facilities. Enactment of the Jones-Conable bill, including the 10-year write off for commercial real estate, should make it easier for companies in the retail industry to expand and improve their facilities. Without this provision, retailers would receive significantly less benefit from the legislation.

The retail industry is a major employer with 14 million persons on its payroll. It accounts for more than $800 billion in annual sales. Retailers today employ one out of six American workers. Between 1948 and 1977, employment in retail and wholesale trade increased 105 percent compared with 25.8 percent in manufacturing. And between 1965 and 1976, employment in general merchandise retailing increased by 31.6 percent compared with 23.2 in total U.S. employment. Retail investment often stimulates employment in the inner city and elsewhere of many part-time and semi-skilled workers, including married women returning to the work force, students and older persons.

Yet according to Treasury Department studies, retailing pays among the highest effective federal income tax rates of any major business group, and has done so consistently over a period of years. This is caused, in large measure, by the fact that retailing obtains proportionately less benefit than other industries from such tax incentives as the investment tax credit and depreciation deductions.

The real estate portion of the Jones-Conable bill would go far to correct this situation. Because of the highly competitive nature of retailing, the savings it would enjoy from these tax reforms would be quickly passed on to the consumer. Moreover, there might also be benefits in terms of energy policy. The Jones-Conable bill would encourage investment in new buildings and experience has demonstrated that new buildings are more economical to operate than older structures and particularly are more energy efficient at a time when great stress is properly placed on the need to conserve energy.

The Treasury Department is opposed to the real extate provision because of the potential revenue costs which may be involved. However, Treasury's own figures indicated that the revenue cost should not be an issue. In 1979, corporate income taxes were approximately $70 billion. If no changes are made in present law, Treasury predicts that corporate taxes will rise to a staggering $118 billion by 1984. Even if the Jones-Conable bill were to cut corporate taxes by the approximately $50 billion which Treasury predicts, corporations would still pay the same amount in taxes in 1984 as they paid last year. These computations do not even take account of "feed back" revenues which would be received by Treasury as a result of the stimulative effect which the Jones-Conable bill would have on the economy. Even Treasury concedes that this feed back would wipe out about 30 percent of the revenue losses.

The real extate provision has also been criticized on the ground that it might serve as a vehicle for a tax shelter conferring unintended benefits on persons not using commercial property for legitimate business purposes. However, there are ways to prevent this. One device which might be considered would be to provide in the legislation that the 10-year write off for real estate would not be available to the "ron-corporate lessor", thereby making it difficult or impossible for individuals not engaged in a legitimate trade or business to use the 10-year write off to shelter non-business income by leasing their real property to others.

I would like to comment briefly on one issue pending before the Congress; that of a restructuring of the U.S. tax system. Specifically, I would like to comment on VAT.

NMRI has not taken a formal position on VAT. We believe it could be inflationary and possibly inequitable as well. Some of the inequities might be reduced by exempting critical items such as food, medical supplies and shelter, but as the tax is made more equitable, it will invariably become more complex as well.

The VAT could have a serious adverse impact on the retail trades. In fact, one stated purpose of the tax is to discourage consumption. This potentially means reduced sales and fewer jobs in our industry.

The retail trades are already in trouble. According to Department of Commerce figures, the recent combination of declining real incomes and a slight rise in personal savings have led to a big drop in consumer spending. With this in mind, the Congress should look long and hard into any tax which could exacerbate the problems of an already declining industry.

Of course it is to be hoped that American exports will increase, but in today's highly competitive world economy, it is unrealistic to expect that an increase in America's share of world exports will offset any serious decline in U.S. consumer spending. As Chief Economist Slater pointed out in her recent remarks, the consumer sector accounts for two-thirds of the gross national product and that sector must inevitably "lead everything". A tax, such as VAT, which causes a decline in the retail sector, will inevitably "lead" every other sector of the American economy into decline.

There is a need for a restructuring of the American tax system and the American economy. But constructive results will not flow by encouraging a change from consumption to production. Rather, the need is for a change from "government" to production. The basic restructuring which should occur is the reduction of the ratio of taxes to the total gross national product with a corresponding reduction in government spending. By this means, and only by this means, can we have a tax cut which will stimulate the economy and reduce unemployment, without triggering a potentially ruinous new round of inflation.

APRA TAX PROPOSALS

* * * * *

AMERICAN PETROLEUM REFINERS ASSOCIATION

on behalf of

Small, Independent Domestic Refiners

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July 15, 1980

APRA TAX PROPOSALS

The American Petroleum Refiners Association represents 64 small and independent refiners. In addition, it has 21 associate members. Also, APRA is the largest trade association representing small, independent domestic refiners.

APRA recently caused a study to be made of the existing tax provisions applicable to small refiners and possible changes in those provisions that might help the small refining industry survive the current turmoil caused by abrupt decontrol of domestic oil prices, the phase out of entitlements, increasing crude oil costs, changes in the existing mix of available crude (from sweet, light crude to more and more sour crude), and the lack of access by small refiners to remaining sweet crude supplies.

As a result of that study and preliminary discussions with others in the industry and persons in Government--both on and off Capitol Hill, APRA has developed a number of tax proposals to provide, during a transition period, a measure of relief to this industry. This work was done with the help of APRA's special tax counsel, Charles M. Bruce of Cole Corette & Bradfield. We have also developed the necessary background information and revenue estimates (with the help of an independent consultant, William K. Hunter, and the accounting firm of Ernst & Whinney) that will be necessary for these proposals to be fairly assessed.

These proposals can be viewed as a package or separately.

Underlying these proposals is the recognition that the small refining industry cannot in the future rely upon government assistance, but must stand on its own. At the same time, the industry is faced with the necessity of financing the conversion of its facilities from refineries processing principally sweet crude oil to more economical, more energy efficient refineries capable of running more readily available crude types.

APRA's tax proposals are intended to help this industry through this transition period and to enable it to stand "on its own two feet."

There are going to be business failures in the small refining industry as a result of the severe changes and new conditions. Without some Government recognition of the need to carefully traverse this transition period, this vital segment of the refining industry may simply disappear--leaving only the major oil companies to meet the nation's needs as they wish. Furthermore, the independent segment throughout the U.S. energy distribution chain (including jobbers, marketers, and service station owners) will be in grave peril as well.

Most objective observers feel that the small refining industry plays a unique and necessary role, for instance, in its production of special products, its servicing of relatively isolated markets, and its development of new, innovative processes, products, and marketing techniques.

These proposals, it is hoped, will enable the industry to continue to help fulfill this country's energy needs.

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President, Laketon Asphalt Refining, Inc.
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Terry P. Gallagher
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S - U - M - M - A - R - Y

PROPOSALS FOR SMALL AND INDEPENDENT REFINERS

Small and independent refiners in this country face fierce competitive pressures from the major, integrated oil companies, on the one side, and erratic marketplace and regulatory forces on the other.

They and the country together face the need to produce a wider range of more sophisticated petroleum products at a lower cost to the consumer, to adjust to a more sour crude oil supply, and to continue to serve the many diverse--sometimes isolated--domestic markets.

In order to create a stable economic climate, in which refiners that are willing to adapt to the needs of the country can survive, the American Petroleum Refiners Association ("APRA") and its member companies are proposing that new tax and other legislative and administrative measures be adopted.

The proposals can be viewed as a package or separately.

A number of the proposed provisions would be temporary. They would apply only during a transition period lasting a few years (remembering, however, that delays in obtaining permits can postpone refinery construction for 5 years or more).

Given these measures, the small and independent refiners will be able to produce the petroleum products that this society needs and do so in competition with some of the world's largest corporations.

APRA and its members propose, for small and independent refiners:

-- INCENTIVES TO "FREE-UP" CRUDE OIL SUPPLIES for small and independent refiners;

-- AN ADDITIONAL 10 PERCENT INVESTMENT TAX CREDIT for certain investments in new refining equipment that expands and modernizes existing refinery facilities so as, for example, to permit the processing of more sour crude and to conserve energy;

-- BROADENED ASSET DEPRECIATION RANGE (ADR) for this same type of investment to permit a lower range life of 7 years;

-- allowance of an IMMEDIATE WRITE-OFF, OR EXPENSING, OF POLLUTION CONTROL EQUIPMENT;

-- RAPID WRITE-OFF OF CERTAIN OBSOLETE EQUIPMENT;

-- NONRECOGNITION TREATMENT (tax to be deferred rather than paid currently) on sale of assets and reinvestment, plus RELAXATION OF EXISTING RESTRICTIONS ON CARRYOVERS OF NET OPERATING LOSSES; and

-- CREATION OF SPECIAL FOREIGN TRADE ZONES for certain refineries, where their operations would be wholly or partially exempt from certain Federal, State and local taxes, duties and fees and from which the reexport of refined foreign crude oil would be simplified.

APRA and its members, together with other organizations and groups, will work with the Legislative and Executive Branches towards enactment of these proposals.

Also, the Administration is presently formulating its capital formation proposals. These proposals should take into account the situation facing domestic small and independent refiners.

REVENUE EFFECTS

The revenue effects of the APRA proposals have been estimated to the extent possible at this time. This work was performed by the accounting firm of Ernst & Whinney, based upon information provided by APRA, its independent consultant, William K. Hunter and its tax counsel, Charles M. Bruce of Cole Corette & Bradfield.

Revenue estimates for three of the proposals (additional 10% investment tax credit, broadened asset depreciation range, and immediate write-offs for pollution control equipment) have been made. One of the proposals (incentives to "free-up" crude oil supplies) is not susceptible of accurate revenue estimates at this time, due to the difficulty of estimating the response to such a proposal and the size of the deduction that would be necessary to create an effective incentive. The revenue effect of another proposal (relaxation of existing restrictions on carryovers of net operating losses) could not be accurately determined because the NOLs of small refiners cannot be accurately estimated and, furthermore, no reasonable estimate can be made of the extent to which such NOLs ultimately would be utilized. In any event, it is likely that this proposal would have a negligible revenue effect. One proposal (rapid write-off of certain obsolete equipment) is thought to be largely a clarification of existing practice.

Two remaining proposals (changes in the non-recognition rules and creation of special foreign trade zones) are estimated to have only slight revenue effects. For the three proposals for which revenue effects are available, the maximum aggregate revenue loss for fiscal year 1980, assuming an effective date for these proposals of January 1, 1980, would be $42.4 million; for fiscal year 1981, $164.5 million; and for fiscal year 1982, $236.9 million.

The revenue effects of the proposals can be summarized as follows:

-- Aggregate Revenue Effects. Taking into consideration the three proposals for which revenue estimates are available, the maximum aggregate revenue effects for each year in a 10-year period beginning with 1980 are as follows:

	Calendar Year (in millions)	Fiscal Year (in millions)
1980	($ 56.6)	($ 42.4)
1981	($ 195.7)	($ 164.5)
1982	($ 240.2)	($ 236.9)
1983	($ 226.9)	($ 231.1)
1984	($ 230.8)	($ 228.7)
1985	($ 204.3)	($ 211.5)
1986	($ 122.9)	($ 141.5)
1987	($ 46.5)	($ 61.0)
1988	$ 19.0	$ 6.3
1989	$ 68.1	$ 59.1

-- Revenue Effects for Four Hypothetical Refiners. Revenue estimates were made for four hypothetical refiners. These estimates show the magnitude of the tax benefits being proposed in comparison with the expenditures that will have to be made by small refiners.

A small, sweet crude refiner that finds itself faced with the necessity of processing sour crude--or going out of business, will need to spend as much as $140,000,000 in order to upgrade its facilities. This expenditure will allow it to operate at a capacity of 30,000 bpd. In the likely event that it decides at the same time to expand its capacity, the required expenditure may be twice that amount.

For purposes of illustration, four hypotheticals were developed: Refiner A has a Category I refinery and expends $28,100,000 to expand its facility and move into Category II. (This development is unlikely to occur since Refiner A would simply be increasing its capacity and therefore compounding its marketing problems; it would not be growing in sophistication of processing or improving the marketability of its product slate.) Refiner B has a Category I refinery and expends $77,500,000 to move into Category III. Refiner C has a Category I refinery and expends $127,900,000 to move into Category IV. Refiner D has a Category I refinery and expends $139,100,000 to move into Category V.

For purposes of these estimates, the small refining industry is divided into the following five categories:

Category	Operation Type	Crude Oil Capacity	Crude Oil Type
I	Topping	8,500 BPD	Lt. Crude with 0.5% S
II	Topping	30,000 BPD	Lt. Crude with 0.5% S
III	Hydroskimming	30,000 BPD	Lt. Crude with 0.7% S
IV	Catalytic Cracking	30,000 BPD	Lt. Crude with 2.0% S
V	Hydrocracking	30,000 BPD	Lt. Crude with 2.0% S

The total and individual year revenue effects for each hypothetical refiner are as follows (in thousnds of dollars):

Refiner A	1980	1981	1982	1983	1984
	(23.5)	(237.2)	(517.6)	(1,194.0)	(1,891.2)
	1985	1986	1987	1988	1989
	(1,645.6)	(1,061.3)	(659.8)	(310.7)	38.4

Refiner B	1980	1981	1982	1983	1984
	(65.0)	(654.3)	(1,448.5)	(3,409.1)	(5,398.0)
	1985	1986	1987	1988	1989
	(4,675.4)	(3,009.4)	(1,869.7)	(879.2)	113.9

Refiner C	1980	1981	1982	1983	1984
	(107.4)	(1,079.8)	(2,428.7)	(5,842.2)	(8,607.5)
	1985	1986	1987	1988	1989
	(6,811.4)	(4,269.7)	(2,655.3)	(1,249.6)	168.7

REFINER D	1980	1981	1982	1983	1984
	(116.8)	(1,174.3)	(2,639.8)	(6,345.3)	(10,057.5)
	1985	1986	1987	1988	1989
	(8,687.8)	(5,591.5)	(3,477.4)	(1,639.4)	203.5

July 15, 1980

BACKGROUND MEMORANDUM
PROPOSALS FOR SMALL AND INDEPENDENT REFINERS
AMERICAN PETROLEUM REFINERS ASSOCIATION

This memorandum discusses tax and other measures proposed by the American Petroleum Refiners Association and its members on behalf of domestic small and independent refiners.

Small refiners range up to 50,000 bpd in capacity. Independent refiners are generally those refiners that have less than 30% of their own crude oil supplies and must rely on others for the remainder. As a group, these refiners are generally referred to as "small refiners".

The proposals can be viewed as a package or separately. A number of the proposals might be applied only during a transition period lasting a few years. It should be pointed out, however, that due to delays in obtaining permits, construction and expansion of refining facilities can be delayed for 5 years or more.

These proposals are intended to allow small and independent refiners to effectively compete with the major oil companies in meeting the needs of consumers for a growing list of sophisticated petroleum products. At the same time, they encourage

--getting the most out of each barrel of crude oil;

--utilizing the refining capacity and talents of this country in the most economical fashion;

--the establishment of a logical and workable national refining policy.

INCENTIVES TO "FREE-UP" CRUDE OIL SUPPLIES

There are precedents for using tax incentives to promote certain types of behavior. For example, included in the Energy Tax Act of 1978 were incentives for conversion to coal-fired boilers. Also, there is precedent for applying incentives in order to compel or coax one taxpayer to make something available to another taxpayer. For example, Section 1071 of the Code ("Gain From Sale or Exchange to Effectuate Policies of F.C.C.") provides for the nonrecognition of gain or loss when a station owner is forced to sell his property pursuant to an F.C.C. policy.

Major, integrated oil companies should be encouraged to make appropriate quality crude oil supplies available to small and independent refiners by the application of tax provisions. This goal can be achieved, for example, by allowing tax deductions for companies that have these supplies but that opt to process sour, heavier crudes instead. The amount of the deduction might be set at a level sufficient to offset approximately the cost differential between sweet and sour crudes, the operating cost differential between processing sweet and sour crudes (such as additional costs for hydrogen, chemicals, fuel, etc; but not capital costs for equipment), and the estimated "market penalty" for producing a product slate from sour crude supplies.

Adequate domestic supplies of crude appropriate for processing by small refiners presently exist. These supplies should be made available to small refiners during a transition period (during which these refiners will convert and retrofit). Certainly, small refiners should not be subjected to the deliberate withdrawal of these supplies from the marketplace by the majors.

INCENTIVES FOR CONVERSION AND RECONFIGURATION

Tax incentives should be provided for certain types of qualified expenditures. Qualified expenditures should include:

--Expenditures for equipment added to or replacing an existing petroleum refining facility. The purpose of this provision is to encourage increased efficiency, reduce operating costs, and improve safety of operations. The provision is also intended to encourage small refiners to attain economies of scale.

--Expenditures for equipment for converting or modifying existing petroleum refining facilities from sweet, light crude processing to sour, heavy crude processing. Specific items of equipment (such as, equipment specially designed to permit the processing of highly-corrosive high sulfur crude oil, residual oil desulfurization units, and coking and visbreaking units) should be listed in the statute. The purpose of this provision is to facilitate the adaptation of this segment of the refining industry to changes in the mix of available crude oil supplies.

--Expenditures for certain specified equipment that is added to an existing petroleum refining facility. This equipment should be listed in the statute. Examples might include a catalytic cracking unit, a reformer, and a hydrocracking unit. The purpose of this provision is to promote the production of certain products, such as, unleaded gasoline and petroleum feedstocks, by small and independent refiners.

--Expenditures for equipment for conserving energy where these expenditures do not presently qualify under the Energy Tax Act of 1978.

The incentives would be in the form of an additional 10% investment tax credit (on top of the existing 10% investment tax credit and 1 1/2% TRASOP credit) and a broadened Asset Depreciation Range (ADR) to permit a lower range life of 7 years.

The additional investment tax credit should be made refundable if and when the existing 10% investment tax is made refundable.

Analogues for each of these forms of incentives currently exist in the tax law. For example, in the Energy Tax Act of 1978 (P.L. 95-618), Congress provided an additional 10% investment tax credit for the following types of energy property: alternative energy property, so-called specially defined energy property, solar or wind energy property, recycling equipment, shale oil equipment, and equipment for producing natural gas from geopressurized brine. Section 48(1), Internal Revenue Code of 1954. Other examples are the 5-year amortization rule for certain pollution control facilities (section 169) and the additional limited first-year depreciation allowance for small businesses (section 179). Additional examples were added by the recently enacted Crude Oil Windfall Profits Tax Act of 1980.

RAPID AMORTIZATION OF
POLLUTION CONTROL FACILITIES

Under existing law, a taxpayer may elect to write-off over a five-year (60-month) period the cost of certain certified pollution control equipment. Section 169, Internal Revenue Code. This provision came into the law as part of the 1969 Tax Reform Act and was made permanent by the Tax Reform Act of 1976. The 1976 Act also extended the provision to cover equipment placed in service after 1975 if installed in plants that were in operation before 1976. In order to qualify, the facility must be used in connection with a plant or other property in operation before 1976.

Petroleum refiners should be allowed to expense Government mandated equipment (that is, to write it off in one year). Proposals along these lines for all industries were proposed, and have received considerable support, in the Ninety-Fourth, Ninety-Fifth and Ninety-Sixth Congresses.

TAX WRITE-OFFS FOR
OBSOLETE EQUIPMENT

At present, obsolescence is a factor in computing depreciation. Thus, if a piece of equipment were suddenly to become obsolete, depreciation on the remaining depreciable basis should be accelerated or that basis should simply be written-off. In the Revenue Act of 1978, special treatment was provided for depreciation of a gas or oil-fired boiler which is retired or replaced before the end of the originally determined useful life.

A provision should be instituted to clearly designate certain outmoded refining equipment as obsolete and subject to an immediate write-off. Much of this equipment can properly be written off under current rules; as to that type of equipment, this provision would merely codify existing practice. Included in the category of "obsolete" equipment should be equipment with high maintenance costs, a poor safety record, or high energy/cost inefficiencies. Refinery equipment that leaves a high percentage of "bottoms" should be viewed as obsolete in today's economy.

Moreover, the Treasury Department should issue rulings or regulations permitting a write-off for certain existing petroleum refining assets on the ground that these assets have been made obsolete by changes in the mix of available crude supplies and the prevailing regulatory scheme. This action can be taken apart from any legislative action.

NONRECOGNITION AND NOL PROVISIONS

In order to attract new equity investment in the small refining industry, several technical changes should be enacted with respect to small refiners.

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--The sale should be treated as a nonrecognition transaction. The sellers should not be taxed on any gain so long as it is reinvested in another small business within an 18-month period. Proposals along these lines have been put forth on several occasions in the past. There are a number of nonrecognition provisions in the tax law today.

--Existing restrictions on carryovers of net operating losses (NOLs) should be relaxed, so that an acquiring corporation can take advantage of the losses generated prior to sale.

FOREIGN TRADE ZONES FOR REFINING ACTIVITIES

There presently exists the concept of foreign trade zones. These are areas established under Federal statutes where goods can enter the country and be worked on -- bulk packages can be broken down and inspected, goods can be assembled, some manufacturing using imported raw materials can even take place -- without being subject to customs entry, payment of duty, certain Federal taxes, some personal property taxes, or bond. Some States and localities do not apply their property tax to these foreign trade zones either by statute or on the ground that Federal law preempts them from doing so.

Federal statutes should encourage small and independent refiners to establish and operate refining facilities in foreign trade zones.*/ Also, refineries so located, whether they act only as refiners or also as importers of foreign crude, should incur import fees only on quantities of product shipped out of the zone. Also refiners located in these zones should be permitted to freely reexport products refined from foreign crude oil pursuant to toll refining agreements, under a general license for reexport. Under a toll refining agreement, a domestic refiner acquires foreign crude oil supplies for a stated per barrel price plus the commitment to refine and reexport a certain amount of foreign crude oil.

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*/ At least two small refineries at present operate in foreign trade zones. Any site within the United States, upon application and authorization, can be designated a foreign trade zone. A plant or a warehouse or a refinery need not be moved or relocated.

Ernst & Whinney

1225 Connecticut Avenue, N.W.
Washington, D.C. 20036

202/862-6000

July 15, 1980

Mr. Ray F. Bragg, Jr.
Executive Director
American Pétroleum Refiners Association
Washington, D.C. 20036

Dear Mr. Bragg:

At your request we have prepared a report on the revenue effect of seven legislative proposals designed to help small refiners compete effectively after the entitlements program is phased out. The legislative proposals considered were:

- An Additional 10 Percent Investment Tax Credit.
- Broadened Asset Depreciation Range.
- Immediate Write-Off of Pollution Control Equipment.
- Incentives to "Free-Up" Crude Oil Supplies.
- Rapid Write-Off of Certain Obsolete Equipment.
- Rollover Treatment on Sale of Assets Plus Relaxation of Existing Restrictions on NOL Carryovers.
- Creation of Special Foreign Trade Zones.

In addition to our principal conclusions regarding the estimated revenue effects of your proposals, we also have set forth our analysis and estimated revenue effects in respect of four hypothetical cases developed by APRA. They illustrate the revenue effect of upgrading and expanding certain small "profile" refining operations. In all cases the projected effects on revenues are based on the information supplied by you and Mr. William K. Hunter.

We appreciate the cooperation and information provided by you and Mr. Hunter. If you have any questions concerning any aspect of our report, we would be pleased to respond to your inquiry.

Very truly yours,

Ernst & Whinney

AMERICAN PETROLEUM REFINERS ASSOCIATION

REVENUE EFFECT OF LEGISLATIVE PROPOSALS

In General

Pursuant to the request of the American Petroleum Refiners Association (APRA), the attached estimates have been prepared setting forth the approximate revenue loss to the U.S. Treasury of certain legislative proposals recommended by APRA and its membership. These revenue estimates are based upon assumptions and other information supplied by Mr. William K. Hunter, special consultant to APRA, and Mr. Ray F. Bragg, Jr., Executive Director of APRA. (The estimates do not take into account any possible "feedback" effect.)

The legislative proposals submitted by APRA are as follows:

- AN ADDITIONAL 10 PERCENT INVESTMENT TAX CREDIT for certain investments in new refining equipment that expands and modernizes existing refinery facilities;
- BROADENED ASSET DEPRECIATION RANGE (ADR) for this same type of investment to permit a lower range life of 7 years;
- IMMEDIATE WRITE-OFF, OR EXPENSING, OF POLLUTION CONTROL EQUIPMENT;
- INCENTIVES TO "FREE-UP" CRUDE OIL SUPPLIES for small and independent refiners;
- RAPID WRITE-OFF OF CERTAIN OBSOLETE EQUIPMENT;
- NONRECOGNITION TREATMENT (tax to be deferred rather than paid currently) on sale of assets and reinvestment plus RELAXATION OF EXISTING RESTRICTIONS ON CARRYOVERS OF NET OPERATING LOSSES (NOLs); and
- CREATION OF SPECIAL FOREIGN TRADE ZONES.

Based on the information supplied by APRA, the estimated revenue effect for the period January 1, 1980 through December 31, 1989 of the first three proposals -- Additional ITC, Broadened Depreciation Range, and Immediate Write-Off of Pollution Control Equipment -- would be $1,236.8 million on a calendar year basis. The estimated revenue effect for each of these years, assuming enactment of all three proposals, is as follows:

	Calendar Year (in millions)	Fiscal Year (in millions)
1980	($ 56.6)	($ 42.4)
1981	($ 195.7)	($ 164.5)
1982	($ 240.2)	($ 236.9)
1983	($ 226.9)	($ 231.1)
1984	($ 230.8)	($ 228.7)
1985	($ 204.3)	($ 211.5)
1986	($ 122.9)	($ 141.5)
1987	($ 46.5)	($ 61.0)
1988	$ 19.0	$ 6.3
1989	$ 68.1	$ 59.1
	($1,236.8)	($1,252.2)

For the remaining proposals it was determined that the revenue effect of the proposals to free-up crude oil supplies, to create foreign trade zones and to relax existing NOL carryover restrictions was not susceptible to estimation. With regard to the incentive proposal, no reasonable estimate can be made at this time of the response of companies holding sweet crude supplies to such a proposal or the amount of the deduction or credit that would be necessary to effect a crude oil cost equalization between sweet and sour crude oil stocks. Likewise, it was not possible to estimate the revenue effect of the proposal to create foreign trade zones. The revenue effect of the NOL proposal could not be determined, because the NOLs of small refiners cannot be estimated and, furthermore, no reasonable estimate can be made of the extent to which such NOLs ultimately will be utilized.

The proposal to defer the recognition of gain on the sale of assets by the small refiners was estimated to have a negligible revenue effect since we understand, and have been advised, that most small refiners would not realize any significant gain on the sale of their equipment due to the high cost of removing it. The proposal for a rapid write-off of certain obsolete equipment was determined to have a negligible effect.

Assumptions and Methodology

In order to compute the revenue effect of the proposals for Additional ITC, Immediate Write-Off of Pollution Control Equipment, and Broadened Depreciation Range, APRA provided the following:

- A list of small refiners and the estimated expenditures to be made by each of them.

- A percentage breakdown of the total expenditures that would be spent on plant equipment, pollution control equipment, and building and site preparation. These percentages varied depending on the magnitude of the project to be undertaken.

The list of small refiners consisted of two parts. First, it listed those refiners that presently are constructing new facilities or are committed to begin such construction (approximately 44 companies), estimated the amount of the expenditures to be made, and specified the year the equipment would be placed in service.

The estimate of the capital equipment placed in service by year for these 44 companies is as follows (in millions):

	1980	1981	1982
Plant Equipment	$616.9	$1,383.6	$246.1
Pollution Equipment	34.4	77.5	13.8
Building and Site Preparation	10.7	29.0	5.1
	$662.0	$1,490.1	$265.0

Second, it indicated which of the 162 existing small refiners likely would make additional expenditures to expand and modernize their refineries if adequate incentives were offered. Of this group, it was estimated that 76 companies would be unable to take advantage of the proposed legislation because of economic circumstances, or the lack of an adequate crude oil supply. The remaining 86 companies were segregated into general expenditure categories of $20 million (69), $100 million (10), and $200 million (7), based on 1979 price levels. In our analysis we have assumed that the companies projected to spend $20 million began planning for their expansion on July 1, 1980, and will complete construction by July 1, 1983. For those companies projected to spend $100 million or $200 million, we have assumed that planning began on July 1, 1980, and construction would be completed on July 1, 1984.

As noted, APRA also provided an estimate of the breakdown of total expenditures between plant equipment, pollution control equipment, and building and site preparation. These percentage breakdowns are as follows:

Total Expenditure (in millions)	% Plant Equipment	% Pollution Equipment	% Building & Site
$ 20	94.8	5.2	0
$100	91.8	5.2	3
$200	92.3	5.2	2.5

In addition, APRA provided an estimate of the flow of expenditures that the refiners would incur. For those small refiners with expansion projects scheduled for completion in 1980-1982, it was assumed that no revenue effect resulted until the project was completed. For those companies with estimated expenditures of $20 million, the flow of expenditures was assumed to be 18%, 62%, and 20% for the subsequent 12 month periods beginning July 1, 1980 and ending July 1, 1983, e.g., 18% of the total expenditure contemplated would be incurred in the period beginning July 1, 1980, and ending July 1, 1981.

For the categories of companies spending $100 million or $200 million, it was assumed that the expenditures would be incurred at the rate of 2%, 16%, 62%, and 20% for each of the twelve-month periods beginning July 1, 1980, and ending July 1, 1984, e.g., for the period beginning July 1, 1982, and ending July 1, 1983, 62% of the total expenditures would be incurred by the refiner. In addition it was assumed for this group that no expenditure for building and site preparation would be made until the 25th month.

Based upon the above information, we computed the revenue effect on the U.S. Treasury for calendar years 1980 through 1989. See Exhibit I and the "Additional Assumptions" which follow:

EXHIBIT 1

AMERICAN PETROLEUM REFINERS ASSOCIATION
Revenue Estimate
(In millions of dollars)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	Total 1980-1989
Additional 10% Investment Tax Credit [1]	(43.6)	(142.8)	(164.5)	(135.5)	(75.4)	(36.3)	(20.1)	(10.1)	(3.1)	(.4)	(631.8)
Immediate Writeoff of Pollution Control Equipment [2]	(7.4)	(15.0)	4.4	(11.2)	(38.0)	6.7	17.3	15.0	13.1	11.5	(5.6)
Broadened Depreciation Range [3]	(13.0)	(52.9)	(75.7)	(91.4)	(155.4)	(168.0)	(102.8)	(36.4)	22.1	68.5	(605.0)
Additional 10% Investment Tax Credit	(43.6)	(142.8)	(164.5)	(135.5)	(75.4)	(36.3)	(20.1)	(10.1)	(3.1)	(.4)	(631.8)
Broadened Depreciation Range	(13.0)	(52.9)	(75.7)	(91.4)	(155.4)	(168.0)	(102.8)	(36.4)	22.1	68.5	(605.0)
TOTAL [1]	(56.6)	(195.7)	(240.2)	(226.9)	(230.8)	(204.3)	(122.9)	(46.5)	19.0	68.1	(1236.8)

[1] Proposal is not affected even if the immediate writeoff of pollution control equipment passes, as refiners will opt for the additional 10% ITC since it results in the greater financial benefit.

[2] Assumes that both the additional 10% ITC proposal and the broadened depreciation range proposal do not pass, since each of those proposals will result in a greater financial benefit to the refiner.

[3] Proposal is not affected even if the immediate writeoff of pollution control equipment passes, since under present law refiners will lose the current 10% ITC that they are entitled to for pollution control expenditures. Thus, the broadened depreciation range and the current 10% ITC results in a greater financial benefit than the immediate writeoff of pollution control equipment.

<u>Additional Assumptions</u>

Because total expenditures were based on 1979 price levels, it was necessary to adjust them for inflation occurring during the construction period. For this purpose, we assumed an annual inflation rate of 10% occurring evenly over the 3 to 4 year period of construction. (For those companies scheduled to complete projects in 1980, 1981, or 1982, no inflation rate was applied since the majority of the expenditures have been incurred or a binding contract in current dollars was assumed to exist.) During the various 12-month periods, the expenditures to be incurred were allocated to various components based upon the ratios of component expenditures to total expenditures to be incurred on the work-in-process during the respective 12-month period. For example, during the period July 1, 1980, to July 1, 1981, it was assumed that, for the 10 refiners in the spending category of $100 million, a total of $20 million (2%) would be incurred in this period and 94.64% (91.8 ÷ 97) would be attributable to plant equipment and 5.36% (5.2 ÷ 97) would be attributable to pollution control equipment. The expenditures for the final 12-month period were allocated to the components in the amount necessary to reflect the appropriate allocations supplied by APRA, <u>i.e.</u>, for refiners expending $100 million, the expenditures for the period beginning 37 months after the commencement of the project would be allocated to the various components to bring the expenditures for plant equipment, pollution control equipment, and building and site to 91.8%, 5.2% and 3.0%, respectively, of the total expenditures. After those amounts were allocated, the assumed inflation rate adjustment was applied to the various component expenditures.

Once the total expenditure, after adjustment for inflation, was allocated by period for each of the various components, the amount of additional investment tax credit was computed on the progress expenditures as permitted under Section 46(d) of the Internal Revenue Code of 1954. It was assumed further that only 90% of the total allowable ITC would be utilized, with 75%, 10%, 5%, 5% and 5% of this amount being claimed in the 5 successive years beginning with the year the progress expenditure for the equipment was incurred. We believe this assumption is consistent with sound revenue estimating practices.

Depreciation was computed on the plant equipment and pollution control equipment using both a 13-year life, the lower limit under the Asset Depreciation Range (ADR) System for Petroleum Refining assets, and a 7-year life under the APRA proposal. For purposes of computing depreciation it was assumed that all assets were placed in service in the middle of the year. In addition, it was assumed that the refiners would maximize depreciation, i.e., adopt the double-declining balance method and switch to the sum-of-the-years-digit method when most advantageous. The tax effect of the difference in depreciation was computed using a 38% effective corporate tax rate which we believe should be representative of the small refiner's industry as a whole.

Finally, the revenue effect of the immediate write-off of pollution control equipment was computed. To compute this amount, the effect of deducting the cost of the pollution control equipment for the year such equipment was placed in service was compared to foregoing both the depreciation deduction based on a 13-year life and the current-law 10% investment tax credit. The difference between the immediate write-off deduction and depreciation was, once again, tax effected at 38%. (It should be noted that a sulfur plant was not treated, for purposes of this proposal, as an item of pollution control equipment.)

As part of the computation, the impact of the immediate write-off proposal was compared to the impact of the additional 10% ITC proposal and the broadened depreciation range proposal. Based on a 10% discount rate, we could not identify any instance where it would be more beneficial for a refiner to elect immediate write-off of the cost of pollution control equipment if either the additional ITC proposal or the broadened depreciation range proposal were enacted. In other words, if all three of APRA's legislative proposals were adopted, the small refiners would not elect the immediate write-off of pollution control equipment. Accordingly, the maximum loss to the U.S. Treasury of the APRA proposals is the sum of the revenue effect of the additional 10% ITC proposal and the revenue effect of the broadened asset depreciation range proposal -- a total of $1236.8 million for the period 1980-1989.

Individual Case Studies

In addition to the revenue effect of the APRA legislative proposals on the U.S. Treasury, APRA requested that we compute the revenue effect of these proposals for certain small refiners for upgrading their present refinery capacity. In particular, APRA requested that the revenue effect be computed for a small refiner for upgrading its operations from a topping operation with 8,500 barrels per day (BPD) of capacity to the following:

1. A topping operation with 30,000 BPD capacity on low sulfur crude oil;

2. A hydroskimming operation with 30,000 BPD capacity on semi-sour crude oil;

3. A catalytic cracking type operation with 30,000 BPD capacity on sour crude oil; and

4. A hydrocracking type operation with 30,000 BPD capacity on sour crude oil.

For further details regarding these various cases refer to the discussion in the APPENDIX hereto which was prepared by Mr. Hunter.

Mr. Hunter supplied a breakdown of the potential cost to a small refiner for each type of expansion proposal allocated among the components of the proposed facility. In tabular form, the breakdown of the estimated costs is as follows (in thousands):

	Hypothetical 1	Hypothetical 2	Hypothetical 3	Hypothetical 4
Plant Equipment	$22,810	$65,050	$106,630	$116,090
Pollution Equipment	2,000	5,400	13,400	14,300
Building & Site Preparation	3,290	7,050	7,870	8,710
TOTAL	$28,100	$77,500	$127,900	$139,100

In order to compute the revenue effect under each hypothetical case, it was necessary to modify certain of the underlying assumptions made with respect to the computation of the aggregate revenue effect. In particular, it was assumed that the marginal tax rate would be 46% and that the refiner would be able to utilize 100% of the ITC earned for the year, assuming that the payments were qualified progress expenditures under Section 46(d) of the Code. As a result of the different allocations in the APRA assumptions and our modified assumptions, the individual cases do not have a direct correlation to the aggregate revenue effect.

Based upon the information supplied, the maximum revenue loss per refiner for hypotheticals one through four would be as follows (in thousands of dollars):

Hypothetical One	- ($ 7,502.5)
Hypothetical Two	- ($21,294.7)
Hypothetical Three	- ($32,882.9)
Hypothetcial Four	- ($39,526.3)

Detailed schedules by proposal for each hypothetical are attached as Exhibits II, III, IV, and V.

EXHIBIT II

AMERICAN PETROLEUM REFINERS ASSOCIATION
Revenue Estimate Hypothetical One
(In thousands of dollars)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	Total 1980-1989
Additional 10% Investment Tax Credit [1]	(23.5)	(237.2)	(517.6)	(1194.0)	(1096.5)	(206.7)	———	———	———	———	(3,275.5)
Immediate Writeoff of Pollution Control Equipment [2]	1.8	19.1	41.7	96.3	(808.5)	(69.5)	155.7	140.9	127.9	114.7	(179.9)
Broadened Depreciation Range [3]	———	———	———	———	(794.7)	(1438.9)	(1061.3)	(659.8)	(310.7)	38.4	(4,227.0)
Additional 10% Investment Tax Credit	(23.5)	(237.2)	(517.6)	(1194.0)	(1096.5)	(206.7)					(3,275.5)
Broadened Depreciation Range	———	———	———	———	(794.7)	(1438.9)	(1061.3)	(659.8)	(310.7)	38.4	(4,227.0)
TOTAL [1]	(23.5)	(237.2)	(517.6)	(1194.0)	(1891.2)	(1645.6)	(1061.3)	(659.8)	(310.7)	38.4	(7,502.5)

[1] Proposal is not affected even if the immediate writeoff of pollution control equipment passes, as refiners will opt for the additional 10% ITC since it results in the greater financial benefit.

[2] Assumes that both the additional 10% ITC proposal and the broadened depreciation range proposal do not pass, since each of those proposals will result in a greater financial benefit to the refiner.

[3] Proposal is not affected even if the immediate writeoff of pollution control equipment passes, since under present law refiners will lose the current 10% ITC that they are entitled to for pollution control expenditures. Thus, the broadened depreciation range and the current 10% ITC results in a greater financial benefit than the immediate writeoff of pollution control equipment.

EXHIBIT III

AMERICAN PETROLEUM REFINERS ASSOCIATION
Revenue Estimate Hypothetical Two
(In thousands of dollars)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	Total 1980-1989
Additional 10% Investment Tax Credit [1]	(65.0)	(654.3)	(1448.5)	(3409.1)	(3142.6)	(592.7)	———	———	———	———	(9,312.2)
Immediate Writeoff of Pollution Control Equipment [2]	5.0	50.1	111.0	261.3	(2183.5)	(187.7)	420.9	381.0	345.4	310.0	(486.5)
Broadened Depreciation Range [3]	———	———	———	———	(2255.4)	(4082.7)	(3009.4)	(1869.7)	(879.2)	113.9	(11,982.5)
Additional 10% Investment Tax Credit	(65.0)	(654.3)	(1448.5)	(3409.1)	(3142.6)	(592.7)					(9,312.2)
Broadened Depreciation Range	———	———	———	———	(2255.4)	(4082.7)	(3009.4)	(1869.7)	(879.2)	113.9	(11,982.5)
TOTAL [1]	(65.0)	(654.3)	(1448.5)	(3409.1)	(5398.0)	(4675.4)	(3009.4)	(1869.7)	(879.2)	113.9	(21,294.7)

[1] Proposal is not affected even if the immediate writeoff of pollution control equipment passes, as refiners will opt for the additional 10% ITC since it results in the greater financial benefit.

[2] Assumes that both the additional 10% ITC proposal and the broadened depreciation range proposal do not pass, since each of those proposals will result in a greater financial benefit to the refiner.

[3] Proposal is not affected even if the immediate writeoff of pollution control equipment passes, since under present law refiners will lose the current 10% ITC that they are entitled to for pollution control expenditures. Thus, the broadened depreciation range and the current 10% ITC results in a greater financial benefit than the immediate writeoff of pollution control equipment.

EXHIBIT IV

AMERICAN PETROLEUM REFINERS ASSOCIATION
Revenue Estimate Hypothetical Three
(In Thousands of dollars)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	Total 1980-1989
Additional 10% Investment Tax Credit (1)	(107.4)	(1079.8)	(2428.7)	(5842.2)	(5406.2)	(1020.2)	—	—	—	—	(15,884.5)
Immediate Writeoff of Pollution Control Equipment (2)	12.0	120.5	271.1	652.2	(5420.4)	(465.6)	1045.7	946.7	858.2	770.1	(1,209.5)
Broadened Depreciation Range (3)	—	—	—	—	(3201.3)	(5791.2)	(4269.7)	(2655.3)	(1249.6)	168.7	(16,998.4)
Additional 10% Investment Tax Credit	(107.4)	(1079.8)	(2428.7)	(5842.2)	(5406.2)	(1020.2)					(15,884.5)
Broadened Depreciation Range	—	—	—	—	(3201.3)	(5791.2)	(4269.7)	(2655.3)	(1249.6)	168.7	(16,998.4)
TOTAL (1)	(107.4)	(1079.8)	(2428.7)	(5842.2)	(8607.5)	(6811.4)	(4269.7)	(2655.3)	(1249.6)	168.7	(32,882.9)

(1) Proposal is not affected even if the immediate writeoff of pollution control equipment passes, as refiners will opt for the additional 10% ITC since it results in the greater financial benefit.

(2) Assumes that both the additional 10% ITC proposal and the broadened depreciation range proposal do not pass, since each of those proposals will result in a greater financial benefit to the refiner.

(3) Proposal is not affected even if the immediate writeoff of pollution control equipment passes, since under present law refiners will lose the current 10% ITC that they are entitled to for pollution control expenditures. Thus, the broadened depreciation range and the current 10% ITC results in a greater financial benefit than the immediate writeoff of pollution control equipment.

EXHIBIT V

AMERICAN PETROLEUM REFINERS ASSOCIATION
Revenue Estimate Hypothetical Four
(In thousands of dollars)

	1980	1981	1982	1983	1984	1985	1986	1967	1988	1989	Total 1980-1989
Additional 10% Investment Tax Credit [1]	(116.8)	(1174.3)	(2639.8)	(6345.3)	(5870.8)	(1107.9)	—	—	—	—	(17,254.9)
Immediate Writeoff of Pollution Control Equipment [2]	12.8	128.8	289.5	695.9	(5784.3)	(496.9)	1115.9	1010.3	915.8	821.8	(1,290.4)
Broadened Depreciation Range [3]	—	—	—	—	(4186.7)	(7579.9)	(5591.5)	(3477.4)	(1639.4)	203.5	(22,271.4)
Additional 10% Investment Tax Credit	(116.8)	(1174.3)	(2639.8)	(6345.3)	(5870.8)	(1107.9)					(17,254.9)
Broadened Depreciation Range	—	—	—	—	(4186.7)	(7579.9)	(5591.5)	(3477.4)	(1639.4)	203.5	(22,271.4)
TOTAL [1]	(116.8)	(1174.3)	(2639.8)	(6345.3)	(10057.5)	(8687.8)	(5591.5)	(3477.4)	(1639.4)	203.5	(39,526.3)

[1] Proposal is not affected even if the immediate writeoff of pollution control equipment passes, as refiners will opt for the additional 10% ITC since it results in the greater financial benefit.

[2] Assumes that both the additional 10% ITC proposal and the broadened depreciation range proposal do not pass, since each of those proposals will result in a greater financial benefit to the refiner.

[3] Proposal is not affected even if the immediate writeoff of pollution control equipment passes, since under present law refiners will lose the current 10% ITC that they are entitled to for pollution control expenditures. Thus, the broadened depreciation range and the current 10% ITC results in a greater financial benefit than the immediate writeoff of pollution control equipment.

UPGRADING OF SMALL REFINERIES

William K. Hunter

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INTRODUCTION

Presented herein is an abbreviated analysis of the complexity and cost factors which would be involved in the upgrading of a small, low capacity refinery of the topping variety which currently operates on low sulfur crude (0.5 wgt. % sulfur or less).

Small refiners can conduct marginal operations at small capacity on low sulfur content crude oil. Their operations, however, are limited in capacity primarily because of the marginal nature of the products produced and their ability to market those products. An increase in the sulfur content of crude oil supplies available to these refiners forces them to consider upgrading both the capacity and the complexity of their facilities.

As a basis for providing a meaningful comparison of different approaches to upgrading, with a minimum of technical language, the following cases can be compared:

Category No.	Operation Type	Crude Oil Capacity	Crude Oil Type
I	Topping	8,500 BPD	Lt. Crude with 0.5% S
II	Topping	30,000 BPD	Lt. Crude with 0.5% S
III	Hydroskimming	30,000 BPD	Lt. Crude with 0.5% S
IV	Catalytic Cracking	30,000 BPD	Lt. Crude with 2.0% S
V	Hydrocracking	30,000 BPD	Lt. Crude with 2.0% S

It should be noted that the maximum capacity contemplated for purposes of this comparison is 30,000 bpd. It might be argued that economies of scale are achieved at a higher capacity level (perhaps approximately 50,000 bpd).

The operations of refineries in Categories I and II are based on the processing of light sweet crude oil where the sulfur content is in the range of 0.5 weight per cent. Refineries in Category III operate on light semi-sour crude oil where the sulfur content is in the range of 0.7 weight per cent. Finally, refineries in Categories IV and V operate are on light sour crude oil with sulfur content in the range of 2.0 weight per cent. In order to simplify comparison, bases have been selected which are well recognized in the industry and have been utilized in a number of studies and articles presented to define the small refiners' situation under current and future market conditions.*/

The primary bases for cost estimation are the Nelson Indices and Complexity Factors.

DESCRIPTION OF REFINERY PROCESSES

Category I represents a topping operation at 8,500 bpd capacity on low sulfur (0.5%) crude. This category represents a petroleum refinery in its simplest form. Such a refinery is dependent on the availability of low sulfur crude oil in order to produce salable products and is restricted in its marketing capabilities. The refinery can produce salable distillate and residual fuel only to the extent that the sulfur content of these products falls in marketable ranges. The refinery can also produce jet fuel such as Type JP-4 and/or sell its naphtha to other refiners for upgrading or blending. A typical flow scheme for a Topping Refinery is shown in ATTACHMENT 1.

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*/ See, for example, Nelson, W. L., "The Concept of Refinery Complexity", The Oil and Gas J. (September 13, 1979); Nelson, W. L., "Cost Indexes", The Oil and Gas J. (May 5, 1980); Bonner & Moore Associates, Inc., "Analysis of Recent Financial and Operating Data for Segments of the U.S. Domestic Petroleum Industry" (Mar. 31, 1978) (unpublished report by industry consultants); National Petroleum Council, "Refinery Flexibility - An Interim Report" (Dec., 1979); Purvin & Gertz, Inc., "An Analysis of Potential for Upgrading Domestic Refining Capacity" (Mar., 1980) (unpublished report for the American Gas Association by industry consultants); Office of Regulations & Emergency Planning, Economic Regulatory Administration of the U.S. Department of Energy, "Incentives for Small Refiners to Utilize Sour Crude and/or Produce Higher Octane Clear Pool Gasoline" (unpublished paper at DOE Public Affairs Office); and Office of Regulations, Economic Regulation Administration of the U.S. Department of Energy, "Small Refiner Bias Analysis" (Jan., 1978) (unpublished paper at DOE Public Affairs Office).

Category II represents a larger-size version of Case I (30,000 bpd capacity). This case is considered for comparison purposes only. The high volume of marginal products produced by it would simply create a greater marketing problem for the small refiner.

Category III represents a hydroskimming operation of 30,000 bpd capacity on semi-sour (0.7%S) crude oil. This is the type of operation that might be seriously considered by a Category I small refiner faced with increased crude oil sulfur levels. Such a refiner would consider adding Catalytic Reforming to upgrade his naphtha to motor fuel and also distillate desulfurization to reduce sulfur content in his distillate fuels. Some lower sulfur content distillate product might be blended with residual fuel to reduce its sulfur content and improve its marketability. A typical flow scheme is shown in ATTACHMENT 2.

Category IV represents a catalytic cracking type operation with a 30,000 bpd capacity, on sour (2.0%S) crude oil. This type of operation would be considered by a Category I refiner faced with a conversion to sour crude oil. The operation essentially requires the addition of a Catalytic Cracking Unit to the Category III or Hydroskimming operation. Such a configuration permits the upgrading of the gas oil portions of residual oil or topped crude to more salable and valuable products. A typical flow scheme for a Catalytic Cracking operation is shown in ATTACHMENT 3.

Category V represents a hydrocracking type operation with a 30,000 bpd capacity, on sour (2.0%S) crude oil. Such an operation is an alternative which might be considered by a small refiner faced with the conversion to high sulfur crude. This operation consists of the addition of a Hydrocracking Unit to the Hydroskimming or Category III operation. Such an addition permits the vacuum gas oil portion of the residual oil or topped crude to be converted to more marketable products which are, generally speaking, desulfurized. The Hydrocracking operation offers improved operating flexibility in that it can be operated to produce a variable range of products from motor fuel to light fuel oils. It can also be operated with lighter feedstock than gas oil. A typical flow scheme for a Hydrocracking type operation is shown in ATTACHMENT 4.

The presentations in ATTACHMENTS 1-4 offer a simplified version of each of the categories described above. In addition to the major process units shown, each catalytic reformer, where indicated, would almost certainly have a combined catalytic desulfurization unit to pretreat its feedstock. Also, facilities would be included to process and/or desulfurize gases as well as to provide environmental control.

REFINERY COMPLEXITY

Refining complexity factors (as developed, for example, by W. L. Nelson) represent an effort to describe the investment cost of a refinery in terms of the operations which are to be conducted.*/ Such complexity can vary with the type of crude oil being processed as well as with its sulfur content. For estimation purposes, a typical light crude production distribution was estimated along with a typical distribution of sulfur content among the various fractions. ATTACHMENT 5 presents a listing of the estimated capacities for the process units involved in each scheme along with a calculated complexity factor.

REFINERY COSTS

Refinery investment costs were estimated based upon the Nelson Complexity Factor data and related Unit and Offsite Costs. The costs estimated are based upon Gulf Coast erection and are adjusted to reflect the Nelson Refinery Cost Index for Decmeber 1979.

The overall costs for a new refinery in each of the Categories has been estimated and is presented in ATTACHMENT 6. A net additional investment is also reflected for the Category I refiner to expand and upgrade into each of the alternative categories. Also presented in ATTACHMENT 6 is a breakout of the investment for environmental control items. This includes, where involved, the sulfur plant, the desulfurization of gas, environmental controls, and the ecology items if subsumed within offsite costs.

CONCLUSIONS

The investment costs shown herein will vary with location, the specific crude oils involved, and the process selection and product mix desired. A more detailed study might result in only slightly different cost figures. In any event, type and range of investments are believed to be reasonable for the conditions selected. A small refiner faced with the need to convert to semi-sour crude

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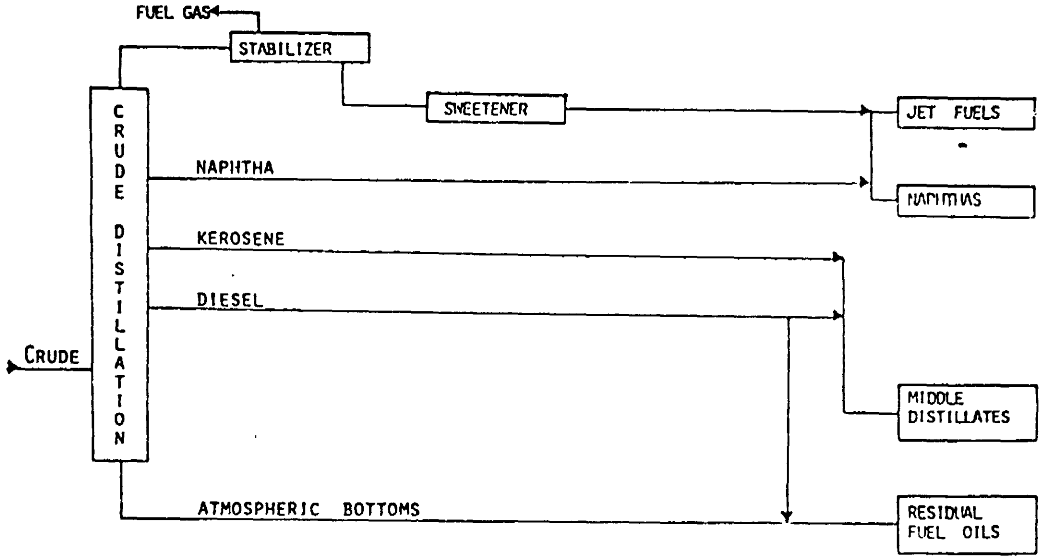
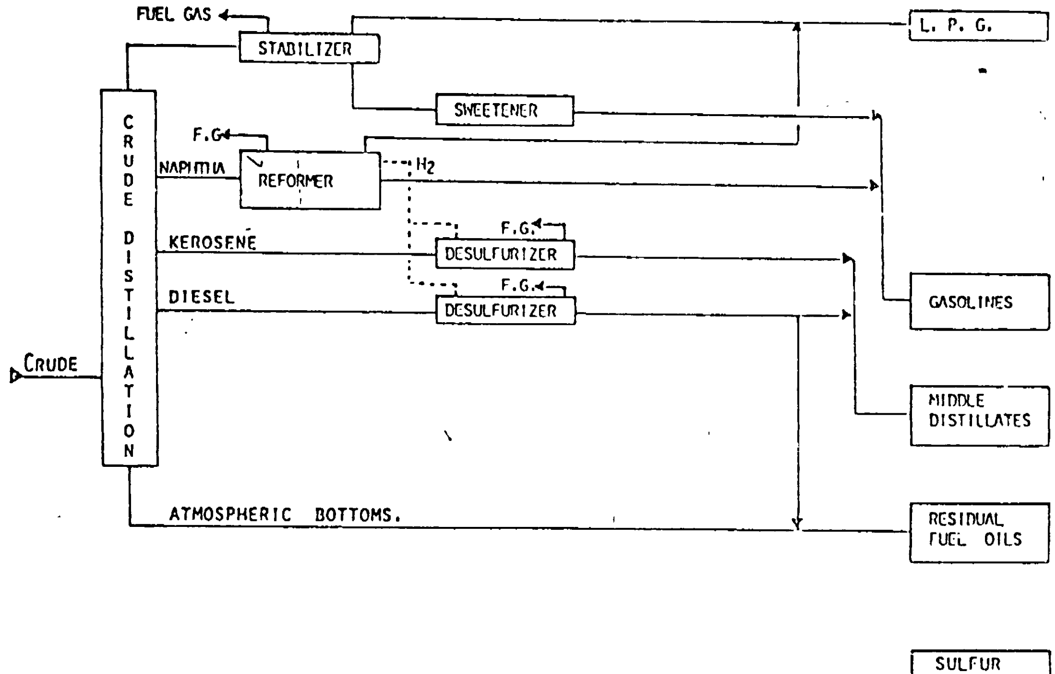
*/ The Nelson factors are widely used, both by government agencies and industry members.

would likely be faced with an expenditure of approximately $78 million in order to take the first steps toward upgrading both its products and its capacity. In order to incorporate the next gradations of sophistication in its facilities and be able to process crude oil with a still higher sulfur content, this same small refiner would have to spend an additional $50-62 million, for a total of $128-140 million; and to make these modifications at a somewhat higher capacity level (50,000 bpd rather than 30,000 bpd) would require substantially greater expenditures--perhaps twice as large as these amounts.

ATTACHMENT 1

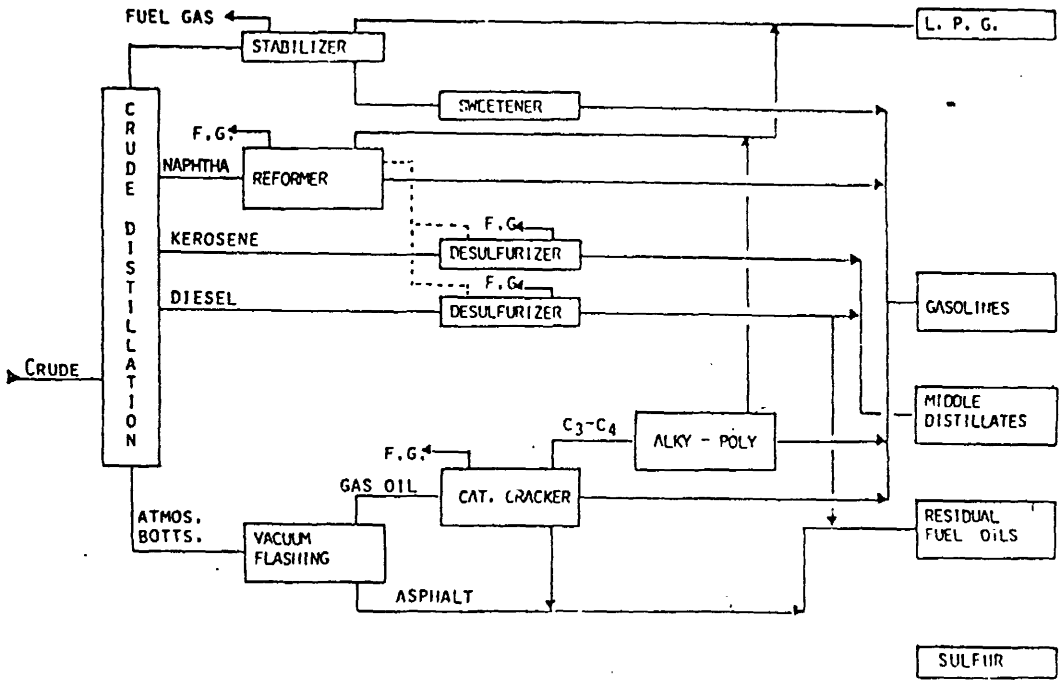


CATEGORY I & II <u>Topping Refinery</u>



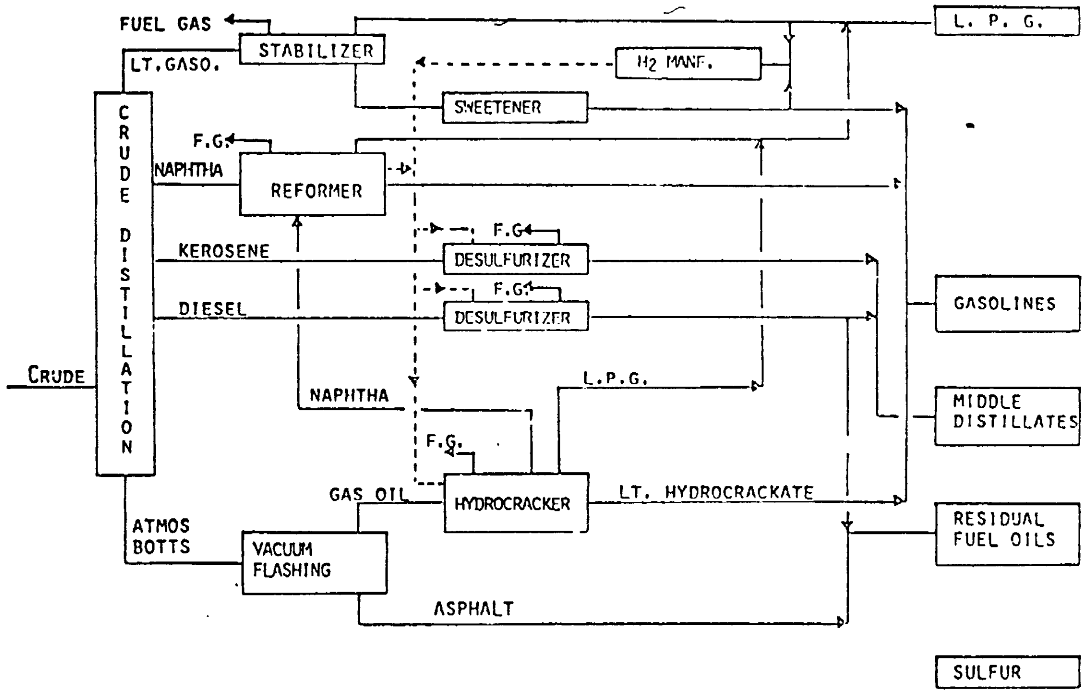
CATEGORY III **Hydroskimming Refinery**

1724



CATEGORY IV CATALYTIC CRACKING REFINERY - HIGH SULFUR CRUDE

ATTACHMENT 4



CATEGORY V HYDROCRACKING REFINEPY

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ATTACHMENT 5

Category			I & II		III		IV		V	
Item	Process Operation	Complexity Factors (1)	(MMCFD) BPD	Complexity	(MMCFD) BPD	Complexity	(MMCFD) BPD	Complexity	(MMCFD) BPD	Complexity
1.	Crude Unit	1.0	8,500/30,000	1.0	30,000	1.0	30,000	1.0	30,000	1.0
2.	Vacuum Unit	2.0	—	—	—	—	11,670	0.8	11,670	0.8
3.	Naphtha Desulfurizer	3.0	—	—	7,800	0.8	7,800	0.8	7,800	0.8
4.	Naphtha Splitter	0.3	—	—	7,800	0.1	7,800	0.1	7,800	0.1
5.	Reformer	5.0	—	—	6,000	1.0	6,000	1.0	7,590	1.3
6.	Distillate Desulfurizer	3.0	—	—	6,000	0.6	10,500	1.1	10,500	1.1
7.	Hydrocracker	10.0	—	—	—	—	—	—	7,200	2.4
8.	Hydrogen Plant (6)	—	—	—	—	—	—	—	—	—
9.	Catalytic Cracker	6.0	—	—	—	—	7,200	1.4	—	—
10.	Alkylation Unit	11.0 (3)	—	—	—	—	1,620	0.6	—	—
11.	Gas Processing	1.0 (2)	—	—	—	—	(2.8)	0.1	(2.8)	0.1
12.	LPG Gas Plant	3.0	—	—	—	—	576	0.1	576	0.1
13.	Desulfurization of Gases	0.7 (2)	—	—	—	—	(3.1)	0.1	(3.1)	0.1
14.	Distillate Product	0.5	5,185/18,300	0.3	18,300	0.3	18,300	0.3	18,300	0.3
15.	Treating and Handling Sulphur Plant	85.0 (4)	—	—	5 LT/D	NIL	25 LT/D	0.1	40 LT/D	0.1
SUBTOTAL				1.3		3.8		7.5		8.2
16.	Environmental Controls	5.3% (5) of above		0.1		0.2		0.4		0.4
TOTAL				1.4		4.0		7.9		8.6

(1) Complexity adjusted by BPD thruput except where noted.
(2) Based on MCF/D.
(3) Based on BBLS/Day of product.
(4) Based on long tons/day.
(5) Note that desulfurization of gases and the sulfur plant are also environmental controls. Also the ecology provisions in the offsites would be considered as a part of the environmental package.
(6) Included with hydrocracker cost in Category V.

ATTACHMENT 6

REFINERY COSTS(1)
(in millions)

Category	I	II	III	IV	V
Process Unit Costs	4.2	11.8	33.6	66.4	72.2
Offsite Costs	10.5(a)	29.5(b)	57.1(c)	73.7(d)	80.1(e)
TOTAL REFINERY COST	14.7	41.3	90.7	140.1	152.3
Net Additional Investment(2)	--	28.1	77.5	127.9	139.1
Environmental Investment	1.0	2.9	6.3	14.3	15.2
Net Additional Environment Investment		2.0	5.4	13.4	14.3

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(1) Assumes that original investment is 90% recovered in the expansion; offsite multipliers based on complexity: (a) 350% (b) 350% (c) 170% (d) 211% (e) 211%.

(2) The costs used herein are based on December 1979 with Gulf Coast erection.

APRA Membership by State

ALABAMA

CORAL PETROLEUM, INC.
Refinery: Cordova, Alabama

MARION CORPORATION
Mobile, Alabama
Refinery: Theodore, Alabama

MOBILE BAY REFINING COMPANY
Chickasaw, Alabama
Refinery: Chickasaw, Alabama

ARIZONA

LA JET, INC.
Phoenix, Arizona

CALIFORNIA

GOLDEN EAGLE REFINING COMPANY, INC.
Los Angeles, California
Refinery: Carson, California

GULF STATES OIL & REFINING COMPANY
Beverly Hills, California

LA JET, INC.
Los Angeles, California

LUNDAY-THAGARD OIL COMPANY
South Gate, California
Refinery: South Gate, California

POWERINE OIL COMPANY
Santa Fe Springs, California
Refinery: Santa Fe Springs, California

COLORADO

ASAMERA OIL (U.S.) INC.
Denver, Colorado
Refinery: Commerce City, Colorado

WYOMING REFINING COMPANY
Denver, Colorado

GEORGIA

YOUNG REFINING CORPORATION
Douglasville, Georgia
Refinery: Douglasville, Georgia

IDAHO

UNITED INDEPENDENT OIL COMPANY
Boise, Idaho

ILLINOIS

CALUMET INDUSTRIES, INC.
Chicago, Illinois

INDIANA

GLADIEUX REFINERY, INC.
Fort Wayne, Indiana
Refinery: Fort Wayne, Indiana

INDIANA FARM BUREAU COOP ASSN., INC.
Mount Vernon, Indiana
Refinery: Mt. Vernon, Indiana

INDUSTRIAL FUEL AND ASPHALT OF INDIANA, INC.
Hammond, Indiana
Refinery: Hammond, Indiana

LAKETON ASPHALT REFINING, INC.
Evansville, Indiana
Refinery: Laketon, Indiana

IOWA

PESTER REFINING COMPANY
Des Moines, Iowa

KANSAS

E-Z SERVE, INC.
Refinery: Shallow Water, Kansas

HUDSON OIL COMPANY, INC
Kansas City, Kansas

PESTER REFINING COMPANY
El Dorado, Kansas
Refinery: El Dorado, Kansas

PIONEER REFINING, LTD.
Wichita, Kansas

LOUISIANA

BRUIN REFINING, INC.
Refinery: St. James, Louisiana

CALUMET INDUSTRIES, INC.
Refinery: Princeton, Louisiana

CANAL REFINING COMPANY
Church Point, Louisiana

CLAIBORNE GASOLINE COMPANY
Refinery: Lisbon, Louisiana

CONSOLIDATED PETROLEUM INDUSTRIES, INC.
Refinery: Lake Charles, Louisiana

ERGON REFINING, INC.
Monroe, Louisiana

EVANGELINE REFINING COMPANY, INC.
Jennings, Louisiana
Refinery: Jennings, Louisiana

HILL PETROLEUM COMPANY
Refinery: Krotz Springs, Louisiana

INTERNATIONAL PROCESSORS
New Orleans, Louisiana
Refinery: St. Rose, Louisiana

LA JET, INC.
Refinery: St. James, Louisiana

MT. AIRY REFINING COMPANY
Refinery: Mt. Airy, Louisiana

PLACID REFINING COMPANY
Refinery: Port Allen, Louisiana

SOUTH LOUISIANA PRODUCTION CO., INC.
Lafayette, Louisiana
Refinery: Mermentau, Louisiana

T & S REFINING CO., INC.
Refinery: Jennings, Louisiana

MICHIGAN

FLINT CHEMICAL COMPANY
Detroit, Michigan

INDUSTRIAL FUEL AND ASPHALT OF INDIANA, INC.
Grand Rapids, Michigan

LAKESIDE REFINING COMPANY
Southfield, Michigan
Refinery: Kalamazoo, Michigan

TEXAS AMERICAN PETROCHEMICALS, INC.
Refinery: West Branch, Michigan

MISSISSIPPI

ERGON REFINING, INC.
Jackson, Mississippi
Refinery: Vicksburg, Mississippi

SOUTHLAND OIL COMPANY
Jackson, Mississippi
Refineries:
Yazoo City
Sandersville
Lumberton

NEW JERSEY

SEAVIEW PETROLEUM COMPANY
Refinery: Paulsboro, New Jersey

NEW MEXICO

NAVAJO REFINING CO.
Artesia, New Mexico
Refinery: Artesia, New Mexico

TONKAWA REFINING COMPANY
Roswell, New Mexico

NEW YORK

GULF STATES OIL & REFINING COMPANY
New York, New York

OHIO

Mt. AIRY REFINING COMPANY
Cincinnati, Ohio

OKLAHOMA

ALLIED MATERIALS CORPORATION
Oklahoma City, Oklahoma
Refinery: Stroud, Oklahoma

CANAL REFINING COMPANY
Tulsa, Oklahoma

E-Z SERVE, INC.
Oklahoma City, Oklahoma

GULF STATES OIL & REFINING COMPANY
Tulsa, Oklahoma

HUDSON OIL CO., INC.
Refinery: Cushing, Oklahoma

OKC REFINING, INC.
Refinery: Okmulgee, Oklahoma

OKLAHOMA REFINING COMPANY
Oklahoma City, Oklahoma
Refinery: Cyril, Oklahoma

TONKAWA REFINING COMPANY
Oklahoma City, Oklahoma
Refinery: Arnett, Oklahoma

PENNSYLVANIA

SEAVIEW PETROLEUM COMPANY
Blue Bell, Pennsylvania

SOUTH DAKOTA

WYOMING REFINING COMPANY
Rapid City, South Dakota

TEXAS

BRUIN REFINING, INC.
Houston, Texas

CARBONIT REFINERY, INC.
Houston, Texas
Refinery: Hearne, Texas

CLAIBORNE GASOLINE COMPANY
Dallas, Texas

COPANO REFINING, INC.
San Antonio, Texas

CORAL PETROLEUM, INC.
Houston, Texas

CONSOLIDATED PETROLEUM INDUSTRIES, INC.
Abilene, Texas
Midland, Texas

E-Z SERVE, INC.
Abilene, Texas

FLINT INK CORPORATION
Refinery: San Antonio, Texas

FRIENDSWOOD REFINING CORP.
Houston, Texas
Refinery: Friendswood, Texas

GUAM OIL AND REFINING, INC.
Dallas, Texas

GULF ENERGY REFINING CORPORATION
San Antonio, Texas
Refinery: Brownsville, Texas

GULF STATES OIL & REFINING CO.
Houston, Texas
Refinery: Corpus Christi, Texas

HILL PETROLEUM COMPANY
Houston, Texas

HOWELL CORPORATION
Houston, Texas
Refineries: Corpus Christi, Texas
San Antonio, Texas

INDEPENDENT REFINING CORPORATION
Houston, Texas
Refinery: Winnie, Texas

LA JET, INC.
Abilene, Texas
Dallas, Texas
Houston, Texas

MARION CORPORATION
Houston, Texas

MT. AIRY REFINING COMPANY
Houston, Texas

NAVAJO REFINING COMPANY
Dallas, Texas
Houston, Texas

OKC REFINING, INC.
Dallas, Texas

PETRACO-VALLEY OIL & REFINING COMPANY
Houston, Texas
Refinery: Brownsville, Texas

PIONEER REFINING, LTD.
San Antonio, Texas
Refinery: Nixon, Texas

PLACID REFINING COMPANY
Dallas, Texas

QUINTANA REFINERY COMPANY
Houston, Texas
Refinery: Corpus Christi, Texas

QUITMAN REFINING COMPANY
Houston, Texas
Refinery: Quitman, Texas

RANCHO REFINING COMPANY OF TEXAS
Houston, Texas
Refinery: Donna, Texas

SABER REFINING COMPANY
Houston, Texas
Refinery: Corpus Christi, Texas

SECTOR REFINING INC.
Houston, Texas
Refinery: Palestine, Texas

SIGMOR CORPORATION
San Antonio, Texas
Refineries:
Three Rivers, Texas
Corpus Christi, Texas

SOUTH HAMPTON REFINING CO.
Silsbee, Texas
Refinery: Silsbee, Texas

T & S REFINING CO., INC.
Houston, Texas

TEXAS AMERICAN PETROCHEMICALS, INC.
Midland, Texas

TEXAS ARMADA REFINING CO.
Euless, Texas
Refinery: Fort Worth, Texas

TIPPERARY REFINING CORPORATION
Midland, Texas
Refinery: Ingleside, Texas

WYOMING REFINING COMPANY
Houston, Texas

UTAH

LITTLE AMERICA REFINING COMPANY
Salt Lake City, Utah

WASHINGTON

UNITED INDEPENDENT REFINING CORPORATION
Refinery: Tacoma, Washington

WYOMING

JOHNSON OIL CO., INC.
La Barge, Wyoming
Refinery: La Barge, Wyoming

LITTLE AMERICA REFINING CO.
Refinery: Evansville, Wyoming
Cheyenne, Wyoming

WYOMING REFINING COMPANY
Refinery: Newcastle, Wyoming

Associate Members

ALEXANDER & ALEXANDER, INC.
DALCO PETROLEUM CORPORATION
E. I. DUPONT DE NEMOURS & COMPANY
ENGLEHARD MINERALS & CHEMICALS CORPORATION
ETHYL CORPORATION
FEDCO OIL COMPANY
FIELDS ENERGY RESOURCES, INC.
FIRST CITY NATIONAL BANK OF HOUSTON
HOWE-BAKER ENGINEERS, INC.
MELLON ENERGY PRODUCTS COMPANY
MINRO OIL, INC.
NALCO CHEMICAL COMPANY
THE ORTLOFF CORPORATION
OXIRANE CORPORATION
PPG INDUSTRIES, INC.
THE QUARLES AGENCY, INC.
STATIO TERMINALS, N.V.
WEST TEXAS MARKETING

STATEMENT OF THE HONORABLE WALTER FLOWERS
VICE-PRESIDENT
WHEELABRATOR-FRYE, INC.

ON BEHALF OF

THE NATIONAL COUNCIL ON SYNTHETIC FUELS PRODUCTION

BEFORE THE

SENATE FINANCE COMMITTEE

JULY 30, 1980

I. INTRODUCTION

The National Council on Synthetic Fuels Production was formed March 7, 1980 to bring potential synthetic fuels producers and others interested in the commercial production of synthetic fuels together in an association devoted exclusively to advancing the commercial production of synthetic fuels from domestic resources. The Council presently consists of 40 members involved in every type of synthetic fuels production and technology. Our members are at the forefront of current federal efforts to construct commercial demonstration plants for direct coal liquefaction and high Btu coal gasification. Council members will probably participate in the first commercial oil shale demonstration and also are involved in the production of energy from tar sands and biomass. Additionally, many Council members are conducting research and development into advanced synthetic fuels production processes.

II. CAPITAL FORMATION

The Council commends the Committee and the Congress for the tremendous efforts which already have been devoted to providing financial incentives for synthetic fuels production in the Energy Security Act [1/] and the Windfall Profit Tax Act. [2/] We strongly endorse the dual approach (i.e., the approach of direct federal incentives provided through the Energy Security Corporation and indirect incentives provided through the Internal Revenue Code) which you have adopted for the development of a domestic synthetic fuels industry. These incentives will be critical to the development of our industry. The creation of a synthetic fuels industry, however, will involve the additional investment of billions of dollars in private capital over the next several years to develop new technologies and to plan, design and construct commercial scale synthetic fuels

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1/ Pub. L. No. 96-294, 94 Stat. 611 (1980).

2/ Pub. L. No. 96-223, 94 Stat. 229 (1980).

production facilities. [3/] As a representative of the emerging synthetic fuels industry, the Council joins other industries which have testified before this Committee in support of a major improvement in capital formation incentives.

A. Capital Cost Recovery

The Council advocates restructuring the current depreciation system as best exemplified by "10-5-3." [4/] Because it eliminates the useful life concept associated with traditional theories of cost accounting, "10-5-3" will allow a firm making the commitment to commercial production of synthetic fuels to recover the large capital costs required for such a facility in a time frame sufficient to prevent it from having to make a choice between commitment of its financial resources to synthetic fuels production or to a more customary business alternative with a near term return. [5/]

Without "10-5-3" virtually the entire synthetic fuels industry will be forced to rely on "facts and circumstances" depreciation. [6/] At the present time only one Asset Guideline Class dealing with an existing synthetic fuels technology has been created under the Asset Depreciation Range system. [7/]

Due to the exceptionally long lead time involved in the planning, design and construction of a commercial synthetic fuels facility, the "payment" rule of "10-5-3" will be

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3/ The Congressional Budget Office estimated the total capital cost of a synthetic fuels industry capable of meeting a production target of 2 million barrels per day by 1995 to be $168 billion. Congressional Budget Office, Synthetic Fuel Production in the United States, A Preliminary Overview of the Major Legislative Issues 418 (1979).

4/ H.R. 4646, 96th Cong., 1st Sess., 125 Cong. Rec. 5279(1979); S. 1435, 96th Cong., 1st Sess., 125 Cong. Rec. 8665(1979).

5/ With regard to the inclusion of public utility property (within the meaning of I.R.C. §167(l)(3)(A)) as "recovery property" under "10-5-3" or similar legislation, the Council recommends that present rules regarding "normalization" should be retained. These rules have been in effect for a considerable period, have been the subject of numerous rulings and are relatively well understood by the IRS, the regulatory bodies and taxpayers.

6/ Treas. Reg. §1.167(a)-1(b).

7/ Rev. Proc. 77-14, 1977-1 C.B. 571. This Revenue Procedure applies only to assets used in the production of pipeline quality gas from coal using the Lurgi process with advanced methanation.

of major benefit to the synthetic fuels industry. 8/ The "payment" rule allows depreciation for payments on capital recovery property to begin in the year in which payment is made even though the property actually may not be placed in service for many years. A conforming change is also made to the investment credit allowing a credit for advance payments. We believe the inclusion of such a "payment" rule in any version of a capital cost recovery proposal is essential to the development of a national synthetic fuels industry.

While the Council suggests that a range of financial incentives must be made available to stimulate production of synthetic fuels, it is not our objective to "double up" on the direct federal assistance programs provided by the Synthetic Fuels Corporation. The Windfall Profit Tax Act includes provisions applicable to the energy investment credit which prohibit "double dipping" with respect to projects which are benefitting from direct federal assistance. 9/ A similar provision is included in the Energy Security Act which requires the directors of the Corporation to consider tax incentives and other benefits available to a project in evaluating the need for assistance from the Corporation. 10/

B. Extension of the Energy Investment Credit

The Council recommends that the Committee review the 1982 expiration date for the energy investment credit. Few commercial scale synthetic fuels demonstration plants will be completed by the December 31, 1982 expiration date. 11/ If the objective

8/ Proposed I.R.C. §168(d)(2); H.R. 4646 §3(b).

9/ Pub. L. No. 96-223, §223(c), 94 Stat. 266(1980).

10/ Pub. L. No. 96-294, §131(t), 94 Stat. 658 (1980).

11/ Senate Committees on Banking, Housing, and Urban Affairs and Energy and Natural Resources, Extending the Defense Production Act of 1950, as Amended, S. Doc. No. 387, 96th Cong., 1st Sess. 135-141 (1979).

of the energy investment credit is to provide an incentive to private firms to invest in synthetic fuels plants, the credit must be extended at least through 1990.

The Council believes that the "affirmative commitment" rule added by section 221 of the Windfall Profit Tax Act will aid only a few of the most advanced commercial and demonstration projects. 12/ For example, it is our assessment that many of the Eastern coal projects will not be able to meet the January 1, 1983 and 1986 threshold dates. Moreover, the rule fails to take into account the fact that many of the synthetic fuels projects which may meet the threshold dates involve large amounts of direct federal funding. While the extension offered by the rule will aid these projects to the extent private funds are involved, the benefits will be insignificant compared to the relief which will be required for a project not involving direct federal funding.

C. Research Development and Pre-operating Expenses

The Council also suggests that the Committee explore additional tax incentives to encourage further research and development of synthetic fuels technologies. There are presently a number of technologies available for the production of synthetic fuels. However, this is a new industry in the United States, and it is expected that a commitment to expanded synthetic fuels research and development by American industry will reap substantial dividends by improving the efficiency of existing technologies and causing the development of new processes and technologies.

The Council notes that expenditures for research and development in the United States have declined from over three percent of our gross national product in the mid-1960's to slightly over two percent in 1979. This is a bleak trend, particularly when

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12/ Section 221 extends the energy investment credit through 1990 for companies which have completed all engineering studies necessary to begin construction and filed applications for all federal, state and local environmental and construction permits necessary to begin construction by December 31, 1982. In addition a firm must have entered into binding contracts for acquisition and construction involving at least 50 percent of the cost of all specially designed equipment by December 31, 1985.

related to our substantial trade deficit and decline in industrial productivity. We are aware that many members of Congress share this concern as reflected by the large number of legislative proposals which have been introduced to promote additional research and development. For example, the Council would support those proposals which would use existing statutory provisions to provide an additional tax incentive for research and development costs through allowing the 10-percent investment credit for research and experimental expenditures, as defined in Code section 174.

We also support legislation which would allow the cost of start-up programs, training, feasibility and environmental studies for new projects to be deducted as ordinary business expenses rather than requiring them to be capitalized and written off with the physical assets of the enterprise.

III. CLARIFYING CHANGES TO ENERGY TAX INCENTIVE PROVISIONS

The Council also would like to direct the attention of the Committee to several aspects of the present law concerning energy tax incentives, which were enacted under the Energy Tax Act of 1978 and the Windfall Profit Tax Act of 1980. It is necessary to clarify or redefine several of the existing provisions so that the entrepreneurial development of synthetic fuels is encouraged. Also, this will complete the Congressional commitment to synthetic fuels development reflected by enactment of S.932, the Energy Security Act, earlier this year. The Council believes that these changes will complement the various forms of direct financial assistance available from the Synthetic Fuels Corporation under the provisions of the Energy Security Act. Therefore, we believe the following problem areas should be addressed.

A. Shale Oil Equipment

The definition of shale oil equipment eligible for the 10-percent energy investment credit under Code section 48(l)(7) excludes expenditures for equipment for hydrogenation or other processes subsequent to retorting. Kerogen, the thick, tar-like substance which is recovered from the oil shale, cannot be refined or even put into pipelines until it is treated or upgraded by hydrogenation or a similar process. The cost of hydrogenation or upgrading before refining adds several dollars to the cost of a barrel of shale oil which then must compete economically with conventional oil and gas.

The Council believes that it was the original intent of Congress, when this provision was enacted in 1978, to allow the energy credit for shale oil equipment to the point where the substance produced is the equivalent of petroleum and can be refined or processed like petroleum. Since the kerogen recovered from oil shale cannot be piped or refined like petroleum until it has been treated by hydrogenation or a similar process, the present statutory rules should be clarified to reflect this intent. Legislation has already been introduced in the Senate (S. 2783) which would allow the energy credit for equipment used in hydrogenation or similar upgrading processes prior to refining, but it does not include refining equipment. The amendment carries out Congressional intent, removes an inequity in current law, and treats oil shale investment the same as other alternative energy investments. It would provide certainty and stability in planning long lead-time shale oil projects.

B. Petroleum Coke Or Pitch As a Fuel or Feedstock

Under Code section 48(l)(3) the 10-percent energy tax credit is available for equipment to burn an "alternate substance" as a primary fuel or to convert an "alternate substance" into a synthetic fuel. In addition, the credit is available for equipment to convert coal into a substitute for an oil or natural gas derived feedstock or into methanol, ammonia, or a hydroprocessed coal liquid or solid. An "alternate substance" is defined as a substance other than oil, natural gas, or a product of oil or natural gas. As a result of this latter limitation, the energy credit is not available where oil refinery products, including by-products such as petroleum coke and petroleum pitch, are used as a primary fuel or as a basic feedstock to produce methanol, a substitute feedstock, or a synthetic fuel. The bottom-of-the-barrel by-products of petroleum refining which are not readily marketable, such as petroleum coke and petroleum pitch, have high Btu contents like coal, but also, like coal, contain concentrations of sulphur and other pollutants which discourage their use as a fuel or as a raw material for the production of synthetic fuels or feedstocks. Large quantities of these substances are either exported or dumped because there are insufficient incentives for their domestic use in comparison with those provided for other fuels or feedstocks, such as coal or biomass. It is proposed that the statutory provisions be amended so that the energy credit is not denied where not readily marketable by-products of petroleum refining, such as petroleum coke and petroleum pitch, are used as a primary fuel or as a raw material to produce methanol, a substitute feedstock, or a synthetic fuel.

C. Off-Stream Property in Synthetic Fuel and Substitute Feedstock Plants

The statutory rules for synthetic fuels and substitute feedstock equipment eligible for the 10-percent energy investment credit under clauses (iii) and (v) of Code section 48(l)(3)(A) define such equipment by using the phrases "equipment for converting" and "equipment to convert." The literal language of these two statutory phrases may cause other equipment at a synthetic fuel or substitute feedstock plant to be excluded from eligibility for the energy credit where the equipment is not in the conversion stream. For example, the Conference Report on the Windfall Profit Tax Act of 1980 states that equipment not directly involved in a coal conversion process (but which produces a feedstock or catalyst for the process) will not qualify for the energy credit.

Examples of property, at a synthetic fuel or substitute feedstock plant, which may not be eligible for the energy credit under this interpretation include an oxygen or hydrogen plant, equipment to recover by-products, equipment to treat or recover water, catalysts or other reactants used in the process, equipment to store and transfer by-products or end-products after they have been produced or recovered, structures to support and house qualifying equipment, and equipment to transmit process heat to the on-stream equipment or to generate and transmit electricity to the on-stream equipment.

These categories of property are necessary and integral parts of a synthetic fuel or substitute feedstock plant and comprise a substantial part of the significant investment in these plants. The Council believes that it was the original intent of the Congress to make eligible for the energy investment credit all equipment in a synthetic fuel or substitute feedstock plant, such as those categories of equipment described above, which are integrally related to the functioning of the plant. It is, therefore, proposed that the provisions of clauses (iii) and (v) in Code section 48(l)(3)(A) be clarified to reflect this intent.

D. Production Incentives For Coal-Derived Alcohol

Under the provisions of Code sections 4081 and 4041, gasohol, a motor fuel which is a blend of gasoline or another motor fuel and at least 10-percent alcohol, is exempted from the 4-cents-per-gallon federal excise tax on motor fuels. However, gasohol which contains alcohol derived from oil, natural gas or coal is not eligible for this exemption. Under Code section 44E, added by the 1980 Act, a complementary income tax credit for the production of alcohol fuels was enacted for situations where the excise tax exemption did not apply or where more than 10-percent alcohol was used in a motor fuel. This credit is equal to 40-cents-per-gallon of alcohol. As is the case with the excise tax exemption, the production credit is not provided for alcohol produced from oil, natural gas or coal.

The denial of a level of parallel treatment under the excise tax exemption and alcohol fuel production credit provisions for alcohol produced from coal, while providing these tax incentives for alcohol produced from biomass, is discriminatory and discourages the development of this alternative fuel resource since the same public policy, that of encouraging production of alternative liquid fuels from indigenous resources, is equally applicable to coal-derived alcohol (methanol). Further, the substantial investment and long lead-time associated with the construction of methanol plants, along with other contingencies, create real risks concerning such investments. These risks can be ameliorated by extending the tax incentives for biomass-derived alcohol to coal-derived alcohol.

E. Extension of Energy Credit to Integrated Facilities Which Produce Chemicals From Alternate Substances

The provisions of Code section 48(1)(3)(A)(v) appear to extend the energy investment credit on a project only so far as the equipment used in obtaining a feedstock such as methanol for the manufacture of other chemicals. The Conference Report on the 1980 Act interprets these provisions by stating that equipment would generally qualify for the energy tax credit "only to the point where either a marketable substance or a substitute for a petroleum or natural gas derived feedstock is produced." This limitation, similar to those noted in issue C above, severely restricts the incentive to produce chemicals from coal.

It is proposed that the provisions of Code section 48(1)(3)(A)(v) be amended to provide that when a manufacturer builds an integrated facility to produce a chemical using coal as a raw material, the energy investment credit is available for the entire process, even though methanol or some other intermediate is produced in the stream, so long as this methanol or other intermediate is not marketed by the manufacturer.

[Whereupon, at 1:10 p.m., the committee recessed, to reconvene at 10 a.m., Thursday, July 31, 1980.]

TAX CUT PROPOSALS

THURSDAY, JULY 31, 1980

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

The committee met pursuant to notice at 10 a.m., in room 2221, Dirksen Senate Office Building, the Honorable Bill Bradley (acting chairman) presiding.

Present: Senators Bradley, Nelson, Heinz, Danforth and Chafee.

Senator BRADLEY. The committee will come to order.

We are involved in hearings on the tax cut proposals that are before the Senate.

We have a list this morning of very distinguished guests who will make their presentations.

Our first guest is our colleague, Senator Schweiker from Pennsylvania.

I would like to welcome you, Senator Schweiker: You may proceed with your testimony.

STATEMENT OF HON. RICHARD S. SCHWEIKER, U.S. SENATOR FROM THE STATE OF PENNSYLVANIA

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

I am glad to see this committee being chaired by my good friend, colleague and neighbor this morning. I appreciate the opportunity to be heard. I know you have a busy schedule, and I will try to be concise.

Mr. Chairman and members of the Finance Committee, I appreciate this opportunity to testify in support of S. 2983, the "Venture and Capital Revitalization Act of 1980," which I introduced July 28 to raise the Federal tax exemption on long-term capital gains income from 60 to 75 percent.

Two years ago during consideration of the Revenue Act the Senate approved an increase in the exemption from individual capital gains to 70 percent. In conference with the House this level was lowered to 60 percent. Increasing the exemption was an economic success; I believe that we should follow up by increasing the exemption on capital gains to 75 percent.

I am pleased to announce this morning that since introduction of the bill on Monday, 14 of our colleagues have already joined as cosponsors—Senator Henry Bellmon, Senator Thad Cochran, Senator Robert Dole, Senator Jake Garn, Senator Orin Hatch, Senator Hayakawa, Senator Helms, Senator Jepsen, Senator Laxalt, Senator Lugar, Senator McClure, Senator Roth, Senator Stevens, and Senator Wallop.

The ability to raise capital has never been more important. Statisticians who monitor our economy have documented a continued reduction in productivity. The economy has sagged into stagflation. We suffer not only inflation from excessive Government spending and the accommodative monetary policy of the Federal Reserve System but also high levels of unemployment and underutilization of productive capacity.

One solution to these joint problems of inflation and unemployment is to increase through Government action the productive capacity of the economy. Yet, this increase cannot take place without raising total investment.

Government action to bring this about is very important. We have observed over the last 15 years a decline in the capability of the economy to recover from the type of cyclical recession we are now experiencing. The 'vate sector has less capability to snap back now than before, so Federal responsibility to manage the recovery has grown.

For example, a recent study by Salomon Bros., the investment banking firm, points to a "picture of impaired financial soundness." Their study cites the difficulty firms have in raising long-term capital, especially equity capital, as one of the critical reasons for impaired financial soundness. Without a firm foundation new investments prove difficult to finance.

Mr. Chairman, in 1978 Congress accepted the concept that lower capital gains taxes will increase the sales of holdings and improve the mobility of equity capital stimulating investment. It was predicted then that an overall increase in economic activity would result. Moreover, Congress estimated that the increase in economic activity with its resultant expanded tax revenues would go a long way toward offsetting Federal revenues foregone by the tax rate reduction.

These predictions have turned out to be correct. Lower capital gains tax rates brought new funds to the venture capital market, a critical source of funds for small high-technology firms. Small firms increased their capitalization by making public stock offerings; and after the 1978 change in the tax law equity capital raised jumped 63 percent to $250 million from a 1977 level of $153 million. Continuing this trend, new stock offerings yielded $506 million in 1979.

To document the significance of this development, I would like to remind the committee of a 1979 Commerce Department report which showed that most new jobs are created by small firms.

These new jobs cost the Federal Government very little in the short run. Information released by the Treasury Department indicates that over 75 percent of the revenue foregone by lowering the exemption in 1978 was made up by an increase in the dollar size of investor capital gains. The $1.25 billion reduction originally predicted for increasing the capital gains exemption for individuals is now expected to amount to only $250 million.

In the long run, the 1978 changes will likely mean an increase in Federal revenue. It takes just one major new discovery from one small firm to raise the tax base enough to pay the Government back. On balance, increasing the exemption in 1978 worked well. I believe this favorable outcome justifies continuation of the experiment through adoption of S. 2983 to boost the exemption from 60 to

75 percent and thereby encourage additional jobs creating investment.

If the United States is going to recover fully and quickly from the present recession, we must take advantage of the stimulative effects of a further reduction in the long-term capital gains tax rate.

By increasing the tax exemption from 60 percent to 75 percent, we can provide our nation with an opportunity to maintain its competitive position admidst the economic powers of the world. I might add, Mr. Chairman, that two of our most effective economic competitors, Japan and West Germany, for all intents and purposes, do not tax individual capital gains. It would be appropriate for the U.S. tax law to move in this direction now to improve our competitiveness with these nations.

In order to recreate the vigorous economy this Nation has known for most of its 204 years, we must provide greater incentives for individuals to invest, particularly in risky new ventures which provide the cutting edge for economic growth and new jobs. Unfortunately, capital gains taxes reduce very substantially the incentive to invest in such ventures.

In addition, many investments are held by those who would rather sell them and redeploy their funds in more valuable roles. The release of these holdings is prevented by present law which taxes what are in many cases fictitious gains caused by inflation. Whether the gains are fictitious or real, however, is not the most important issue. The real issue is whether our tax laws encourage investment and the release of existing economic resources to their most efficient use.

Mr. Chairman, I thank you for this opportunity to testify before the committee in behalf of S. 2983, the Venture and Equity Capital Revitalization Act of 1980 and I respectfully urge that you incorporate its provisions into your tax change recommendations this year.

Senator BRADLEY. Thank you, Senator Schweiker.

Let me just ask one question: Why is this exemption preferable to a decline in the capital gains rate itself?

Senator SCHWEIKER. Well, in essence that would be the effect of it. By exempting 75 percent, only 25 percent of the gain is subject to federal income tax. If for example you are in the 70-percent tax bracket, that 25-percent taxable gain would imply an effective rate of 17.5 percent.

Senator BRADLEY. Thank you very much.

Senator SCHWEIKER. Thank you.

Senator BRADLEY. Our next witness is Congressman Richard Gephardt from the State of Missouri.

I would like to welcome Congressman Gephardt to the committee. We are interested to hear your testimony, and I am particularly interested to hear your testimony.

Please proceed.

STATEMENT OF HON. RICHARD A. GEPHARDT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MISSOURI

Mr. GEPHARDT. Thank you, Mr. Chairman. Thank you very much for the opportunity to come here today to testify with regard to these hearings on tax reduction, and to particularly advocate to the committee, S. 2920, which was introduced by yourself, Senator Bradley. I think tax is one of the major problems that we face as we begin to look at the alternative ways to effect tax reduction in 1981 and 1982.

I would note that Senator Eagleton of my State presented a bill for a 20-percent income tax credit against payroll taxes a year or so ago and, of course, the bill that you presented, S. 2920, is much like the bill I presented on the House side, which calls for a refundable credit against income taxes equal to 10 percent of payroll taxes.

As you know, it provides a credit to employers, employees and the self-employed and is authorized for a period of 2 years.

I would point out that one of the benefits of this proposal is that it provides income tax reduction immediately if it were enacted before January of 1981. The reduction would be reflected in the paychecks of workers because we plan to offer an amendment on the House side, which could be offered, which calls for the reflection of the credit in the income tax withheld from workers beginning as soon as the credit would be effective.

At the back of my testimony we have two charts which I think are important in understanding the proposal. The first chart shows two things: First, the revenue loss from this proposal by fiscal and calendar years 1981 to 1985. It of course shows for fiscal 1981 the revenue loss would be estimated to be $10.3 billion; for 1982 the revenue loss would be $16.9 billion; and at the lower part of the page you can see the benefits from this proposal by income level.

You will note that the majority of the benefit goes to those in the income level of between $20,000 and $30,000. However, a fairly large proportion of the cut goes into the lower income level, the smaller reduction for the upper income levels.

The second chart shows the actual dollar effect of the reduction for workers in different categories. The worker making $5,000 a year, a one-earner family, would get a $33 reduction; an earner making $30,000 a year, a one-earner family, would get a reduction of $190.

I think that this reduction does not completely offset the increases called for in January of 1981, but for many, many workers it does completely offset the increase. Only for the workers at the higher end of income is there not a total reduction or a total offset.

I would point out that there are a number of arguments that can be made for this kind of reduction. I would like to go through them very quickly.

First, I think we are all aware of the increases that were called for in the 1977 act. In 1981, as you are all well aware, the rate on the social security payroll tax goes from 6.13 percent to 6.65 percent, and the base goes from $25,900 to $29,700, and, of course, the rate for self-employed goes to 8.1 percent.

In 1982 the rate goes from 6.65 to 6.70 for employees and the wage base goes to $32,400 and the rate for self-employed goes to a very high 9.3 percent.

I think that it is obvious that we need to address the question of offering relief to workers who are going to pay these very high levels of payroll taxes.

Let me talk about what I think the economic effects of such a proposal would be, which I think are very important. It is obvious to me that if we pass tax-cut legislation we are offering to offer relief on the business side, the industrial side, and then on the individual side.

I would strongly advocate that we effect the reduction on the individual side with a cut of this kind. I say that for two reasons: The normal reason we try to effect tax cuts is to stimulate the economy in a time of recession. This kind of social security tax credit would do that.

CBO estimates it would reduce unemployment by approximately 200,000 jobs; it would increase the GNP by $8 billion in calendar year 1981, raising it approximately five-tenths of 1 percent, which I think is an impressive statistic. But while it would stimulate the economy—and this is very, very important—it would reduce inflation; it would reduce the consumer price index by two-tenths of 1 percent.

I think the greatest argument that we can make and the thing we ought to be most concerned about in effecting tax-cut legislation in the economic atmosphere we are in, is that that tax-cut legislation should not further aggrevate and incite inflation. We are living now with an underlying inflation rate of 10 percent or more, and I don't think anybody believes, any economists believe, that inflation rate is going to go down very quickly. In fact, most would say that it is going to take from 5 to 10 years to have a significant reduction in that underlying inflation rate.

If that is the kind of atmosphere we are in, it seems to me it is incumbent upon us to effect tax cuts to stimulate the economy that are at the same time not inflationary; and this kind of a tax cut certainly meets those criteria.

Let me talk about the social security system for a moment, because I know there is a lot of concern about entering into legislation that would have a long-term effect on the viability and the philosophy of the social security system.

I have put a 2-year sunset or a 2-year termination on my proposal in the House, and I believe, Senator Bradley, your proposal has a similar termination. I feel very strongly that termination date should be retained in the legislation. I serve on the Social Security Subcommittee of the Ways and Means Committee. I was present during the debate and discussion over the 1977 amendments. I voted for those amendments. I believed then and I believe now that there is a great deal more reform that must go on in the social security system.

I have my agenda for reform. I am sure that most of you have your agendas for reform. None of us know how that is going to come out or the exact specifics of that second wave of reform of social security. I can assure you that we need to make that reform. I am sure you believe that, too.

I don't think we prejudge the specifics of that reform by enacting a social security tax credit in 1981. I think we may make it more important that the reform take place. I hope that is the case. But I don't think we prejudge it.

I, for instance, believe that we need to reexamine the benefit structure. I think we need to reexamine the supply level benefit. I think we need to reexamine the use of the CPI in adjusting benefits after they are given. I think we need to reexamine the retirement age. I think we need to reexamine the funding of what some call the transfer aspects of social security by the payroll tax, as opposed to general revenue.

I think we need to examine universal coverage and the issue of the treatment of females. I hope all of these things are done, but I don't think that in any way we prejudge those issues. In fact, I think we emphasize the need for reform by passing a credit, by saying that it is an interim solution, and by emphasizing the need over the next 2 years to address the urgent issues of reform that are before the Congress and before the country.

To sum up then, I think that as we approach the individual side of this tax cut that we do need to address the serious problem of the level of social security taxation. We need to address the problem of how we can enact a tax cut that does not further incite inflation. We need to address the question of how we can do that without making perhaps a permanent step in the social security system. So, I would urge the committee to consider the proposal that has been made by the Senator from New Jersey.

I thank you very much for the time to be here.

Senator BRADLEY. Thank you very much, Congressman Gephardt.

I think that you have done an outstanding job in talking about the bill that is before the Senate at the moment.

I would like to ask you just a few questions.

Before the Finance Committee in the last 1½ weeks we have had a great number of economists and businessmen, and I would say one of the areas of consensus is that there should be some tax cut. When we get to an individual tax cut there is a dispute. They find our approach interesting because it is not a $36 billion revenue loss in the next year, but they are concerned about the integrity of the social security trust fund.

I think that you have addressed that issue, but you might take another crack at it because I don't understand this. I wasn't here at the time in 1977, but it is as if you begin to open the door and suddenly the deluge comes through, and people treat this more as tampering with the social security trust fund than they do with the tax cut aspects and the beneficial macroeconomic aspects to this approach.

Mr. GEPHARDT. Let's be very clear about it. This is indirect, general revenue financing in the social security system, even though it doesn't happen directly, because we are not allocating or appropriating general revenue into the social security trust fund.

All of the tax called for in the 1977 amendments, the payroll tax going to the social security trust fund, if this proposal were passed, would continue to go to those trust funds. The level of funding in the trust funds would not be injured or changed or modified in any way; but clearly by inference this does allow general revenue to be used to offset taxes that are being paid by taxpayers to the social security trust fund, and so the argument can be made that we have partially opened the door or cracked the door toward the introduction of general revenue into the social security system. It does not, however, prejudge that issue, and I would refute the argument that we have made the judgment, the judgment that general revenue should be used in the system or by doing this we will lose the discipline of the social security system, or that we somehow have started a trend that is irreversible and can't be stopped.

I would be very, very much against—and I think many, many other members would be, too—simply rolling back the social security tax and throwing general revenue into the social security system without making some other very important reforms in social security.

I am sure we have many differences of opinion on those issues. My hope is that we get into those issues. I sense that if we don't do something now about the social security tax, that is, as inflation goes on and as we rock along, in 2 years we will continue to hear the argument that we shouldn't touch social security, that we shouldn't do anything about it, that we shouldn't worry about it, we shouldn't harm it, and certainly there are a lot of groups in the country that would argue should never get to those questions, and we will sweep under the rug for another year, or perhaps for another 10 years the questions that have to be answered, in my view, with regard to social security.

We are going to wake up in this country 10 or 20 or 30 or 40 or 50 years from now and find out there are no answers to the social security problem. We have either got to find ways to increase revenues or we have got to do something about the benefit structure; and I would suggest to you that the way we put the emphasis on the need to answer those questions is to do something today to enact a credit with regard to the income tax system that will make it necessary in the next 2 years to get on with that reform.

Senator BRADLEY. Why, if we want to give tax relief of approximately this level, the $10 billion to $16 billion level of income tax relief, and if we want to direct it at people of $20,000 to $30,000 in income primarily, but also with some effect below and above, why is this income tax credit approach better than simply targeting a rate adjustment or a bracket adjustment?

Mr. GEPHARDT. Because doing that would be inflationary because it would be all on the individual side. I am sure you understand that a credit for the income tax that is geared and related to the payment of a payroll tax, goes half to business or somewhat half to business, because we have an offset on the deduction to reflect credit, but almost half of it goes to business and the other half goes to individuals.

The reason this proposal has an anti-inflationary effect is because of the amount of the cut that goes to the employers. Economists believe that at least half of that reduction will be passed along to consumers in the form of reduced commodity prices, or at least will result in the holding down of commodity price increases. It also has a direct, I think, impact on their willingness to employ people, because they realize that the credit is related to employment costs.

So, I think the real benefits of this proposal come from the fact that it is an income tax reduction that is clearly and directly related to the payroll tax, which is paid by employers and employees.

If you simply geared this individual reduction to individuals and you give a cut, even if it is somehow loosely related to the payment of payroll taxes, you will lose those anti-inflationary and, I think, those proemployment features.

Senator BRADLEY. Thank you very much.

Senator Dole?

Senator DOLE. Well, I appreciate the testimony. I think one area of concern you have touched on is that this is in effect going to open the door to funding the social security program, the OASI, and EI benefits from general revenues.

You may put a 2-year sunset provision on it, but once you establish that program, I suggest it is going to be very difficult to end. If it were coupled with some reforms in the program, then I think it might have more legitimacy, but as it is, it would seem to me it might be a band-aid approach, but not one that would have any lasting impact. Plus, as I look at it, the 10-percent tax credit will give more to individuals than their increase in tax, but will give less to the self-employed.

Is that an accurate statement?

Mr. GEPHARDT. Because the level of taxation for self-employed is so much greater than people who are not self-employed, I think that would be the case.

This is not a total offset, therefore, of the increase.

Senator DOLE. In fact, I think it is more than the increase for many millions of individuals.

Mr. GEPHARDT. It is in the lower salaried categories; but as you get into the upper salaried categories—I forget the break point—and probably for the self-employed it is not a total offset. We look at a 20-percent credit which would affect that.

In my view the revenue loss was greater than we really want in this tax cut at this time. Obviously, you can adjust the credit at any level you want, but indeed that is the case.

If I can respond, Senator, briefly, I appreciate your disagreement, and obviously that is a major point of disagreement.

I would simply say to you that I have a lot of reforms for social security, and I am sure you do, too. I believe strongly that we need to adjust the benefit structure. I feel strongly that parts of social security could and should be funded by general revenue, but they should be brought out of the social security system in order to achieve that.

Obviously, it was not the time to effect the kind of long-term reform that I think we all think is necessary. We struggled mightly to get the 1977 bill passed. We have not been, on the House side, able to come to a consensus on social security reform for a variety of reasons.

I would just suggest to you that I think the desire, the possibility, that we will do nothing in 2 years if we can suffer along with the system is greater than that we will do something; and I would suggest to you that this will force reform rather than put reform under the rug.

Senator DOLE. That may be true, but having viewed it from this side, as you viewed it from that side, everybody has a list of reforms but nobody wants to vote on them; and it is nice to talk as long as you don't have to vote on the reforms, because there are a lot of people who receive social security benefits.

You particularly wouldn't want to vote on them in September and October of any even-numbered year. So I understand all the politics of it, not partisan but just the straight politics of it.

On the other hand, once we start down the benefit trail, it is going to be very easy to extend the tax credit for 2 more years. It may be that we will finally come up with some combination of what has been suggested by you and Senator Bradley or what has been suggested by others on the committees on both sides; but it is certainly one to consider.

I appreciate your views.

Mr. GEPHARDT. Thank you.

Senator BRADLEY. Senator Danforth?

Senator DANFORTH. I appreciate your testimony very much. I think that the idea itself is certainly worth thinking about and is characteristic of the type of input that Congressman Gephardt typically has in the field of taxation and generally the matters of jurisdiction that are shared by the Ways and Means Committee and the Finance Committee.

If we have a tax bill this year, a portion of that bill will be for business and a portion will be for individuals, and traditionally the break for the portion of it that is for business is about one-third. Some people are saying now that it should be more like one-half in this particular bill, and the business portion should be a so-called supply side tax cut, that is, it should be for depreciation, maybe something for research and development.

How willing would you be to modify your proposal so that it would take care of only the individual side of social security and provide only a credit for individuals? It would seem that the portion which would reduce the business share of social security tax in any tax bill would have to come out of something else, and what it would most likely come out of would be depreciation.

Mr. GEPHARDT. I appreciate those concerns, and I think we are all now worried about the size of this tax cut, especially in light of the fact that it is now estimated the deficit for fiscal 1981 will be larger than any of us thought it would be. In fact, there are respected economists who believe it will be even higher than that. So we all have to be worried about the level.

I would be most willing to address changes that would fit this tax cut into our fiscal needs and our economic policy. Obviously, one of the important features of the bill as presented is that the part of the cut that goes to employers has a good anti-inflationary effect; but I can understand your argument that it would detract from the depreciation part or the investment supply side part of the tax cut; and, therefore, if we are going to keep within a reasonable overall figure that we have got to adjust the cost of this proposal.

I would be more than willing to explore those possibilities.

Senator DANFORTH. Now, another variation of offsetting the social security tax would be to finance the medicare portion of social security out of general revenue and just use what would otherwise be the medicare portion of the tax for old age and survivors' insurance.

What would be the wisdom of doing that? Is that a reasonable variation on your theme?

Mr. GEPHARDT. I don't think so. I voted for that in the Ways and Means Committee 2 years ago, in 1977, but I don't think that it is possible to move to that radical a reform at this point. There are a couple of reasons for that:

One, to totally pay for medicare, the cost for fiscal 1981 would be, I think, greater than the cost of the Bradley proposal. Further than that, I don't sense in the House at least any willingness to enact such a major reform in social security in this short time period.

Our subcommittee is going to go into a full set of hearings and, hopefully, markup next year on further reform of social security. I don't sense any desire to take such an important and significant step.

So, I think this kind of a proposal is the only thing we can address in this time period.

Thank you.

Senator BRADLEY. Thank you, Congressman.

I know that Senator Nelson wanted to have the opportunity to question you. He has gone to vote. We are in a situation now where we have three back-to-back votes, so for the other people who are waiting, I think that the way we will proceed is that Senator Nelson will come back and take the chair while Sentor Danforth and I go and vote; and then probably from about 10:30 to 11 we will probably recess the committee because it doesn't make much sense to sit here 4 minutes and hear American Express or whoever is the next witness. So I think that what we want to do is to keep you here until Senator Nelson returns, and I might do that by asking a few more questions myself.

One of the things that we have considered in the committee is a general rate reduction, and I would like to know your views on the general rate reduction, not the targeted but the Kemp-Roth approach to individual tax cuts.

Mr. GEPHARDT. Well, I would be opposed to that kind of a proposal, for a couple of primary reasons:

First, I think that the amount as suggested in the Roth-Kemp proposal is far too great for the economic situation which we find ourselves in. I am very concerned about the amount of the deficit for 1981. I think to move to a tax cut that would have that revenue impact would be a fiscal and economic error of major proportions.

I realize the feedback argument. I realize there may well be substance to those arguments. I don't discount the fact that there could be more feedback than some economists say. But I don't think you can leap into a radical approach, hoping that the feedback will be much greater than most economists say, and I don't think that is the kind of risk we want to take in this economic atmosphere.

I further believe that not only will the tax cut of that kind have a revenue impact, and therefore, a deficit impact that has an inflation impact, but also that the very idea of simply using the traditional kind of tax cut that we have used for individuals is simply not appropriate for these economic times.

As I said earlier in my statement, I think we now understand that inflation is imbedded in our economy. It is going to be imbedded in our economy for some time to come, and we have got to come up with some innovative ways to offer stimulation that does not increase inflation.

I am afraid for those two reasons the Roth-Kemp proposal is deficient.

Senator BRADLEY. Could you explain for the committee why the income tax credit against social security is a progressive relief from a regressive tax?

Mr. GEPHARDT. Well, I think it is a well-known fact that the payroll tax is a regressive tax. It is a flat percentage on all income groups. Right now it is 6.13 percent of payroll whether you make $5,000 a year or $500,000 a year, and therefore unlike the income tax it is not progressive, in the sense that it is not a greater percentage if you make a greater amount of money. Therefore, a credit against the income tax would provide progressive relief from a regressive tax.

If you are making $5,000 a year and you have a 10-percent credit on your income tax against that regressive tax, your relief is going to be greater in percentage than the fellow making $500,000 or $50,000 a year.

I believe that is a good result; it is one that offers more percentage of the tax cut to the economic groups in the middle and the lower than it does at the upper end. If you look at the economic distribution of the Roth-Kemp tax cut, a greater proportion of that benefit goes to the higher middle and higher income groups, and from my vantage point I think that the proposal you offered has a better economic effect and economic distribution.

Senator BRADLEY. You know everyone is talking about a tax cut, which came up like a Missouri tomato in the middle of the summer, and it seems to be gathering speed. The fear, of course, is that once we begin a tax cut we are going to have a Christmas tree here and everybody is going to have their own little thing to put on the tax cut.

As the chairman of this committee has said a number of times in these hearings, he doesn't know of any tax cut that didn't have that propensity. But it seems to me that if we are looking at why the need for a tax cut came up, namely, the macroeconomic circumstances the country finds itself in going into a recession, and if we look at a surgical approach to that, that is, what kind of tax cut to meet the macroeconomic needs of the country—that when you get into a debate weighing the potential damage to the social security trust fund versus the benefits from this kind of an approach, in my view the benefits far outweight the threat to the social security trust fund.

Again, you might for the committee's edification say why you believe that this tax cut meets the precise needs of the economy of the next 6 months to 1 year to 2 years.

Mr. GEPHARDT. Well, before I do that, let me also comment on timing, because I think that is an important issue.

It is my view that our ability to limit and moderate the amount of the tax cut is greater now at the end of this Congress than it will be in the middle of the next Congress or in the first few months of the next Congress. Any tax cut, as your chairman has said, has the propensity to become a Christmas tree. I think that propensity will be greater next year.

I think the issue now should be, do we need a tax cut or don't we at the beginning of January 1981. If we conclude we need it, I think we can do it better now than next spring, that we can limit it better now than next spring, and we ought to do that.

I also believe that in the economic circumstances in which we find ourselves, we have got to enact a tax cut that fits our economic circumstances. I think that the social security tax credit uniquely does that, as opposed to an across-the-board individual tax cut, for all the reasons I have given; and I strongly believe that that benefit far outweighs the risks that we run that we are going to do something untoward to the social security system.

If there is not a majority in Congress to simply swap general revenue into social security, that majority is going to be here 6 months or even 1 year from now just as much as it is here now.

I would suggest we move ahead. I further think it will greatly emphasize the need for reform in the social security system.

Thank you.

Senator BRADLEY. I am sorry we got interrupted by a rollcall. We appreciate your taking the time to testify.

Mr. GEPHARDT. I appreciate it. The Senator thought you might have some questions about this approach. I would be happy to respond. The gentleman is obviously an expert on social security and is well respected.

Senator NELSON. Thank you.

[The prepared statement of Mr. Gephardt follows:]

STATEMENT OF REPRESENTATIVE RICHARD A. GEPHARDT

Mr. Chairman, I appreciate your allowing me to testify on behalf of Senator Bradley's bill, S. 2920, the Social Security Payroll Credit Act. As you may know, my distinguished colleague from Missouri, Senator Eagleton, introduced a similar bill at a 20 percent credit rate. Senator Bradley's bill is identical to mine at 10 percent.

Although the Nation's unemployment rate remained steady in June at 7.7 percent, the Consumer Price Index rose one percent, up 14.4 percent from last year. American productivity fell at an annual rate of 3.1 percent in the second quarter, the sixth straight quarter of decline. If these trends continue, some remedy for our economic woes must be enacted.

The rise in the Social Security tax rate to 6.65 percent and the expansion of the taxable wage base to $29,700 in January are likely to produce further adverse economic effects—namely higher inflation and higher unemployment. As an employer's payroll tax contributions rise so do labor costs; these higher costs will in turn be passed on in the form of increased prices and increased unemployment. As employees' contributions to Social Security increase, disposable income goes down, resulting in lower levels of aggregate demand.

S. 2920, the Social Security Payroll Credit Act of 1980, provides a remedy to the scheduled increase in the Social Security tax and taxable wage base while solving many of our current economic problems. Under the legislation, employees, employers, and the self-employed alike will receive a credit equal to 10 percent of Social Security taxes paid in 1981 and 1982. In its present form, the bill provides a refundable credit against income taxes. Senator Bradley and I have had an amendment drafted by the Joint Committee on Taxation and the Office of the Legislative Counsel to provide a mechanism so that the credit will be worked into the withholding schedule. As you know, by providing this mechanism, the benefits of the bill are substantially increased as it will put money in the hands of business and labor immediately.

Considerable attention has been given to the concept of S. 2920 since its introduction as a method to provide relief to the burden of increasing Social Security taxes. By reducing business labor costs, the Congressional Budget Office estimates that enactment of the bill will result in a decrease in the unemployment rolls by 200,000 jobs or 0.2 percent. CBO has also indicated that enactment of the bill will lower the Consumer Price Index by 0.2 percent and will increase the real Gross National Product by $8 million or 0.5 percent. I should point out that under the legislation, employees will receive a larger benefit than employers. This results from the credit reducing the payroll deduction afforded to business, and thereby raising taxable income by the amount of the credit. As their taxable income is taxed at an average rate of 40 percent, businesses will benefit by only 60 percent of the credit.

The Joint Tax Committee has estimated that the revenue loss resulting from the enactment of this proposal, including any offsets, would be $10.3 billion in Fiscal Year 1981 and $16.9 billion in Fiscal Year 1982. The Joint Tax Committee, in compiling these revenue loss figures, has estimated that the revenue loss offset will be approximately 10 percent in Fiscal Year 1981 and between 3 and 5 percent in Fiscal Year 1982. These figures are based on the premise that in the first year, 45 percent of the employers' credit will go towards higher corporate profits and the other 55 percent towards reducing prices. In the second year, most of the credit will be directed at reducing prices. As 200,000 jobs will be created by the credit, the government's burden of transfer payments will also be reduced.

We are faced with the fact, as a result of the recession, that the deficit for Fiscal Year 1981 may run as high as $60 billion. According to the Congressional Budget Office, balancing the Budget for Fiscal 1981 was expected to decrease the inflation rate by 0.2 percent. By reducing the inflation rate by 0.2 percent, S. 2920 will have as great an impact on inflation as balancing the Budget.

There are other tax cut proposals before the Committee that will aid individuals. However, as compared to an across-the-board tax cut, S. 2920 is far more preferable. Any tax cut passed by the Congress this year would not take effect until next year. By that time, the Nation will be in the midst of a recovery. A tax cut must not only be countercyclical, as is an across-the-board tax cut, but it must also have other redeeming qualities as well. S. 2920 is endowed with these redeeming qualities with its job creating and anti-inflationary features most prominent.

While the concept of Social Security receives virtually unanimous support from the American people, critics claim that its main drawback is that it is funded by a regressive tax. The Social Security tax rate is the same for all employees, however, it will only be applied to the first $29,700 a worker earns beginning in January. Those fortunate enough to earn larger salaries have no further Social Security liability and thus pay a smaller tax per dollar of aggregate earnings than those wage earners below the wage base. S. 2920 reduces the effective Social Security tax rate for all employees. Thus, those employees who earn an income below the wage base receive a larger per dollar benefit than those over the wage base. At a time when the incomes of un-skilled and semi-skilled workers are ravaged by inflation—at a time when the jobs of these workers are so severely threatened—a progressive tax cut is the only form of tax relief that should be considered.

As I have said, this proposal will benefit employees, employers, and the self-employed. This is a refundable tax credit—if a person incurs no tax liability, he or she may file for a refund at the end of the year. Additionally, if an individual has more than one job or should over-withhold his or her tax payments, the credit at the end of the year would not be greater than anyone else's earning a similar income.

A family of four, with one wage earner and an income of $12,500, would benefit by a reduction in tax liability of $83; if a wage earner grossed $25,000 annually, the reduction would be $166. Anyone earning over the wage base of $29,700, with a family of four, would receive $198.

Business would benefit from this proposal through a reduction in its payroll costs. Of those industries comprising the business sector, this bill will benefit labor-intensive industries most of all. As I stated earlier, the Congressional Budget Office has estimated that 45 percent of the credit to employers will go toward increased corporate profits in the first year. These higher profits will in turn stimulate investment and productivity.

According to the general formula applied to any across-the-board cuts in the Social Security payroll tax, employers and employees will each receive 48 percent of the total credit. Self-employed individuals will receive the remaining 4 percent. Therefore, employers and employees each stand to benefit by $5.424 billion, and the self-employed will receive $425 million. Corporate profits in the first year should increase by $2.712 billion.

Finally, I would like to stress that the integrity of the Social Security Trust Funds will not be compromised by the enactment of this bill. As the credit will be funded out of General Revenues, there will be no reduction in Trust Fund tax receipts. The legislation would only be authorized for two years; enactment of the proposal should not influence or preclude any future action which the Congress might deem necessary to maintain the financial viability of the System. We can ill-afford to tamper with the Trust Funds at this time; S. 2920 recognizes this fact.

Mr. Chairman, I appreciate your allowing me to comment on Senator Bradley's proposal. I believe that his credit should be the nucleus of any tax cut legislation the Congress adopts for 1981, but whatever the outcome of these hearings, I am certain that if the Committee determines a tax cut is indeed appropriate, the model it adopts will be fair and equitable for all Americans.

GEPHARDT 10 PERCENT SOCIAL SECURITY CREDIT FOR A FAMILY OF 4 WITH 1 OR 2 EARNERS IN 1981

Income [1]	Social security liability		Income tax reduction 1981	Social security liability [2]		Income tax reduction
	One earner 1980	One earner 1981	One earner	Two earners 1980	Two earners 1981	Two earners
$5,000	$306.50	$332.50	$33	$306.50	$332.50	$33
7,500	459.75	498.75	40	459.75	498.75	50
10,000	613.00	665.00	67	613.00	665.00	67
12,500	766.25	831.25	83	766.25	831.25	83
15,000	919.50	997.50	100	919.50	997.50	100
17,500	1,072.75	1,163.75	116	1,072.75	1,163.75	116
20,000	1,226.00	1,330.00	133	1,226.00	1,330.00	133
25,000	1,532.50	1,662.50	166	1,532.50	1,662.50	166
30,000	1,587.67	1,975.05	198	1,839.00	1,995.00	200
40,000	1,587.67	1,975.05	198	2,452.00	2,660.00	266
50,000	1,587.67	1,975.05	198	3,065.00	3,325.00	333

[1] Assumed to wage and salary income subject to social security

[2] Assuming each spouse earns half the income.

Source: Joint Committee on Taxation.

REVENUE LOSS BY FISCAL AND CALENDAR YEARS 1981-85

[In billions of dollars]

Fiscal year	Revenue loss [1]	Calendar year	Revenue loss [1]
1981	10.3	1981	13.7
1982	16.9	1982	17.4
1983	19.3	1983	19.8
1984	21.8	1984	22.4
1985	25.4	1985	26.3

[1] Includes the revenue offset as complied by the Joint Committee on Taxation (10 percent the 1st year and between 3 and 5 percent the 2d year.)

Source: Joint Committee on Taxation.

Benefits by income level by percent of tax cut

Income levels:	
$0 to $10,000	14.6
$10,000 to $15,000	13.6
$15,000 to $20,000	16.1
$20,000 to $30,000	30.2
$30,000 to $50,000	19.8
$50,000 to $100,000	4.6
$100,000 and over	1.0

Source: Joint Committee on Taxation.

Senator NELSON. We will now hear from a panel consisting of Peter Evenson of the Paul Howard Construction Co. on behalf of the Associated General Contractors of America; Norma Pace, vice president, American Paper Institute; William J. DeLancey, chairman of the American Iron & Steel Institute; and Mr. William Penick, managing director, tax policy, Arthur Andersen & Co.

If you would be kind enough to identify yourself for the reporter starting at my far right.

Mr. PENICK. I am William Penick with Arthur Andersen & Co.

Ms. PACE. I am Norma Pace of the American Paper Institute.

Mr. EVENSON. My name is Peter Evenson with Paul N. Howard Construction Co.

Mr. DELANCEY. I am William DeLancey, chairman of the American Iron & Steel Institute.

Mr. ROOT. I am Thomas Root, AGC staff.

Mr. STOCKTON. George Stockton, AGC staff.

Senator NELSON. All right, go ahead and proceed however you desire.

STATEMENT OF NORMA PACE, SENIOR VICE PRESIDENT, AMERICAN PAPER INSTITUTE

Ms. PACE. Shall I start?

My name is Norma Pace. I am senior vice president and chief economist of the American Paper Institute.

The members of the American Paper Institute and the National Forest Products Association whom I represent today are grateful for this opportunity to present our views on the tax policy at this critical time.

In formulating our policies we were mindful of the need to develop a responsible position in view of the dangerous and conflicting forces operating in the economy today. We know we have recession. We have inflation. We have rapidly rising taxes and tax increases scheduled for 1981, and despite all of this we continue to have large Federal deficits.

After giving careful attention to the nature and severity of these problems, we support a broad based program of phased-in tax cuts that will minimize the impact on revenues and speed up growth and productivity in the United States.

A tax cut of about $25 billion split evenly between business and individuals should be enacted now to take effect on January 1, 1981. It should be the first phase of a longer range program.

Considering the current problems that the economy faces, the only real response that business can make that is logical and helpful is to increase its investment. What we must do right now is to prevent the downturn in consumer spending from spreading to business investment next year.

So, it seems that the key ingredient in this phased-in tax program should be faster capital recovery. Increased investments that will moderate inflation, increase supply, improve worker productivity, and encourage faster economic growth are needed now.

And if I may, I would like to take a few minutes just to illustrate this with the problems of the paper industry.

In 1979 our industry experienced shortages in some grades of paper and tight supply in others. And as the result of this, we increased imports of grades of paper above normal import levels.

Now why has this happened? Have we failed to invest? No, that is not the answer. In 1979 and again in 1980 we are going to spend more than $6 billion a year on plant and equipment. And that is twice what we spent only 3 years ago. But that simply is not enough.

If you look at the investments in energy conservation, in pollution abatement, in reforestation, in the replacement of obsolete and worn out equipment that we will need as well as the additional capacity in the next 5 years, our average annual outlays will increase to $8 billion a year. Even under the best operating conditions we are going to fall short of those requirements by close to $3 billion a year.

Now the result of all of this is that we will experience a lag in investment that could reduce growth in the industry and the economy. It will reduce the potential for job creation. The paper industry wants to invest. It needs to invest.

But present depreciation allowances fall far short of replacement needs alone in this inflationary period. And yet across the border our biggest and nearest competitor, Canada, permits a 2-year writeoff for machinery and equipment.

We made some estimates of 10-5-3 to determine its impact on our industry and on Treasury receipts. When 10-5-3 is fully implemented after a 5-year period, we expect our cash flow to be $900 million higher than it would have been otherwise. This $900 million would finance 1 million more tons of capacity for the paper industry, and this added capacity will generate cumulative tax revenues of over $1 billion after only 3 years.

So what we are saying is that $900 million in tax reductions will increase activity in our own industry and in our customer and supplier industries enough to generate $1 billion in tax receipts after 3 years. And that qualifies as a sound investment in productivity, growth and lessened inflation in the United States.

But even as we recognize the great importance of increasing depreciation allowances or allowing faster capital recovery, we admit that there are other problems in the tax structure. And that is why we believe a broad-based program is needed. We have just listened to a discussion of payroll tax increases. We agree that those are a problem but we are concerned about the particular proposal that was just described because we feel it would involve general revenue financing.

So we are proposing the remission of half the increase in the rate as well as the taxable wage base that is scheduled to take effect in 1981.

We think there is room also for a phased in program of corporate and personal tax reductions. And we certainly think that risk taking and entrepreneurship are greatly affected by our tax structure, and those proposals that would encourage new ventures should be considered. Experience with the recent reduction in the capital gains tax rate is encouraging, and we think that should receive the attention of Congress in this consideration of appropriate tax action.

We hope that the capital gains liberalization would apply to corporations as well as individual tax rates. So what I have described is what I think is a responsible tax position that borders on structural reform, that is equitable and will still move the economy quickly into balanced recovery with higher productivity and real increases in revenues.

Thank you.

Senator NELSON. Thank you. Who is next?

STATEMENT OF WILLIAM C. PENICK, MANAGING DIRECTOR, TAX POLICY, ARTHUR ANDERSEN & CO.

Mr. PENICK. I will go next. My name is William Penick and I am the managing director for tax policy with Arthur Andersen.

We are delighted to have a chance today to present our views on this very important set of hearings.

In our view the impact of our current rate of inflation on both taxes and capital is a primary concern in considering tax reductions at this time.

First, by taxing inflated business profits, industry is in effect being decapitalized.

Second, by pushing individuals into higher tax brackets, a substantial tax increase is being imposed.

Third, at current inflation rates our present tax laws are destroying incentives to work, save and invest.

The term "tax reduction" is a misnomer. If Congress does not act to reduce tax burdens, it is implicitly approving substantial tax increases caused by inflation.

A recent joint committee estimate of the amount of individual "bracket creep," assuming relatively modest inflation rates that were the basis for the first concurrent budget resolution, suggests accumulated inflation induced increases in individual taxes exceeding $380 billion in the next 5 years.

Senator NELSON. Is this bracket at an assumed inflation rate?

Mr. PENICK. The same rates of inflation that were in the first concurrent budget resolution. It starts out for next year at a little over 13 percent and scales down I believe in 1985 to a little over 8 percent.

Senator NELSON. You are not counting increased taxes, social security or windfall profits?

Mr. PENICK. This is purely the individual bracket creep by pushing people to higher brackets.

Senator NELSON. Five years equal to——

Mr. PENICK. Roughly $380 billion. If you would like the details on that for the record, I would submit those.

Senator NELSON. Yes.

[The information to be supplied for the record is as follows:]

INFLATION TAX WINDFALL TO FEDERAL GOVERNMENT [1] INCREMENTAL AND CUMLATIVE

[Dollars in billions]

Year	Assumed inflation factor, in percent	1981	1982	1983	1984	1985	1981–85 total
1981	13.3	$23.4	$26.2	$29.3	$32.9	$36.8	$148.6
1982	10.0		19.7	22.1	24.7	27.7	94.2
1983	9.7			21.4	24.0	26.8	72.2
1984	8.7				21.5	24.1	45.6
1985	8.3					23.0	23.0
Cumulative total		23.4	45.9	72.8	103.1	138.4	383.6

[1] Estimated by indexing the rate brackets, the zero bracket amount, personal exemptions and the earned income credit for the increase in the Consumer Price Index of the years ending in the third quarter of the preceding year. The inflation rates are those assumed in the First Concurrent Budget Resolution for fiscal 1981 and out to 1985. Also assumed are real growth rates in GNP of 0.4 percent for fiscal year 1981, 3.1 percent for fiscal year 1982, 3.4 for fiscal year 1983, 3.8 percent for fiscal year 1984 and 3.8 percent for fiscal year 1985.

Source: Joint Committee on Taxation.

Mr. PENICK. We are not suggesting that Congress would permit increases of this size to become effective but it does indicate the magnitude of the problem.

Current problems of our economy are well-documented. Many businesses are experiencing reduced profits and increased unemployment. Real corporate profits are off significantly. Our productivity growth rate, savings, and investments are lagging behind most of our major competitors.

Tuesday's Wall Street Journal reported a 12.5 percent decline in output of goods and services during the second quarter: The sharpest decrease in the 33 years such data has been compiled. For the first 6 months of this year the GNP decreased.

We are not suggesting that changes in tax policy will solve all the problems facing our economy, but the right kinds of changes could contribute significantly to their solutions.

A key factor in encouraging productive investment is a more effective cost recovery system. This seems the appropriate time for Congress to revise our tax depreciation system to provide: One, a much greater incentive to invest; two, increased protection against the erosion of invested capital caused by inflation; three, creation of a simplified tax depreciation system that will benefit all taxpayers, both large and small. And we certainly commend you, Mr. Chairman, for your efforts toward this kind of objective for smaller businesses.

Our written statement contains a number of comparisons of the capital cost recovery system, the so-called 10-5-3 approach contained in S. 1435, with the simplified cost recovery system, included as part of Ways and Means Chairman Ullman's Tax Restructuring Act of 1980, H.R. 7015.

Based on that analysis as indicated in our written statement, the 10-5-3 approach provides greater investment incentive and greater protection from inflation, particularly for longer lived assets, than the simplified cost recovery approach.

However, the simplified recovery system through its pooled asset account approach provides much greater simplicity. Changes could be made in that system that would provide greater stimulus.

A central theme of these hearings is whether or not tax reduction should be enacted at this time. While a number of changes may be appropriate in our tax system affecting both individual and business taxpayers, we believe that action on cost recovery proposals should be given top priority, even though they might not be effective until 1981.

Major capital investment projects require certainty as to tax consequences since taxes are often a critical factor in determining the rate of return on an investment and deciding whether or not to invest. Delay in action may mean delay in investment at a time when our economy badly needs productive investment.

Our overall Federal tax system badly needs major reexamination. By relying heavily on progressive income taxes, we have created a bias against work, savings, and investment, and favoring consumption.

Among the changes in our present system that should be considered are in our view the integration of corporate shareholder taxes, increased incentives for savings, dividend reinvestment plans, taxation of Americans working abroad, tax deferred rollovers, and so-called marriage penalty tax.

There are many other things we could talk about. I know our time is short. It is a real privilege to have a chance to present our views to this committee. Thank you.

Senator NELSON. Thank you.

STATEMENT OF PETER O. EVENSON, PAUL N. HOWARD CONSTRUCTION CO., ON BEHALF OF ASSOCIATED GENERAL CONTRACTORS OF AMERICA

Mr. EVENSON. Mr. Chairman, my name is Peter Evenson. I am assistant to the president of Paul N. Howard Co., Greensboro, N.C. I appear here today as a member of the Tax and Fiscal Affairs Committee of the Associated General Contractors of America. Appearing with me are Thomas L. Root and George Stockton of AGC's national staff.

I understand that the written statement will be incorporated in the record, so I will be brief and to the point.

AGC is firmly behind the Capital Cost Recovery Act of 1980 as the best available means of providing a stimulus to the economy without fueling the flames of inflation. One of the concerns we have heard expressed is that small business is not behind the 10-5-3 legislation.

AGC consists of almost 90 percent small businesses. We are very much behind this legislation.

The two previous speakers have done an excellent job in terms of summarizing their support of 10-5-3. I can only add that AGC shares their support of this measure.

Senator NELSON. Well, let's see. The real estate, the people in the field of real estate oppose it?

Mr. EVENSON. Yes, but in the construction industry, AGC in particular, we do support it fully. We look upon it as a means of stimulating basic industry, and it provides advantages to the construction industry as well.

Senator NELSON. Well, is there any validity to making a distinction between apartment houses and so forth and, say, retail services or manufacturing industries?

Mr. EVENSON. In terms of manufacturing, we are also looking primarily at the productivity side by giving incentive to accelerated writeoff of capital equipment. A building is just as much a productive capital asset as the equipment in it.

And, for example, in Canada there are writeoffs as short as 1 to 2 years on capital investment.

Senator NELSON. Does that apply to buildings in Canada? I think that is productive equipment. I know they adopted about 7 years ago a 2-year straight-line depreciation as to productive machinery equipment. I was under the impression——

Mr. EVENSON. Not to buildings, no. The point is that we are concerned with the overall eroding productivity in the United States. In construction, we are concerned with regard to dealing with unemployment, to dealing with inflation, and we see the Capital Cost Recovery Act as offering a broad and a strong basis for dealing with these problems.

Mr. Chairman, if I may, I would like to comment further on construction productivity with regard to sections 911 and 913.

Sections 911 and 913 tax burdens have undermined the competitive posture of the U.S. construction industry in the international markets. This is particularly true in the Near East market where we have gone from dominance in 1975 to 12th place recently. In 1975, in the Near East, we held 10 percent of the market as a country. This is down now to 1.7 percent, which is even behind the U.S.S.R. The AGC gives full support to either the Chafee-Bentsen or Jepsen bills which would eliminate the noncompetitive aspects of the current law and would remove major obstacles to the exporting of U.S. construction and engineering services. We urge the committee to consider the inclusion of either of these proposals in the 1980 tax cut package.

I appreciate the opportunity to deliver these remarks. I welcome any questions.

Senator NELSON. Thank you very much.

STATEMENT OF WILLIAM J. DE LANCEY, CHAIRMAN, AMERICAN IRON & STEEL INSTITUTE

Mr. DE LANCEY. I am William De Lancey. As I said, I am chairman of the American Iron and Steel Institute.

Currently employment in the steel industry is at the lowest level in 47 years. We estimate that over 80,000 employees are laid off and an additional 30,000 are on reduced working schedules. The operating rate of the industry is approximately 55 percent.

Shipments of finished steel this year could be as low as 80 million tons, as compared to 100.3 million tons in 1979. As a result, the cash flow urgently needed to maintain investment in our industry could decline $2 billion or more from the 1979 level. Although our business is projected to improve in 1981, the advance overall is expected to be modest. In short, we are looking at 2 very weak years in a row.

This outlook underscores the importance of acting promptly to approve the two tax measures which I am pleased to have this opportunity to recommend to the committee today.

The first measure arises from the fact that the tax laws have played a significant role in constricting the funds needed for investment in new steel plants and facilities.

Over the past 10 years the steel industry's capital investment has averaged about $2.1 billion per year, far less than what was needed. In our view, the rate of industry investment must be more than doubled in this decade in order to maximize productivity, provide job security, and decrease energy usage.

A study jointly prepared by the Treasury Department and the steel industry issued this month by the Steel Tripartite Committee confirms a shortfall in the industry's capital requirements of $1.7 to $2 billion annually over the next 5 years.

U.S. tax depreciation policy has overemphasized the physical life of steel-plant facilities and along with governmental policies in other areas has seriously impeded the industry's ability to take advantage of advancing technology.

Depreciation regulations reflect the so-called useful-life concept and ignore the devastating effect of inflation on an industry whose inherent capital intensity has been aggravated by heavy environmental requirements.

Senator NELSON. Is there an average useful life of the productive machinery and equipment in the steel industry, that is to say, what is the average useful life of the major capital investments in productive machinery in the steel industry?

Mr. DE LANCEY. Well, under the statute the lowest number is now 12, but the problem is that the philosophy of the law has reflected the fact that in steel, where we have these very heavy tonnages of large quantities of equipment to be processed, the facilities necessarily have to be strong and durable. They have to last a long time, and the problem has been that their very duration has worked against moving into newer and better technologies such as continuous casting, which we ought to have done and are restrained from doing because we don't have the cash to do it.

Senator NELSON. Well, do you mean under the IRS' useful life interpretation, the average is 12 years for equipment in the steel productivity industry?

Mr. DE LANCEY. That is the number we are constrained to recognize now, and as has been noted, in Canada overall it is about 2.5 years. We are very much aware of the fact that the Steel Co. of Canada is just now bringing onstream a brandnew steel plant, a very modern and very efficient one, while across the lake, about 50 miles across the lake, United States Steel is unable to find justification to build its new plant at Conneaut, which has been highly publicized; and this is representative of the lack of competitiveness which the industry faces from a tax standpoint, sir.

Senator NELSON. And your position is that the useful life concept, in view of the kind of modern inflation rates we are dealing with, is obsolete?

Mr. DE LANCEY. It really is a deterrrent in our case to making the moves that we need to make and to be competitive and to just maintain our capacity.

Senator NELSON. The economists historically believe, and the conventional wisdom has been, that useful life the concept of a was the appropriate way to allow for depreciation, the argument being made anything more rapid than that somehow or other was a gift to business or industry. Isn't there a compelling argument for the other side of the coin—it seems to me, anyway—and that is to say that the useful-life concept is outmoded in any event, that we have had 1.5- to 2-percent inflation rates which existed most of the time from 1950 to 1970 and, back in the 1950's, of course, much lower than that, but that the concept is outmoded because of inflation? But even laying that apart, isn't there a compelling argument for the concept of simply saying there is no relationship, there should be no relationship, with your depreciation schedule and the useful life of the property, because if you allow a depreciation rate such as allowed in Canada of 2 years that when it is written off, if the company is profitable they would be paying taxes anyway; and if they are not profitable they haven't anything to write off.

In any event, your objective is to maintain modern and productive machinery in a modern, productive industry, and you get it by allowing recapture of capital very quickly; and as I say, it comes out awash, does it not, in the long haul, since if you write it off in 3 years and you use it for 9, you have nothing to write off for the last 6 years?

Is that concept good? Has that holes in it?

Mr. PACE. There is also obsolescence, Senator. It doesn't permit you to move quickly into new technology.

Senator NELSON. I looked at a piece of equipment in a papermill in Wisconsin a couple of times just a couple of weeks ago. It was 2 years old. They were rebuilding on it. Replacement costs, $82 million, and the piece of equipment is a half a city block long, as you well know, representing the industry; and I am told in Germany they will turn that kind of equipment over in 7 or 8 years or something like that.

So, whereas it has a useful life standing alone, and it is a productive piece of machinery, it is obsolete compared to the technology that has been developed in the past 22 years, since this company bought the plants; is that correct?

Mr. PACE. Yes.

Mr. DE LANCEY. Mr. Chairman, the prime example in the steel industry of this situation relates to continuous casters. This is a much more efficient method of creating slabs of steel than are now produced under the orthodox system, which calls for the production of ingots which are then cooled down, they then have to be brought up to temperature again in soaking pits and put through a slabbing mill.

Now, these slabbing mills have to be built to last a very long time, just because of the very large job they do; but so far as the tax law is concerned, they have a useful life that is extensive, and this blocks our being able to get into the continuous casters the way the Japanese have been doing.

Senator NELSON. I see there is another rollcall coming along here. Go ahead and complete your statement.

Mr. DE LANCEY. I will move ahead rapidly.

I think we recognize that no other major industrial nation has a longer capital recovery period than the United States and most countries have a shorter period.

Without substantial additional investment for modernization and replacement of existing facilities, steel capacity in this country will decline significantly.

The shrinkage of the U.S. steel industry should be assessed in terms of its adverse effects in various areas, on declining employment in steel and related industries, on customers forced to become heavily dependent on foreign sources and the premium prices they would exact in tight markets, on the economy of the Nation as inflated by monstrous trade deficits in steel, on local communities suffering plant shutdowns, and on national defense.

The steel industry strongly supports S. 1435, which would open a new era of governmental cooperation with industry, with special recognition of the need to improve productivity; indeed, the very enactment of this legislation would be an encouraging signal which would be of great benefit to the steel industry at this time in lifting business confidence from its low recessionary level.

Over time this legislation would, of course, help the steel industry generate the cash flow it needs for the facilities which ought to be installed to prevent the capacity decline to which I referred.

S. 1435, however, does not provide near-term tax benefits for the steel industry and hence does not address the fact that the decline in cash flow during the recession threatens the cancellation or deferment of the installation of facilities needed by steel companies to advance productivity and to comply with environmental requirements.

Accordingly, we recommend that Congress provide for the refundability of investment tax credits to help forestall such a setback.

Substantial investment in recent low steel profit years has resulted in the accumulation of unused tax credits estimated at about $600 million. Legislative action to authorize the accelerated use of unutilized investment tax credits through refundability would provide immediate cash to most steel companies.

Regrettably, the net effect of the investment tax credit in times like these is that it discriminates against capital-intensive industries with low earnings, such as steel. The credit should not be more beneficial to higher profit, less capital-intensive industries than to those industries which have made the capital expenditures but which are without current tax liability.

In terms of the realization of benefits for the steel industry and all those dependent on it, refundability will be immeasurably more advantageous than if there must be a delay until the return of our industry to the requisite profitability.

Although the steel industry has been hit hard by the recession, at the core it is still strong and can and will build for the future if governmental policies will shift to take better advantage of the dynamics of the private enterprise system. The benefits of such a move would be those accruing from a vibrant and healthy steel industry and should be contrasted with the adverse consequences resulting from a shrinkage in steel capacity.

The tax measures we recommend would help significantly to achieve the desired objective. It is not inappropriate in these circumstances to talk in terms of a return on investment, and I would suggest that the return to the Nation would overwhelmingly justify this tax investment.

Our request is that the committee approve these two measures, to be effective in January 1981.

Thank you, sir.

Senator NELSON. Thank you very much.

The committee appreciates you all taking the time to testify. I thank you all.

[The prepared statements of the preceding panel follow:]

TESTIMONY OF THE AMERICAN PAPER INSTITUTE AND THE NATIONAL FOREST PRODUCTS ASSOCIATION

My name is Norma Pace. I am Senior Vice President and Chief Economist of the American Paper Institute. I represent the Institute and the National Forest Products Association.

The American Paper Institute has over 175 members which provide over 90% of the pulp and paper manufactured in this country. It ranks among the ten largest industries in the United States. The National Forest Products Association is a federation of associations representing 2500 timber growers, manufacturers and wholesale distributors of solid wood products throughout the United States. Nationwide, these groups provide employment for over 1,365,000 people.

The U.S. economy has moved into a deep recession that has affected all major industries, including the paper industry. Despite the recession, individuals and business will pay higher payroll taxes, more "windfall profits" taxes and other legislated increases. Inflation has moderated but still remains at levels that are harmful to both long-term growth and political stability. All U.S. taxpayers are hurt by inflation and taxes which rise faster than income; yet the large and continuing deficits in the federal budget raise serious questions about the advisability of a tax cut now.

After careful consideration to the nature and severity of current U.S. economic problems, the American Paper Institute supports a broad-based program of phased-in tax cuts that can have a moderate effect on tax revenues and a positive effect upon growth. A tax cut of about $25 billion, enacted now but to take effect on January 1, 1981 is the first phase of such a program. This cut should include faster capital recovery and personal income tax cuts which encourage savings and investment. Serious attention must also be given to the negative impact of the current tax structure on productive innovation and entrepreneurship. The steep advance in payroll taxes is also a matter that requires the attention of Congress.

Why legislate it now? The answer is that both individuals and business must have a firm planning base for making their spending, savings and investment decisions in this uncertain climate—without that knowledge the U.S. economy could drift into worse conditions. Enactment of specific tax changes now will restore confidence and a steady flow of decisions that will still not uncork new inflationary pressure.

THE DEFICIT PROBLEM

The growing federal deficit is clearly a matter of alarm for investors at home and abroad. We must recognize the serious consequences of continued neglect of government deficits on our economic viability and the moral fibre of the nation. A balanced budget is a goal we must attain and sustain over time, but balancing the budget in time of recession cannot be accomplished; it must be approached in a longer range perspective. Furthermore we must recognize that it is not merely today's problem but must remain a focus of attention for a long time.

Deficits and inflation

The historical, as well as country-by-country comparisons between government deficits and inflation rates clearly show that deficits *alone* are not responsible for inflation. Deficits financed out of savings have no real effect on inflation but persistent deficits financed out of new money creation will indeed inflame inflation.

Closing the deficit is a necessary step in removing one contributor to inflation. Other steps are also needed, including tax cuts that stimulate savings and investments and a halt to the proliferation in regulatory agency activities and outlays. The steps recently made toward formulating an energy policy that restores incentives to the private sector are encouraging, but more needs to be done. Balancing the budget is not the panacea for inflation, but it is a necessary part of the cure. The root of the government deficit problem lies in rapidly escalating government outlays which seem to have no bounds. Government spending during the past ten years has advanced 193% while private GNP grew 158% and federal tax receipts advanced 171%. This performance persists despite unquestioned evidence that it is debilitating the economy.

Even as it considers an appropriate tax program for 1980 and 1981, Congress must make a determined effort to curtail the rate of expansion in government spending in the future. In addition to the inability of taxpayers to finance such rapid growth, increases in federal outlays have other consequences. The rapid growth in federal outlays, for example, prevents the normal market adjustment mechanisms from working properly. Credit restraints imposed by the Federal Reserve are meant to curtail all spending rates. But these credit restraints have absolutely no effect upon government outlays which increase despite their harmful effect upon inflation and balanced growth. The result is that the private sector always bears an inordinate share of a credit restraint program which in turn reduces tax revenues and increases the deficit. That self-defeating process has never been more evident than in the present dismal situation.

A BALANCED GOVERNMENT PROGRAM IS NEEDED

The thrust of government spending for 1980 and 1981 and the reduced revenues stemming from the recession make sizeable deficits unavoidable in these years. The problem of escalating budget deficits can best be solved with a planned reduction in the growth of government spending and a program that increases tax revenues through healthy growth in the economy.

1. Taxes must be reduced to encourage consumption, savings and investment. The three are closely linked; one should not gain at the expense of the other.

2. Government spending must be curtailed and its growth rate reduced over time so that spending in real terms gradually declines. This will have many beneficial effects:

(a) the tax burden will be eased and tax rates can fall below the inflation rate, without the need for indexing;

(b) government will be forced to establish priorities, just as the private sector does in times of stress;

(c) regulatory bodies will have to increase their efficiencies as budgets become a controlling factor in prioritizing their activities;

(d) the spirit of self-reliance and initiative which has served this country so well will be restored.

TAX CHANGES NEEDED NOW

The need for major structural tax reform is evident; but the present economic situation is such that the long lead time needed for the design and adequate testing of a major tax reform simply does not exist.

There is merit in a simple, easy-to-understand balanced tax program. The combination of recession and inflation calls for tax action that will have a slow but steady and favorable impact on both the economy and federal revenues over time. The greatest stability would be provided by a broad program of phased-in tax cuts that address most of the major problems created by the present structure. It borders on reform.

These tax cuts should include:

1. faster capital recovery phased-in over a 5-year period.
2. reduction in corporate and individual tax rates also phased-in.
3. removal of tax dis-incentives that inhibit risk-taking and entrepreneurship. Liberalization of capital gains tax treatment and tax reduction for smaller businesses, particularly new ventures, should be included. The costs are small and the benefits high.
4. the problem of a steep escalation in payroll taxes is real and Congress could include a temporary cut in the proposed increases in the taxable wage base and tax rates for 1981.

SPECIFIC PROPOSALS FOR 1981

The two most urgent needs at present are some relief from the steep advance in taxes scheduled for 1981 and the need to encourage savings and investment.

Capital cost recovery

The need to encourage more investment in efficient and new production facilities is large. Faster capital recovery will moderate inflation, increase supply, improve worker productivity and encourage faster economic growth. Furthermore, it brings our capital recovery system closer to that of other countries which compete with us in domestic and foreign markets.

The U.S. paper industry has many advantages over its foreign competitors. We are presently blessed with ample trees, fairly efficient mills, economies of scale which result from heavy investment, and a willingness to invest in our future. The industry's capital expenditures this year will total $6 billion, almost twice the amount spent only three years ago. But even this high level is not enough to sustain our growth and advantages in the future. Investments in energy conservation, pollution abatement, reforestation, replacement of obsolete and worn-out equipment, as well as needed additional capacity will require at least $8 billion a year during the next five years. Cash flow under existing depreciation schedules—and given full capacity operations in the industry—will provide only 67 percent of these needed capital outlays. Clearly, investment will lag requirements and inflationary pressures will be heightened.

The U.S. is behind other industrial countries in this matter of tax incentives for investment. The American Paper Institute examined the depreciation allowances for the paper industry in five nations that compete with us in international pulp, paper and paperboard markets; namely, Canada, Mexico, Brazil, Sweden, and Finland. All had far more liberal policies than the United States. Canada, our nearest competitor, for example, has a two-year write-off for machinery and equipment. How can the U.S. persist in this lag when its productivity is falling behind that of competitor nations?

In evaluating the tax revenue impact of S. 1435, the so-called 10-5-3, the American Paper Institute estimated that it would add $900 million a year to the industry's cash flow when fully implemented over a five-year period, enough to buy almost a million tons of additional capacity. API further estimates that the implementation and operation of 1 million tons of new mill capacity would generate total cumulative tax revenues of over $1.2 billion after only three years of operation. That qualifies as a sound investment in productivity, growth and lessened inflation in the United States. The cost in 1981 of this program for all industry is only $5 billion.

Corporate rate tax cuts

While faster capital recovery will assist the capital intensive industries whose asset values have been seriously eroded by inflation, there is also a need to encourage investment in manpower intensive industries as well. A cut of 2 percentage points in the corporate tax rate would increase cash flow by $4 billion and provide more savings and investment. Adjustments in the rates for smaller business should be part of this tax cut.

INNOVATION AND ENTREPRENEURSHIP

Risk-taking in the U.S. is now penalized by the tax structure as well as the mountain of paper work and regulations which inhibit the business outlet for creativity. We would suggest that Congress review various proposals that have been made for encouraging new ventures. The experience with the recent reduction in tax rates for capital gains shows that it has lost no revenue for the government and may have even increased such revenue. A costless tax change that encourages investment has got to be good for the country and we encourage additional liberalization in the tax treatment of capital gains. This liberalization should apply to corporate as well as individual capital gains.

THE PROBLEM OF PAYROLL TAXES

Payroll tax increases have been among the fastest growing costs for the wage earner. In 1981 these taxes will increase sharply, adding about $1 billion to the trust fund revenues. While some of these additional revenues may be needed to help support the steep advances in benefits which are tied to the Consumer Price Index, these trust funds have some flexibility which can help over the short run, even if Congress were to enact only part of the legislated increase. We would not propose a total remission of the increase but only half. This could be accomplished by legislating an increase of only half the tax rate and taxable wage rate change. The additional tax revenues from the increase in payroll taxes in 1981 would be $7.5 billion instead of the estimated $15 billion.

Funding of the Old Age and Survivors Insurance should continue to be divided evenly between employers and employees and should be on a sound fiscal basis. The government is in the process of re-assessing the composition of the Social Security Trust Fund as well as its financial needs in view of the current steep indexing of old age benefit payments to the Consumer Price Index. A careful analysis of the proposals of the various committees and the National Commission should be a high priority for the next session of Congress. A long range solution is urgently needed. The proposed remission of half the increase is a temporary adjustment which would restore $7 billion of the buying power to the private sector and would further moderate the rise in unit labor costs, an important contributor to inflation.

In summary, a phased-in tax program with an initial cut of $25 billion, taking effect on January 1, 1981 split evenly between business and individuals will move the economy closer to balanced recovery in 1981. This will increase real revenues and the productivity base of the nation. It should be enacted now.

SUMMARY OF TESTIMONY, AMERICAN PAPER INSTITUTE AND NATIONAL FOREST PRODUCTS ASSOCIATION

After careful consideration to the nature and severity of current U.S. economic problems, the American Paper Institute supports a broad-based program of phased-in tax cuts that can have a moderate effect on tax revenues and a positive effect upon growth. A tax cut of about $25 billion, enacted now but to take effect on January 1, 1981 is the first phase of such a program. Coupled with a planned reduction in the growth of government spending, the tax cut should include:

(1) faster capital recovery phased-in over a 5-year period

(2) reduction in corporate and individual tax rates also phased-in

(3) removal of tax disincentives that inhibit risk-taking and entrepreneurship including liberalization of capital gains tax treatment and tax reduction for smaller businesses

(4) a temporary tax cut in the proposed increases in the taxable wage base and tax rates of payroll taxes for 1981.

Statement on

Impact of Inflation on Taxes and Capital

before the

Committee on Finance

of the

United States Senate

Public Hearing on Tax Reduction Proposals

Submitted by William C. Penick
Arthur Andersen & Co.

July 31, 1980

ARTHUR ANDERSEN & CO.
STATEMENT OF WILLIAM C. PENICK
SUMMARY OF POINTS

I. Impact of inflation on taxes and capital is of primary concern in considering tax reductions.

   a. By taxing inflated business profits, industry is being decapitalized.

   b. By pushing individuals into higher tax brackets, a tax increase is being imposed.

   c. Present tax law at current inflation rates is destroying the incentive to work, save, and invest.

II. "Tax Reduction" is a misnomer. If Congress does not act to reduce tax burdens, it is implicitly sanctioning unlegislated tax increases. Recent Joint Committee estimates of individual "bracket creep", assuming modest inflation rates, suggests inflation induced increases in individual taxation of over $380 billion in the next five years.

III. Importance of capital recovery system in encouraging productive investment.

   a. Need for an incentive to invest.

   b. Minimize erosion of capital caused by inflation.

   c. Need for simplified tax system to benefit all taxpayers.

IV. Comparison of capital cost recovery system (HR 4646), and simplified cost recovery system (HR 7015).

   a. CCRA provides more incentive and protection from inflation.

   b. SCR provides greater simplicity.

   c. SCR could be modified to provide greater stimulus.

V. Congress should commence a major reexamination of our Federal tax system as soon as time permits. However, current economic conditions require immediate attention to our inadequate level of investment in productive assets.

VI. Action on cost recovery proposals should be taken now even though not effective until later. Capital investment programs require certainty as to tax rules since taxes are often a critical factor in determining the rate of return on an investment, and in deciding whether to invest.

My name is William C. Penick, and I am Managing Director for Tax Policy for Arthur Andersen & Co. We welcome the opportunity to testify before this committee today on the subject of tax reductions, and commend the Chairman for scheduling these hearings.

Ours is an international accounting firm, with offices in major parts of the world. While we have many clients who would be affected by tax reduction proposals that will be considered, we do not represent them in this testimony and the views expressed are those of the Firm itself.

INTRODUCTION

Inflation is clearly one of the major problems facing our country today and its impact on our tax system and on the pool of capital available to meet tremendous needs in the next few years is of great concern. We believe that (1) reductions in the Federal income tax burden on individual and business taxpayers are needed, (2) such reductions should be considered this year, even though not effective until 1981, and (3) the reductions should focus on the creation of incentives, or the elimination of disincentives, for much needed capital investment to improve productivity and to stimulate our economic system.

Other witnesses at hearings this year, as well as in previous years, have noted some of the fundamental problems facing our economy. For many businesses, profits are down and unemployment is up. Productivity growth rate is down and lags significantly behind our major competitors. For the first six months of this year, in real dollar terms, our gross national product is down. Savings and productive investment are lagging considerably behind our competitors. Tax policies alone will not correct all of these problems. However, the appropriate kind of tax policies can contribute a great deal to their solution.

Aside from problems created primarily by inflation, our Federal tax system badly needs major reexamination. Our heavy reliance on income taxes, particularly high marginal tax rates, has created a clear bias against savings and toward consumption. The Tax Restructuring Act of 1980 (HR 7015), introduced by Chairman Al Ullman, suggests such a rexamination, and your Chairman has suggested such a review of fundamental tax concepts. This Congress may not have the time to make the kind of in-depth study that might lead toward restructuring the system, but subsequent Congresses should undertake this project.

Many areas should be explored. These could include such things as the (1) integration of corporate-shareholder taxes, (2) greater flexibility in tax deferred rollovers of investments, (3) increased incentives for savings, (4) dividend reinvestment plans, (5) the fundamental question of whether or not there should be greater reliance on a consumption tax, (6) the so-called marriage penalty tax, and (7) the the taxation of Americans working abroad.

The White House Conference on Small Business adopted several important recommendations for tax changes that require early consideration. If time permits, they should be reviewed as part of this year's legislative process.

In considering the need for tax reduction we must recognize that, unless such reduction is enacted, Congress will in effect be imposing large unlegislated tax increases on the American taxpaying public. By taxing inflated earnings at progressively higher individual rates as well as overstated business profits caused by inflation, a major tax increase is being imposed on the U.S. economy. The magnitude of this problem is discussed later in this testimony.

In this statement, we are directing our attention to critical areas that we think demand immediate consideration by this Congress.

IMPACT OF INFLATION

Tax reductions adopted this year should provide a stimulus for new investment and should also overcome, or at least mitigate, some of the inadequacies of our present methods for accounting for profits and taxes. The calculation of profits and, to some extent, of taxes using "generally accepted accounting principles" may be accurate in a stable, non-inflationary economy, but there is a substantial overstatement of profits in an inflationary environment where the dollar is declining in value.

This overstatement of business profits has been well documented. Studies made by Martin Feldstein and Lawrence Summers of the National Bureau of Economic Research, and by the Machinery and Allied Products Institute, have documented the substantial overstatement of profits because of the understatement of depreciation allowances and inventory costs.

Perhaps the most dramatic of the analyses of the erosion of profits caused by the understatement of costs is provided in information disclosed in the 1979 financial statements of many of America's largest corporations. The Financial Accounting Standards Board requires, under its Statement No. 33, larger enterprises to disclose the effects of inflation on their profits.

SEC Chairman Harold Williams summarized the results of a recent analysis of this inflation data by Price Waterhouse & Co. in his testimony before the Joint Economic Committee. While some perceive that corporations are taxed at an effective rate of less then 40% rather than the statutory rate of 46%, the real effective rate for the industrial corporations studied was 53%. Some industries are paying rates as high as 62% (utilities), 61% (petroleum) and 55% (automotive). Dividends, rather than representing the traditional ratio of one third of corporate after-tax income, were really about two-thirds of inflation-adjusted income.

Finally, the aggregate of taxes and dividends approaches and in some industries exceeds total corporate income as adjusted. Chairman Williams' conclusion is inescapable; some portions of the industrial sector are paying their taxes and dividends out of capital resources. It is no wonder, then, that we are experiencing a plummeting productivity rate. The demands of the government for high taxes and the demands of investors for good returns in the form of dividend payments are met at the price of partially liquidating capital. Obviously, the internal capital needs of an entity cannot be met if capital is liquidated in real dollar terms. The inevitable impact of liquidated capital investment is a decline in productivity.

Significance of Cost Recovery

One of the primary reasons for the overstatement of profits and resulting high taxation is the method used for recovering the costs of wasting assets. Presently, depreciation deductions are based on the historical cost of assets, and not on the true cost of replacing those assets. A system is needed which would provide more rapid recovery of capital costs to mitigate the impact of inflation, and to allow companies to retain more of their earnings and provide the capital needed to finance growth and productivity gains.

We concur with the conclusions of Treasury Secretary Miller who, when testifying before the Senate Finance Committee in his capacity as Chairman of the Federal Reserve

Board, indicated that the most efficient form of tax benefit for stimulating business investment would be a system of rapidly accelerated depreciation. He suggested in 1978 a scheme that would allow a write-off of buildings in ten years, equipment in five, and mandated pollution control equipment in one year.

INFLATION APPROACHES IN OTHER COUNTRIES

Attached as Appendix A is a summary of some of the approaches followed by other countries to deal with problems created by inflatio in their tax systems. While some countries use indexation extensively (i.e., Brazil), other countries follow different approaches. A central theme, however, is concern over adequate capital investment in productive assets. Not only are accelerated cost recovery techniques used, but other nations provide incentives such as:

- Grants or low interest financing
- Tax abatement for distressed regions
- Tax and investment credits
- Allowances in excess of cost
- Tax deductible provisions to investment reserves
- Deferral of gains "rolled over" into subsequent investment
- Indexation or inflation adjustments

Comparisons among countries can be misleading, unless the entire tax system is studied and other incentive programs to stimulate investments are considered. There are many techniques for accomplishing investment stimulus, but the important factor is that the countries that are our major competitors around the world have as a matter of public policy taken steps to stimulate capital investment in productive assets. In many cases, this has contributed to significant productivity gains.

CAPITAL COST RECOVERY PROPOSALS

We come, then, to a discussion of the principal alternatives now under consideration. While many capital formation and anti-inflation proposals are pending, we shall limit our attention to the Capital Cost Recovery Act (CCRA) embodied in HR 4646 and S. 1435, and the simplified cost recovery plan of the Tax Restructuring Act of 1980, found in HR 7015.

Capital Cost Recovery Act

CCRA is a natural outgrowth of the Revenue Act of 1978. During the consideration of that legislation, Congress evaluated several depreciation proposals, but enacted none of them, choosing rather to signal its recognition of our capital formation needs by reducing capital gains taxes. A growing body of data suggests that this bold action has had important beneficial effects, particularly in venture capital markets.

Just as the benefit conferred by reduced capital gains flows only to those who have made an investment, so also the benefits of enhanced capital cost recovery require that an investment be made. As a result, enhanced cost recovery is generally believed to create the greatest amount of investment per dollar of tax reduction.

The features of CCRA are generally well known. Assets are assigned to one of three classes, without regard to actual useful life. Class I applies to investments in buildings and structural components and has a ten year life. Class II applies to all tangible personal property not included in Class I or III, and has a 5-year life. Class III applies to the first $100,000 invested annually in automobiles and light duty trucks, and has a 3-year life. The system does not apply to land, intangible property, or residential rental property. The cost recovery allowance is computed using the principles of accelerated depreciation.

When fully phased in, the following percentages will apply to the basis of assets to determine the cost recovery allowance:

Ownership Year	Class of Investment I	II	III
1	10%	20%	33%
2	18	32	45
3	16	24	22
4	14	16	
5	12	8	
6	10		
7	8		
8	6		
9	4		
10	2		
Total	100%	100%	100%

In addition, investment credit rules would be changed to permit a full 10% credit on Class II and Class I property to the extent such property presently qualifies as Section 38 property. A 6% investment tax credit is permitted on Class III property.

The CCRA system supplants the present ADR and facts and circumstances depreciation rules. Among its important features is an election whereby taxpayers may choose to deduct all or any portion of the capital cost recovery allowance in any year. Any unclaimed allowance can be carried over to future years. This "portability" feature is particularly useful to companies with losses in some years and to new companies with substantial start-up costs.

Ordinary income recapture on disposition or retirement of an asset is required, and used property is eligible for the benefits of the CCRA allowances. The placed-in-service rule is modified to allow a deduction in the year in which funds are expended to acquire property.

To reduce immediate Treasury revenue shortfalls, the proposed CCRA would generally be phased in over 5 years (Classes I and II) and immediately on Class III.

Simplified Cost Recovery

A second proposal presently warranting consideration is the simplified cost recovery system (SCR) found in Chairman Al Ullman's Tax Restructuring Act of 1980 (HR 7015). Under this proposal, the cost of most depreciable tangible personal property would be classified into four recovery accounts, with specified recovery periods of three, six, nine or 12 years. The Treasury Department would be directed to assign specific assets to each of these classes to reflect at least a 35% reduction from present ADR lives. An annual election to use 200%, 150% or 100% of the equivalent straight line rate would afford some flexibility for calculations of cost recovery for each class.

Assets included in this system would be accounted for under the pooled account theory, somewhat like that used successfully in Canada. In essence, all assets for a particular class, regardless of when required, would go into a single account, and the percentage elected for each year would be applied to the ending balance in that account. The calculations are similar to those for the declining balance method now permitted by the U.S. tax system. Because of the declining balance method, however, the total asset investment is never fully recovered until all assets in an account are disposed of. For example, even after 12 years, the cost of assets in the six-year class will not have been fully recovered.

The SCR system makes changes in the investment tax credit rules somewhat similar to CCRA. A 6% credit would be allowed for assets in the three year class, while a 10% credit would be allowed for assets in the six-year or longer classes.

Under the pooled asset account concept, gains and losses on the disposition of assets would be deferred. The proceeds of sales of assets would be credited to the account and would reduce the balance used to determine the cost recovery deduction.

The SCR system produces significant simplification because of the accounting techniques employed. Furthermore, taxpayers who now hold assets with relatively short ADR lives would receive benefits under this system roughly comparable to those under CCRA. For longer lived assets, however, CCRA offers greater incentives and more protection against inflation than does the Ullman plan.

For depreciable real estate, the new system would provide "audit proof" lives - 15 years for farm buildings, 30 years for buildings that currently have a useful life of more than 45 years, and 25 years for buildings with a present life of 45 years or less.

For real estate, present depreciation methods, such as the 150% declining-balance method, would still be available and current depreciation recapture rules (IRC Sec. 1250) would continue to apply. Furthermore, public utility property would remain under present tax depreciation rules but utilities could elect a 35% variance from current ADR lives.

Policy Considerations and Comparisons

An effective capital cost recovery system should meet four principal objectives. It should (1) provide a stimulus for investment, (2) mitigate the erosive effects of inflation, (3) simplify accounting and reporting, and (4) be accessible to both large and small businesses. Both CCRA and SCR achieve these ends to some degree.

The importance of investment incentives and the need to mitigate inflation have been treated elsewhere in this testimony. The simplification aspects of these proposals are significant. The adoption of a single system would eliminate the need to choose among ADR and facts and circumstances tests, and the need for choosing among straight line, declining balance and sum-of-the-years digits methods of computing depreciation. Moreover, establishment of a limited set of classes with specified lives and eliminating the concept of useful life removes an area from the tax system which has always been fraught with controversy between taxpayers and the IRS.

Small business especially stands to benefit from adoption of a simple, certain system. Much has been said and written in the months before and since the White House Conference on Small Business. The record of that conference was overwhelming in its consensus that capital formation is crucial, and a most important aspect of capital formation for small business is a revised and simple cost recovery system. The conference endorsed the concept of CCRA, and included it as its second top priority recommendation.

CCRA and SCR differ somewhat, however, in the degree to which they achieve these policy objectives. CCRA provides the greater investment stimulus and hedge against inflation. SCR is more limited because assets are generally assigned longer lives than under CCRA. In addition, the cost of assets is recovered more slowly under the Ullman plan.

The declining balance method used under SCR causes this slower recovery for two reasons. First, under that method, depreciation is computed by applying a factor to the balance in an account, i.e., a smaller and smaller increment of cost, whereas the CCRA method applies a factor to the entire cost of an asset each year.

Second, at the end of a class life under SCR, there will still be an increment of cost, or balance, in the account. At the end of a class life under CCRA, however, there will be no balance in the account. Thus, for example, it will take more than 9 years to recover the full cost of an asset in a 9-year SCR account, but it will take just 5 years to recover the full cost of an asset in a 5-year CCRA account.

SCP achieves greater simplicity. Although this plan has a greater number of classes (7 as opposed to 3), the taxpayer simply pools all of his investments in the appropriate account and then applies the proper factor to the balance in that account. CCRA, on the other hand, requires the maintaining of separate yearly accounts. While the computations and the assignment to classes are simple under CCRA. the yearly accounts, over time, could become burdensome.

While the portability feature of CCRA and the flexibility under SCR are helpful, especially for small and new businesses, they will require careful recordkeeping. Small businesses may need instruction in vintage accounting methods under CCRA and carryover computations as well as carry-over planning.

The following charts compare some features of the CCRA and SCR proposals.

Chart I compares the cost recovery allowances under CCRA for assets in the five-year category with the maximum allowances under SCR for similar types of assets falling in the three, six, nine or 12-year classes. For simplicity in presentation, all of the allowances have been calculated on the basis of an asset with an original cost of $1,000.

Chart I: CCRA and the Ullman Plan Systems Compared

Year	CCRA (H.R. 4646) 5-yr.	Ullman Plan (H.R. 7015) 3-yr.	6-yr.	9-yr.	12-yr.
1	200	333	167	111	83
2	320	444	278	198	153
3	240	149	185	154	127
4	160	49	123	119	106
5	80	17	82	93	89
Total Recovered in Five Yrs.	1,000	992	835	675	558
6	—	5	55	72	74
7	—	2	37	56	61
8	—	1	24	44	51
9	—	—	16	34	43
10	—	—	11	26	36
Total Recovered in 10 Yrs.	1,000	1,000	978	907	823
11	—	—	7	21	30
12	—	—	5	16	25
Total Recovered in 12 Yrs.	1,000	1,000	990	944	878

The amount recovered in five years is considerably less under SCR for the six, nine, and 12-year categories than under CCRA. For assets that fall within the three-year class for SCR, the recovery for the first three years would be $926, as compared with $760 for the five-year CCRA class. However, SCR would provide only a 6% investment credit, while CCRA would permit a 10% credit.

Chart II compares the major provisions of CCRA and the Ullman plan.

Chart II: Comparison of Cost Recovery Proposals—H. R. 4646 and H. R. 7015

	Jones/Conable H. R. 4646	Ullman H. R. 7015
General applicability	Mandatory	Generally mandatory, but some provisions elective
Recovery periods:		
Tangible personal property	Three years (autos and light duty trucks) or five years (machinery and equipment)	Three, six, nine or 12 years Treasury to assign assets to specific classes, using as guideline reduction of life of at least 35% from present midpoint class lives
Real estate	10 years	15 years for agricultural buildings; 25 years if Rev. Proc. 62-21 life is 45 years or less; 30 years if Rev. Proc. 62-21 life is over 45 years
Recovery method:		
Tangible personal property	Accelerated writeoff built into tables	Taxpayer may elect 100%, 150% or 200% declining-balance percentage, or annual basis
Real estate	Same	Same as present law, generally limited to 150% declining balance
Asset accounting		
General	Each year's additions accounted for separately (vintage accounting)	Pooled account approach (similar to Canadian system) for tangible personal property; vintage accounts for real estate
First year	Half-year convention	Half-year convention
Recapture provisions:		
Tangible personal property	Ordinary income recapture on dispositions	No recapture until pooled account fully written off
Real estate	Same	Present law (Sec 1250)
Investment tax credit	6% for three-year class and 10% for five-year	6% for three-year class and 10% for six-year or longer
Preference tax treatment	Accelerated writeoff element subject to preference tax for noncorporate lessors	Noncorporate lessors generally not eligible
Public utilities	Included in CCRA system with *normalization* provision	Shortens ADR lives by 35%
Existing assets	Not eligible	Eligible at taxpayer's election after 1984
Effective date	Property acquired or placed in service after 12-31-79	Property placed in service in taxable years beginning after 12-31-80
Flexibility	Taxpayer can claim as little of CCRA as he wishes, with balance available as carryover	Taxpayer must claim amount determined under cost recovery procedures, with election as to 100%, 150% or 200% percentages (see third item, page 3)

Mathematical Comparisons

An accepted method for comparing alternative cost recovery proposals is to discount to present value the future tax benefits from each proposal. The following tables show the present value of tax benefits from cost recovery and the investment tax credit for a $10,000 asset investment under present law, SCR, and CCRA. These calculations assume present value discount factors of 13% and 17%. The calculations reflect four types of assets with different lives.

This analysis is extracted from Tax Policy Statement 7, to be issued by the American Institute of Certified Public Accountants in the very near future, analyzing capital cost recovery proposals.

CAPITAL RECOVERY COMPARISONS
TAX BENEFIT OF DEPRECIATION/INVESTMENT TAX CREDIT
SUMMARY OF PRESENT VALUES

DISCOUNT FACTOR -- 13%
TAX RATE -- 46%

		METHODS		
	Present Lower Limit ADR Life	Current ADR	SCR (H.R. 7015)	CCRA (10-5-3)
VEHICLE	3 yrs.	4,453	4,700	4,742
HEAVY MACHINERY	10 yrs.	4,161	4,564	4,823
INDUSTRIAL PLANT	20 yrs.	3,339	3,745	4,823
OFFICE BUILDING	40 yrs.	1,128	1,633	3,198

CAPITAL RECOVERY COMPARISONS
TAX BENEFIT OF DEPRECIATION/INVESTMENT TAX CREDIT
SUMMARY OF PRESENT VALUES

DISCOUNT FACTOR -- 17%
TAX RATE -- 46%

		METHODS		
	Present Lower Limit ADR Life	Current ADR	SCR (H.R. 7015)	CCRA (10-5-3)
VEHICLE	3 yrs.	4,333	4,576	4,627
HEAVY MACHINERY	10 yrs.	3,883	4,304	4,641
INDUSTRIAL PLANT	20 yrs.	3,021	3,467	4,641
OFFICE BUILDING	40 yrs.	916	1,353	2,922

For vehicles or other assets with relatively short lives, there is not a great deal of difference between SCR and CCRA. Assuming a 13% discount factor, the present value of the future tax benefits is $4,700, compared with $4,742 under CCRA. At a 17% discount factor, again the results are fairly close.

However, as longer lived property is considered, such as an industrial plant with a 20-year life under present law, the differences between SCR and CCRA become more significant. Using a 13% discount factor, SCR provides discounted tax benefits of $3,745, but CCRA is $4,823, about 30% greater.

For an office building, the difference in treatment is dramatic. Using a 13% discount factor, the discounted value of tax benefits for a building with a 40-year life under present law is around $1,633 under SCR, but nearly twice that ($3,198) under CCRA.

There appears no inherent reason why the economic stimulus and benefits under the SCR system cannot be brought closer to CCRA. Among changes that might be considered are widening the annual elective write-off percentage to 300% of the straight line rate rather than 200%, permitting a full year convention for annual additions rather than a half-year convention, and shortening the lives in the 6, 9, or 12-year categories.

As noted earlier, the SCR system has considerable appeal because of the pooled account approach inherent in it. It should be attractive to both large and small business entities. At a time when we need to encourage productive investment, we believe that the stimulus provided by the cost recovery method chosen is extremely important in the choice among the alternatives avilable.

If a 300% of straight line elective write-off were permitted under SCR, the benefits under that method would be greater than CCRA for 3 and 6-year categories. The following table shows this comparison, assuming a 13% discount factor and the same approach followed in the earlier examples.

CAPITAL RECOVERY COMPARISONS
TAX BENEFIT OF DEPRECIATION/INVESTMENT TAX CREDIT
SUMMARY OF PRESENT VALUES

DISCOUNT FACTOR - 13%
TAX RATE - 46%

		METHODS		
	Present Lower Limit ADR Life	Current ADR	SCR* (H.R. 7015)	CCRA (10-5-3)
VEHICLE	3 yrs.	4,453	4,936	4,742
HEAVY MACHINERY	10 yrs.	4,161	4,894	4,823
INDUSTRIAL PLANT	20 yrs.	3,339	4,218	4,823
OFFICE BUILDING	40 yrs.	1,128	1,633	3,198

*Assuming 300% option for all classes except building

INFLATION'S EFFECT ON INDIVIDUAL TAXPAYERS

No discussion of tax reduction this year would be complete without considering the impact of inflation on individual taxpayers. Just as corporations have been to some extent decapitalized in recent years by a combination of inflation and taxation, so also have individuals been penalized by inflation.

The problems of so-called "bracket creep" affecting individuals subject to progressive tax rates have been widely discussed and well documented. As reported by the Tax Foundation, recent estimates by the Joint Committee on Taxation demonstrate the magnitude of the problem. Based on inflation rates assumed in the First Concurrent Budget Resolution for fiscal 1981 (13.3%), and extending to 1985 (8.3%), an individual inflation tax windfall to the U.S. Treasury of over $20 billion is projected for 1981. Assuming no changes in present tax brackets, exemption levels, and the like, by 1985, the inflation windfall will approximate $140 billion for that year alone. For the five-year period from 1981 through 1985, the total inflation windfall could exceed $380 billion.

Clearly, the impact of inflation on taxation of individual taxpayers is a major policy issue to be considered by Congress. Individual tax reduction, particularly in middle income brackets, is imperative if we are to restore incentive in our economy for people to work and save.

CONCLUSION

A fundamental question in deciding whether or not tax reductions should be enacted at this time is what happens if Congress does not act. As indicated earlier, inaction will in essence sanction a very substantial tax increase on both business and individual taxpayers. The key question is not whether tax reduction should be enacted, but whether a substantial tax increase should be permitted to become effective.

We believe that tax legislation should be enacted in 1980 that would adopt a simplified and much more effective capital cost recovery system. Consideration should be given to revising the individual tax structure to reduce the increase in individual taxes caused by inflation. These actions should be considered now, so that both business and individual taxpayers can plan investments and savings with some certainty in the ensuing months.

This is particularly true for major capital investment projects. If action on major depreciation reform is deferred until 1981, capital investment programs will also be deferred. The benefits from those investments in improved productivity and stimulus to the economy will also have been deferred or perhaps lost at a time when our economy badly needs them.

We appreciate the opportunity to present our views to your committee on the important issues now under consideration.

7-31-80

APPENDIX A

INFLATION RELATED ADJUSTMENTS IN SELECTED COUNTRIES

BRAZIL

Introduction — Since 1974, a comprehensive indexing system known as Monetary Correction has been used for both business and tax purposes. The Monetary Correction adjustment is applied to financial statements using the O.R.T.N. index which is based on changes in the nominal value of one Readjustable National Treasury Bond (Obrigacao Reajustavel do Tesouro Nacional). (These bonds have a fixed value, causing them to be purchased at larger and larger discounts during periods of inflation.)

To record the Monetary Correction on their financial statements, corporations and other legal entities having a net equity of 195,000,000 cruzeiros must maintain a subsidiary ledger, in O.R.T.N., in which the nominal value of one O.R.T.N. is considered a unit of account.

The adjustment is made to net worth and permanent assets. The Monetary Correction of permanent assets such as fixed assets, depreciation, investments and corresponding provisions for losses, deferred assets and amortization is credited to the profit and loss account. The adjustment to net worth is debited to the same account. A net debit balance is deductible for tax purposes.

Any inflationary income realized (a net credit balance) can be deferred until the realization of the permanent assets that generate the income (i.e., depreciation and amortization expense). The includable portion of such income is determined by a special computation involving current year's inflationary income, realization of fixed assets, and gross permanent assets (at the beginning of the period).

The inflationary income which is deferred is not recorded for the accounting records, but is maintained in the Register for the Computation of Taxable Income (a separate information ledger maintained by each enterprise), which contains a reconciliation between book and taxable profit on an annual basis.

Individual Provisions

Indexing of Tax Rates and Allowances — In the case of personal exemptions, allowances, and tax brackets, annual adjustments are determined by the Minister of Finance. The amount is reasonably predictable since it has generally followed the percentage change in the O.R.T.N. index for the calendar year. In some years, a greater change has been made to lower tax brackets in order to ease the tax burden for individuals with lower incomes.

Indexing of Unpaid Taxes and Refunds — Balances due when tax returns are filed are normally paid in installments with no monetary correction. Adjustments are made to underpayments of tax and penalties (interest is ignored) using Monetary Correction. The amount is based on changes in the O.R.T.N. Index which are published monthly, from the date the tax was due until paid. Income taxes withheld at the source are also adjusted based on a co-efficient determined by the Minister of Finance. The co-efficient used is approximately the same as the one used for indexing tax rates, exemptions, and allowances.

Business Taxes

Inventory Adjustments — There is no Monetary Correction made directly to inventories. Inventory valuation adjustments are made indirectly through the Monetary Correction of net worth.

Fixed Asset Revaluation — Fixed assets are revalued in the sense that they are subject to Monetary Correction via the O.R.T.N. index. Taxable income will increase as a result of the adjustment.

Depreciation Provisions — No special provisions exist regarding depreciation other than depreciation expense which is subject to Monetary Correction.

Other Unusual Adjustments — Monetary Correction (via the O.R.T.N. index) made to the value of bank deposit certificates, savings accounts, etc. is treated as either taxable income or deductible expenses.

An adjustment is also made to the tax loss carryforwards of a business enterprise. The amount is the product of the loss at the beginning of the year and the percentage change in the O.R.T.N. index.

CANADA

Individual Provisions

Indexing of Tax Rates and Allowances	Graduated tax rates are indexed each year on the basis of changes in the Consumer Price Index since the year ending September 30, 1972 (the base year).

Personal exemptions and allowances (marriage allowance, dependents' allowances and old age allowances) are also indexed in a similar manner. To facilitate compliance with the law, the adjustments are automatically incorporated into each year's tax forms.

Business Taxes

Inventory Adjustments — A special provision is allowed to offset the effect on taxable income of rising purchase prices. Both retailing and manufacturing concerns may claim a deduction equal to 3% of their opening inventories. The deduction is not recorded as a bookkeeping entry in financial statements or on a tax balance sheet, and is taken in the tax return only as an adjustment to book income. Accordingly, it does not have any impact on the cost of sales deduction or the determination of ending inventory for the year.

Depreciation Provisions — Depreciable assets are divided into different classes; a capital cost allowance is then computed by applying a maximum percentage rate to the undepreciated capital cost for each asset class. As examples, machinery and equipment are in a single class which is depreciated at a maximum rate of 20% per year; the rates for automotive equipment and advertising signs are 30% and 35%, respectively. In addition, a special acceleration provision allows a two-year write-off for most machinery and equipment used in manufacturing.

A taxpayer may elect not to take any depreciation deduction in any or all classes in any year or may take any amount up to the maximum allowance for each class. The depreciation base for each class is reduced only for amounts claimed and by proceeds of sale received upon the ultimate disposition of the asset.

FRANCE

Individual Provisions

Indexing of Tax Rates and Allowances	No special tax measures have been introduced regarding indexing.

Business Taxes

Inventory Adjustments — Since World War II, commercial and industrial enterprises have been allowed deductions for amounts deemed to represent the additional cost of replacing inventories, through the allowance of special inventory revaluation reserves computed on a product-by-product basis.

The reserve is computed by multiplying the number of units in the year-end inventory by the difference between the unit value of the ending inventory and 110% of the unit value of the beginning inventory. Additions to the reserve for a particular class of goods are, however, limited to the extent that price increases for that class exceed 10% over a two-year period. Therefore, the deduction is equal to the total computed reserve less the prior year's reserve.

In the financial statements, the reserve must be stated as a separate item rather than as a reduction in the carrying value of the inventories. The provision is added back to the taxable income of the seventh fiscal year following the year of the deduction thus resulting in a deferral of taxes.

Also allowed as a deduction is a reserve for price variations to cover increases in the price of base inventories which are determined or influenced by world market price fluctuations. The reserve may be established for basic raw materials acquired in international markets, such as silk, lead and copper. The amount of the reserve is determined by a complex formula which compares changes in assigned inventory values between current and prior years (1945, 1946, and 1947) as well as changes in average market prices for the same period.

Asset Revaluation — In recent years companies have been allowed to revalue assets according to either their own estimate or an expert appraisal of current value. Two types of asset revaluation can occur, the "legal" revaluation applying only to depreciable assets and the "free" revaluation applying to both depreciable assets and nondepreciable assets.

The "legal" revaluation is compulsory for companies quoted on the stock exchange and applies to tax years closing before December 31, 1980. Here, taxable income is recognized to the extent of the revaluation and can be offset against loss carryovers.

The "free" revaluation is optional and has no expiration date. There would be no reason to elect the "free" revaluation unless large loss carryovers exist, which would otherwise not be utilized, to offset the taxable income realized. Both types of revaluation result in an increased tax basis for depreciation.

Depreciation Provisions — Depreciation is computed on the basis of historical cost increased by any revaluation and decreased by any value-added tax paid. Deductions are allowed in excess of the normal straight-line rates for certain classes of property. These classes include but are not limited to equipment and tools used in manufacturing or transportation, water or air purifying installations, and hotel buildings and equipment. Rates range from 150% of the straight-line rate for assets with a useful life of three to four years to 250% of the straight-line rate where the asset's useful life is greater than six years. The minimum depreciation requirement on these classes of assets is the straight-line depreciation amount.

GERMANY

Individual Provisions

Indexing of Tax Rates and Allowance — No special measures have been introduced regarding indexing.

Business Taxes

Inventory Adjustments — Special provisions exist for special inventory reserves when the replacement cost of inventory items increases by a substantial amount (more than 10%) during the course of the taxable year. The ratio of the replacement cost of each category of ending inventory (such as raw materials or finished goods) over 110% of the replacement cost of beginning inventory is multiplied by the historical cost of ending inventory to arrive at the maximum allowable reserve. Reserves of lesser amounts are allowed at the taxpayer's discretion.

The reserves result in a deferral rather than a permanent tax savings since they must be recaptured as taxable income by the end of the sixth year after the year in which they are established.

Depreciation Provisions — Generally, either straight-line or declining-balance depreciation is allowed for depreciable personal property. Declining-balance rates may not exceed two and one-half times the straight-line rates which range from 2% for commercial buildings to 33-1/3% for trucks.

Special accelerated depreciation provisions apply to certain types of assets. Here, 30% to 50% of the cost of an asset can be depreciated during the initial years in addition to a regular deduction computed at the straight-line rate. Qualifying assets include, but are not limited to, research and development facilities, new commercial ships and aircrafts, and installations designed to purify air or water.

Other Unusual Adjustments — Gain realized on some business property may be deferred by replacing certain types of fixed assets which are sold with other qualifying assets within a limited period of time. For example, land, buildings, and such depreciable assets as machinery and equipment qualify as replacement assets. The depreciable cost of the replacement asset is reduced by the amount of gain deferred.

JAPAN

Individual Provisions

Indexing of Tax Rates and Allowances – No provision exists for automatic indexing of tax rates and allowances. Adjustments have, however, been made by the government periodically to offset the effects of inflation.

The amounts of the increases in allowances and decreases in rates have been determined by considering not only the change in the Consumer Price Index and/or Wholesale Price Index but also the effect of the revision on the total economy. However, no revision of the progressive tax rates has been made since 1973.

Business Taxes

Inventory Adjustments LIFO is an accepted inventory method, although certain forms of LIFO such as dollar-value LIFO are not acceptable unless specifically approved by the tax authority.

Additional deductions to establish certain reserves for inventory price fluctuations are also allowed under the "blue return" system (i.e., special return filing privileges are granted to taxpayers who observe proper bookkeeping and honest self-tax assessment). The reserve provides for possible future declines in inventory value and is not to adjust specifically for the effects of inflation. The provision is currently being phased out and will be essentially abolished by April 1985, except for a few inventory items which will remain subject to the provision. Amounts set aside in reserve accounts may be deducted currently, but in some instances are required to be taken back into income in subsequent years.

Fixed Asset Revaluation – No special tax measures have been introduced regarding revaluation in recent years. During the period from 1950 through 1958, business firms were allowed to revalue fixed assets four times to provide a more reasonable basis for tax depreciation.

Depreciation Provisions — Normal depreciation deductions are allowed using both straight-line and declining-balance methods. Two additional deductions, increased initial depreciation and an accelerated write-off, are also available (under the "blue return" system) for certain assets.

Increased initial depreciation allows a special deduction for a portion of the costs of certain assets in the year in which they are acquired, and applies to the first year only. As examples, an initial depreciation allowance of 25% applies on qualified plant and equipment used for the prevention of air and sea pollution, 20% applies to equipment which improves the effective utilization of energy, and 15% applies to qualified steel vessels.

Accelerated write-offs are available for certain other assets. Under this "special additional depreciation" method, a corporation may deduct during each year an additional percentage of the ordinary depreciation taken for that year. The special percentage ranges from 50-150% of ordinary depreciation.

Both these methods reduce the depreciable base of the assets. No depreciation deductions in excess of cost are allowed.

Other Unusual Adjustments — A reserve is presently allowed for the price fluctuations of securities. The reserve is limited to the book value of a security less 95% of the market value for listed stocks and 99.2% of the fair value for nonlisted stocks. Amounts set aside in these reserves must be taken back into income in the immediately suceeding year. The allowable reserve is scheduled to be reduced year by year until it is finally eliminated in April 1990.

Preferential treatment exists with regard to intangible assets even though the treatment is not specifically designed to counter the effects of inflation. The items can be expensed in the year incurred or, if capitalized, can be totally or partially expensed, usually within 5 years. Goodwill, expenditures for research and development of patents, costs of issuing stocks and bonds, and organizational costs are examples of the types of intangible assets which qualify.

UNITED KINGDOM

Individual Provisions

Indexing of Tax Rates & Allowances Since the fiscal year 1978/1979, personal allowances (exemptions) must be changed by an amount at least as large as the increase in the retail price index of the previous calendar year. The index used measures the monthly change in the average level of prices of goods and services purchased. This approach allows the Treasury more flexibility than a system of automatic indexation.

Business Taxes

Inventory Adjustments Stock appreciation relief is the single most significant provision directed towards accounting for the effects of inflation. The law attempts to deal with the liquidity problem which occurs when closing inventories have a much larger cost than opening inventories due to replacement of inventory at higher and higher prices. The stock relief deduction is computed as an amount equal to the increase in the value of inventories (raw material and work in process) between the opening and closing date of the accounting period less 15% of the taxable profits for the period. Recapture provisions apply to the extent of previous stock relief when inventories decrease in value in a later year. Any stock relief which has not been recaptured within six years of the original deduction is permanently free of any potential recapture.

Depreciation Provisions Three types of depreciation deductions are allowed for tax purposes. The "first year allowance" applies only to machinery and equipment and allows a deduction of up to 100% of the cost during the year. The second type of deduction is known as the "initial allowance" and is available at the time the asset is purchased. Rates range from a low of 15% for dredging equipment to 50% for new industrial buildings and 100% for scientific research. Finally, "writing down allowances" are allowed for any remaining basis after the first year and initial allowances are deducted. "Writing down allowances" range from 4% of the remaining basis of new industrial buildings to 25% for machinery and equipment.

Other Unusual Adjustments A rollover is allowed for gain realized on the disposition of land, buildings, ships, aircraft and hovercraft, and goodwill. The effect of the rollover is to treat gain arising from the disposition as a deduction from the basis of new assets. The new assets must be used in the business, but are not required to be of the same class as the old assets.

TESTIMONY OF P. O. EVENSON, THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA

Mr. Chairman, in interests of time I will refrain from reading my written statement and instead present a synopsis of my written comments. I request my complete statement be printed in the record.

I am P. O. Evenson, and I am assistant to the president of Paul N. Howard Co., Greensboro, North Carolina. I appear here today as a member of the Tax & Fiscal Affairs Committee of the Associated General Contractors of America, Inc. Appearing with me are Thomas L. Root and George Stockton of AGC's National Staff.

There are two matters of interest to your Committee that are of vital concern to the tens of thousands of construction firms across the country and the millions of jobs and billions of dollars they represent. Those are adequate capital formation and retention, and an international taxation policy which does not cripple American firms' ability to compete overseas.

I. CAPITAL FORMATION AND RETENTION

AGC firmly supports the Capital Cost Recovery Act of 1979, the so-called 10-5-3 proposal, embodied in S. 1435 and H.R. 4646. I do not intend to explain the mechanism by which these measures will operate; the Committee has already become acquainted with the proposals. I do, however, wish to explain to you why construction contractors believe the measure should be adopted and explain our sense of dismay at the lame arguments being advanced by those persons who oppose the measure.

I do not need to cite the litany of well-established facts which demonstrate the decline of this nation's productivity. Our output-per-worker is well behind our industrialized neighbors, and falling further behind the leaders all the time. America's gross national product and productivity are slumping, workers are out of jobs, and the recession—which some declared "half over" in the spring of 1979—deepens monthly.

AGC agrees with responsible legislators on both sides of the aisle who declare that a tax cut must make more than only short-term political sense. The cut must stimulate growth, renew increased employment, improve productivity and enhance our ability to compete. It must not merely provide a few dollars for each taxpayer to stimulate demand without aiding supply. Inflation continues to be among our most serious problems, and it is a problem which AGC believes is inextricably interwoven with problems of productivity, employment and gross national product.

Edward Deming, the American student of industry to whom goes considerable credit for Japan's industrial prowess, has stated that American workers do not need to work harder, they need to work smarter. With a decaying physical plant at the base of this nation's most important industries, working "smarter," that is, using improved processes and methods to produce more, better quality products, is simply beyond the abilities of our most talented workers and businesspeople.

The 10-5-3 measure will enable business to recover the costs of new investment in structures, physical plant, equipment and other tangible assets more quickly and easily than is possible under the current Asset Depreciation Range system. With an incentive to invest—as in the liberalization of depreciation—modernization will occur in industries quickly. A new steel plant in Nebraska is currently considered the most productive in the world; the manager of the plant frankly admits that his prospective customers are those American businesses now buying foreign steel, because he can match and even beat his foreign competitors' prices. This Nebraska firm prospers while American steel industry languishes because of the new, modern plant used for steel production. This example belies the suggestion by some futurists that America leave basic industries to those foreign countries which seem to have a comparative advantage over us.

The Department of Commerce itself has noted that both the quality and quantity of capital have effects on productivity. The Commerce Department explained that the decline in productivity in the construction industry, a decline which increases the cost of buildings, is directly related to the ever-increasing age of the capital in construction as well as ever-decreasing ratio of capital invested per employee. Even the Honorable G. William Miller, Secretary of the Treasury, who has endorsed only an as-yet undefined depreciation liberalization plan to be proposed at some as-yet unannounced time in the future, testified before the Senate Subcommittee on Taxation and Debt Managmement on October 22, 1979, that ". . . the construction industries have suffered declines in productivity in absolute terms since the late sixties, particularly over the most recent years."

The average AGC contractor in 1977 had an investment in capital assets of approximately five times annual profit. With slim profit margins (an average of

$115,000 after-tax profit on receipts of $12 million gives a return on gross sales of under 1.0 percent), the averge contractor will be able to afford to invest additional capital in tangible capital assets only if capital so invested can be recovered in a reasonable time.

In addressing the opponents of 10-5-3, AGC first wishes to note that to refer to enactment of the Capital Cost Recovery Act of 1979 as a "tax cut" is in error. New Year's Day, 1981, will bring a staggering increase in taxes for all Americans. The Treasury will collect $50 billion more in 1981 than it did in 1980. Decreasing the additional "take" by $5 billion should hardly been seen as government beneficence. The 10-5-3 proposal is more correctly termed a "tax offset."

Opponents first claim that there is too little time to deal with the range of issues which should be considered in a comprehensive tax package. This is probably true. However, that is not to say that 10-5-3 cannot be enacted. This legislation has a life of its own, it has been around for more than year, and has been studied, pro and con, at length. This nation is competing with countries which have capital write-off periods of 1-2 years. We continue to suffer staggering balance-of-trade deficits. Contrary to opponents who claim that speedy enactment of 10-5-3 is a luxury this nation can ill afford, we suggest that procrastination to await a promised but unseen "liberalized depreciation" proposal a year, or two years, or more in the future is a luxury we cannot afford if we wish to remain an industrial power in this country.

The effects on the budget of 10-5-3 is often cited as a reason to shy away from its enactment. Most agree that the first-year costs will be approximately $5 billion in lost revenues, but proponents estimate a "raw" cost of $39 billion in five years, while opponents predict costs of up to $60 and $70 billion in five years. When the effects of additional jobs, more productivity and greater profit are considered, even opponents estimate that the "raw" costs may be decreased by 50 percent. The imminent collapse of the State of California predicted by foes of Proposition 13 sounded strikingly similar to the fears of the opponents of 10-5-3. As a study inserted in the Congressional Record by the Honorable Newt Gingrich on July 23, 1980, found—to paraphrase Mark Twain—the reports of California's death were greatly exaggerated. Unemployment dropped, personal income increased, and state services suffered minimally or not at all.

A recession exists, inflation continues, and America's biggest industries as well as innumerable small businesses, show losses and, in some cases, are going out of business altogether. The American economy is in a relatively unhealthy state, the predicted balanced budget forgotten now, and the expected defict is now higher than ever as the recession slashes revenue projections. For the Treasury to complain at this time about a revenue shortfall of $30 billion at worst in 1986 is akin to fretting over the arrangement of the deck chairs on the "Titanic." This nation's problems are more immediate.

Opponents have suggested that 10-5-3 may create "tax shelters," may harm some industries—including small business in general—and, in the words of a Deputy Assistant Secretary of Treasury, may be "too generous." The quick answer to the "tax shelters" is that this is entirely possible. "Tax shelter" has become perjorative shorthand for "investment incentive," which is the object of the legislation. Those industries which may be harmed by 10-5-3, by finding assets which now can be depreciated in under 5 years extended to artificially longer lives, have not been quick to testify in opposition to 10-5-3. AGC suggests that they do not see themselves to be as injured as opponents of 10-5-3 believe them to be.

Small business, a category to which at least 90 percent of AGC's members belong, has testified on this proposal, and—as the National Federation of Independent Business has made clear to the House Ways and Means Committee—small business fully supports 10-5-3 for the effects it will have on small businesses.

Finally, AGC's response to those who suggest that 10-5-3 is "too generous": we ask to whom? Will it be too generous to the workers who again have jobs in a growing economy, or to the shareholders—including pension funds for American citizens of all professions and vocations—who find their investments appreciating, or to all citizens who benefit from an increased standard of living, that is, an increase in real income made possible by increased productivity?

The 10-5-3 proposal must be enacted immediately as a supply-side tax "offset" measure which will spur the economy without fanning the flames of inflation. The perfect depreciation legislation has yet to be introduced, and promises of better measures to come if only Congress delays on 10-5-3 do nothing to attack our problems of recession, inflation and unemployment. AGC asks that this Committee expedite consideration of the Capital Cost Recovery Act of 1979, and recommend favorable floor action on the proposal.

II. TAXATION OF FOREIGN INCOME OF U.S. CITIZENS

Mr. Chairman, AGC has been working on the issue of taxation of foreign source income since the initial consideration of the amendments to Section 911 contemplated in the Tax Reform Act of 1976 (TRA). During this same period, we were also hit by Tax Court decisions, which pertained to the tax status of employer paid allowances of the excess living costs of overseas personnel. At that time our industry was enjoying an unprecedented level of demand for our services in the overseas markets, primarily in the newly-rich oil producing nations of the middle east and North Africa. After we became fully aware of the magnitude of the TRA and the Tax Court decisions, we endeavored to illustrate the negative impact that these changes would bring about on the competitive position of U.S. firms operating in these markets. We also pointed out that this competitive disadvantage would eventually cause a decline in U.S. export sales.

As you know, the changes included in the TRA never went into effect, and after nearly two years of study and consideration the Foreign Earned Income Act of 1978 (FEIA) was passed by Congress and signed into law. This adopted version of the FEIA represented a tremendous compromise from the House version supported by the industry, and therefore its passage was not interpreted as a victory. On the contrary, the new law and the regulations promulgated under it introduced the most complex filing procedures ever contemplated in a personal income tax measure. Moreover, the FEIA did not restore the competitiveness of U.S. firms operating overseas.

Recent market share studies of the middle east construction market substantiate this fact. In 1975 the U.S. enjoyed a market share of approximately 10.3 percent in the middle east and expectations were very high for the four years to follow. However, our expectations were not met, and as of June 1979, our share had not increased but slipped dramatically to only 1.6 percent of the market. We are presently ranked 12th behind the USSR in the race for contracts in the middle east. U.S. exports to the region have also suffered as a result of this decline, for example, U.S. exports to Saudi Arabia increased by 11 percent from 1978 to 1979, while the French enjoyed an increase of 22 percent during the same period. It is worth noting that the French are presently ranked 4th in the contract competition in the region.

Of course, our competitive problems are not solely attributable to taxation; our government has created innumerable export disincentive measures which apply exclusively to U.S. firms. However, our current tax policies carry the greatest cost and are therefore the most formidable obstacle we face in the export of our services.

Under the current law, the costs of maintaining a U.S. engineer, project manager or lead trade foreman on a foreign project are roughly two times the cost of staffing the same job with a tax-free Canadian or Western European. Our own studies indicate that approximately 75 percent of this increased cost is solely attributable to the difference between the U.S. and Canadian and Western European tax policies. Due to the labor-intensive nature of the typical overseas project, the employment of higher-cost Americans is both uneconomic and noncompetitive. We are therefore forced to rely on foreign nationals in the staffing of these projects.

These staffing decisions translate into a direct loss of export sales for the U.S. This is due to the fact that U.S. firms are forced to employ Europeans in key engineering and procurement positions and, as a result, a significant amount of the imported equipment and material that goes into a typical project is purchased in Europe. This European preference is due to the familiarity of these employees with European vs. American specifications and product lines.

In the broader trade context, a recent study undertaken by Chase Econometrics reveals that the taxation of Americans working overseas is responsible for a 5 percent drop in real exports. This lost business resulted in loss of 80,000 jobs, in the U.S. and cost the Treasury more than $6 billion in corporate and personal income tax revenues. This $6 billion revenue loss compares to only a $500 million revenue loss if all income overseas were to be excluded from tax. The Administration has repeatedly denied any linkage between overseas taxation and lost exports, and it continue to site tax equity as the primary consideration in structuring Section 911/913 tax relief. Mr. Chairman, we submit that time is running out on this approach, and that the time has come for the U.S. to follow the example set by the leading trading nations of the world, which is to exempt the earned income of U.S. citizens working abroad. Three measures which have been introduced in this session of Congress would accomplish this goal. They include: the Frenzel/Jones and Alexander bills in the House, and the Jepsen bill in the Senate. We recognize however, the negative political implications of an unlimited income exclusion and we are therefore favorably disposed to a fall-back position along the lines of the Bentsen or Chaffee bills.

Mr. Chairman, in closing I would like to point out that the tax cut legislation under consideration here today is perhaps the last chance for meaningful Section 911/913 relief. We understand and appreciate the need to focus these tax cuts on the supply side rather than the demand side of the economy, and we are confident that this issue meets these requirements. As the figures and studies presented in my testimony verify, Section 911/913 relief would stimulate investment, output, employment, strengthen the dollar and will also combat inflation by reducing our nation's massive trade deficits. We would therefore encourage this committee during its consideration of the various tax cut proposals to include provision on Section 911/913 which will restore the competitiveness of the U.S. construction industry overseas.

Thank you very much for this opportunity to appear here today and now I would be happy to answer any questions.

The Steel Industry's Capital Sources and Uses: Summary of the Assessments of the Working Group on Modernization and Capital Formation of the Steel Tripartite Committee

The Steel Tripartite Committee asked this Working Group to assess the current status of the U.S. steel industry in the area of modernization and capital formation. This is a summary of the Group's assessments which are contained in four staff reports. Those reports reflect a consensus of the Group's industry, labor and government members, and are based on an analysis of the industry's "Orange Book", updated to reflect 1980 dollars and current shipment levels.

Uses

Assuming a 4 percent annual replacement rate and a replacement cost of $1,130 per shipped ton, the industry will require annually over the period 1980-1984 an average of $4.7 billion to modernize its existing steel capacity and $870 million to retrofit that capacity to meet environmental and safety and health requirements. With an annual increase of $100 million for working capital, and dividends based on 1979 levels, $450 million per year, the industry's total annual capital uses over the five-year period would average approximately $6.1 billion.

Sources

Assuming industry shipments at current industry estimates of 85 million tons (76 percent utilization) in 1980 and 1981-1984 shipment levels which result in an average 90 percent capacity utilization, the total steel capital sources of the industry -- both internal (after-tax profits and noncash expenses) and external (net new debt, additions to stock, asset sales) -- available for its steel segment would average between $4.1 and $4.4 billion annually over the five-year period. The range represents an unresolved difference within the Group on the amount of the industry's nonsteel cash flows which would be available for steel capital uses. Net new debt was assumed at levels which would maintain the industry's current debt/equity ratio of 50 percent. Revenues and costs per ton of shipments were assumed at 1980 levels except for the effect of the capital expenditures on operating costs.

Shortfall

Based on the foregoing analysis, the industry's capital uses to modernize its existing steel capacity and retrofit that capacity to meet environment and safety and health requirements would exceed the capital sources available to the industry for those purposes by an average of approximately $1.7 to $2 billion annually over the period 1980-1984.

Impact of Tax Proposals and Real Revenue Increases on the Shortfall

The Group examined the effects on the shortfall identified of various changes in current tax law and of an increase in real revenues. That examination indicates that, because of the current low profitability of the steel segment of the industry, and consequent low tax liabilities, any tax proposal which merely reduces or eliminates the tax liability, including "10-5-3" or an increase in the investment tax credit, would have no significant effect on the shortfall during the five-year period. A real revenue increase of $16.50 per shipped ton would be necessary under current tax law to reduce the annual shortfall to between $.4 and $.1 billion. The same real revenue increase with the proposed "10-5-3" would eliminate the shortfall. A 10 percent refundable investment tax credit would reduce the annual shortfall during the period to between $1. and $1.3 billion.

The following points should be considered in connection with the above assessments:

- The Group's analysis in the four staff reports was for industry as a whole, based on average data and an assumed replacement rate required for a competitive industry. Individual companies within the industry may have very different investment requirements, sources of capital, degrees of diversification, and tax positions (e.g., carry-back tax refunds).

- The Group divided the industry into steel and nonsteel segments and only the steel segment was analyzed. Faster capital recovery in the steel segment could provide some additional cash for the industry by reducing the taxes on any nonsteel-segment profits.

- The Group's analysis includes neither capital for steel capacity expansion nor capital requirement reductions resulting from a cutback in capacity. The Group has not made a judgment as to the "appropriate" size of the U.S. steel industry over the long term.

* The tax proposals and real revenue increases identified were considered by the Group for analysis purposes only -- they do not represent the policy recommendations of the Group or, necessarily, any individual members of the Group.

* The size of the shortfall is very sensitive to shipment levels and the length of the period over which the shortfall is averaged. For example, if the industry can actually make the modernization expenditures identified for the 1980-1984 period and average 90 percent capacity utilization during the 1981-1989 period, the estimated annual shortfall over this ten-year period would be between \$.5 and \$.7 billion. On the other hand, the annual shortfall for 1980-1981, because of the depressed levels of shipments, would average \$3.1 to \$3.3 billion.

* Some form of faster capital recovery would significantly benefit steel after the first five years of the modernization program because of the increased profits which would result from modernization.

* Faster capital recovery for all industries would presumably result in additional steel shipments which would have an immediate and favorable impact on the industry's steel segment profits. The Group did not attempt to quantify this impact.

* Faster capital recovery would increase the long-term rate of return in steel which would presumably affect the industry's ability to secure debt or equity financing for modernization.

Initial Report to the Working Group on Modernization and Capital Formation on the American Iron and Steel Institute Paper: Steel at the Crossroads: The American Steel Industry in the 1980s

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SUMMARY

The Steel Tripartite Committee asked this Working Group to assess the American steel industry's current status in the area of modernization and capital formation. The Group designated a tripartite staff to analyze the American Iron and Steel Institute's Orange Book and assess:

1. how it compares with the 1977 Solomon Report, and

2. its adequacy for the Group's discussions and the need for a separate independent study for that purpose.

The staff has completed an initial analysis of the Orange Book's assessment of the industry's capital requirements, and has begun an analysis of the Orange Book's assessment of the industry's capital availability. Although not all the differences of opinion between, and unresolved questions of, the industry, government, and labor staff members have been resolved, the staff has been able to reach certain preliminary conclusions and recommendations:

1. Based on the Orange Book's methodology and data, the capital required by the industry in the next several years to modernize its existing steel capacity and meet safety and health and environmental standards is approximately \$4.6-4.9 billion (1978\$). These amounts do not reflect the availability of financing for those needs.

2. Public comment on the assumptions and analyses of the Orange Book should be requested.

3. Until the staff analysis of the Orange Book is completed, no decision for an independent study should be made, and the Group should use the \$4.6 - \$4.9 billion figures as a basis for internal discussion.

This staff review does not necessarily reflect an adoption by the nonindustry staff of the Orange Book's analysis, assumptions or conclusions, nor the industry staff opinion on the appropriate scope of the Group's inquiry. Rather, it is an attempt, in the spirit of cooperation and progress, to reach some conclusion for the Group's use on the industry's capital requirements for modernization and to define areas of difference and further review.

A comparison of the conclusions of the Solomon Report, the Orange Book and the staff indicates that, once the differences in scope, time frame, and cost escalation due to inflation are reconciled, there is substantial agreement between the three:

Annual Capital Requirements Reconciliation

	Orange Book (1978$) average annual needs 1979-1988 (billions)	Staff Report on the Orange Book (1978$) for 1979 & near term (billions)	Solomon Report (1977$) for 1978 & near term (billions)
Modernization and Replacement of Steel Capacity	$4.4	$3.8-$4.1	$3.0
Environmental Expenditures for Existing Steel Capacity	.7	.7	1.0
Safety and Health Expenditures for Existing Steel Capacity	.1	.1	*
Steel Capacity Expansion	.5	•	*
Nonsteel	.8	•	*
Debt Repayment	.4	•	*
Increases in Working Capital	.1	•	*

A staff review of the Orange Book's conclusions on the magnitude of capital available to the industry, and the potential sources of such capital, will be presented at the next Group meeting.

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* Apparently not included within the $4.0 billion estimate.

• Either not examined or to be examined in the capital availability analysis

INTRODUCTION

The Steel Tripartite Committee (the "Committee") has undertaken an assessment of the current state of the American steel industry (the "industry").

To assist in that assessment, the Committee established five working groups to "develop a clear, tripartite picture of the industry's present status" in five areas, one of which was: modernization and capital formation. The Committee directed its Working Group on Modernization and Capital Formation (the "Group") to:

1. Rev.ew the progress and problems of the U.S. steel industry in raising capital for future modernization and investment.
2. Evaluate existing or proposed research on capital formation and modernization relating to the U.S. steel industry.
3. Provide policy input on the modernization and capital formation aspects of the proposed assessment of the U.S. steel industry and labor.

At its organizational meeting on November 16, 1979, the Group considered how it should proceed in meeting its responsibilities and whether a new independent study of the industry's capital needs and sources was necessary. An industry representative on the Group, Mr. Roderick, proposed that the Group use as a basis for analysis the forthcoming American Iron and Steel Institute (the "AISI") study, the so-called "Orange Book", and commission an independent study only if it found the Orange Book was inadequate. He offered to provide the relevant chapters in draft form prior to its public release to expedite the process. The Group designated a staff (the "staff") comprised of industry, labor and government representatives to analyze the relevant chapters of the Orange Book.

Mr. Roderick reported that the study would basically confirm the capital requirement conclusions of the 1977 study of the industry's problems, the so-called "Solomon Report". The Solomon Report concluded that the industry's annual capital requirements would be $4.0 billion for the next several years; its annual cash flows would not exceed $2.2 billion; and a $1.8 billion shortfall existed. Mr. Roderick stated that the Orange Book would conclude that, in 1978 dollars, the requirement for modernizing existing capacity and for meeting environmental standards would be $5.2 billion and a capital shortfall approximating $2-$2.2 billion existed.

On December 12, AISI provided to the staff on a confidential basis in draft form the chapters of the Orange Book that dealt with capital requirements. The Orange Book, entitled "Steel at the Crossroads: The American Steel Industry in the 1980's," was released to the public on January 31, 1980.

The staff met on January 2 and 29, February 11, March 6, and March 10. At the January 2 meeting, the staff concluded that the nature of the Orange Book's analysis rendered it necessary to segment its efforts into several steps.. It determined that the first two steps should focus on the Orange Book's analysis of the industry's capital requirements and its capital availability; other aspects of the analysis in those areas would be addressed afterward. At that meeting, as well as at two subsequent meetings, the labor and government staff raised, and the industry staff responded to, questions concerning the Orange Book's capital requirements conclusions. At the March 6 meeting, the staff, to the extent practicable, achieved consensus on the Orange Book's analysis of the capital requirements issue and began its analysis of the capital availability issue.

SCOPE OF REPORT

This paper reflects that staff consensus on the Orange Book's assessment of the capital required to modernize existing steel capacity and meet environmental and health standards, and relates several of the issues about which consensus was not achieved. It also briefly discusses the Orange Book's analysis of the capital availability issue. A staff report on the latter issue will be provided at the next Group meeting.

The Orange Book, using 1978 dollars and based on data through 1978, concludes that the industry's total annual capital requirements will average $7.0 billion between 1979-1988:

Orange Book Analysis	Capital Required ($ billions)
Replacement and modernization of steel capacity	$4.4
Environmental expenditures for existing steel capacity	.7
Safety & health expenditures for existing steel capacity	.1
Nonsteel	.8
Additional steel capacity	.5
Debt repayment	.4
Increases in working capital	.1
	$7.0

This paper focuses on the Orange Book's analysis of the capital required for modernization, environmental, and safety and health standards: $5.2 billion ($4.4 billion, $.7 billion and $.1 billion, respectively). The staff group concluded that its role was to review only these three elements at the present time since it is the understanding of the staff that the primary function and responsibility of the Group and the Committee was assessing the amounts of capital (i) required by the industry to modernize its existing steelmaking capacity, and (ii) currently available to the industry for that task. Included in the Orange Book, but not addressed in this report are:

- The elements of appropriate industry debt and working capital levels. These will be addressed by the staff in the context of the capital availability issue.

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* The appropriate level of capacity expansion and nonsteel investment. This is not to suggest a judgment by the staff that the industry should not diversify or expand, or nonsteel cash flows should be devoted solely or proportionately to steel or nonsteel expenditures. Rather, it was decided that since these issues may be beyond the Group's mandate, and were likely to raise questions the resolution of which would significantly delay the analysis, they could, if at all, be addressed at a later stage.

In this regard, it should be noted that the industry staff argued that these additional elements of capital requirements should be analyzed by the staff and the results of this analysis included in this paper. The position of the government staff was: (i) the focus of the Solomon Report, the Committee, and the first meeting of the Group was on modernizing existing steelmaking capacity; (ii) the industry would devote available resources to modernization before expansion; and (iii) the decision to diversify was one to be made by individual companies based on relative investment returns and could not be adequately analyzed on an industry-wide basis.

The Orange Book does not discuss how much of the amount allocated to "nonsteel" is steel-related and whether this amount would be used for expansion or modernization. According to the industry staff, approximately one-half of these expenditures would be steel-related (e.g., warehousing and fabrication). Whether this element was included in the Solomon Report's analysis is also unclear.

ANALYSIS

In reaching its conclusions, the staff addressed the following basic elements of the Orange Book analysis:

-- The assumptions and methodology that underlie its computation of capital required for modernization

-- Its assumptions for environment, and safety and health expenditures.

MODERNIZATION OF EXISTING CAPACITY

The Orange Book's computations of the industry's gross need for modernization are based on several assumptions concerning the following:

-- Method of modernization

-- Replacement costs

-- Replacement cycle

-- Use of average data.

Method of Modernization

The Orange Book analysis assumes that the sole method of modernization will be the replacement of existing capacity with state-of-the-art equipment at existing "brownfield" sites. It assumes no replacement by new "greenfield" facilities. It assumes only minimum opportunities for "low-cost roundout"* albeit it does recognize that a modernization program will produce roundout opportunities which would reduce the cost of a capacity expansion.

Staff Discussion. The conclusion that few low-cost roundout opportunities currently exist is verifiable only by a detailed examination of the facilities and modernization plans of representative companies. This has not been done by the staff.

Replacement Costs

The Orange Book computations and analysis assume a replacement cost of $1,175 for each finished ton of capacity at an integrated facility, and $500 per finished ton at an electric furnace facility.

- The $1,175 includes $225 for the mining, preparation, and transportation of raw materials.

- The $500 electric furnace cost is a weighted average of replacing all existing electric furnace facilities. No direct reduction is assumed.

The analysis computes a composite replacement cost of $1,000 per finished ton on the assumption that replacement would occur

* The industry staff provided this explanation: "Pure roundout refers to increases in shipments resulting from the addition of one or a few pieces of equipment to a plant with current imbalances in the capacities of its various facilities. Little improvement in efficiency results from pure roundout. In the industry, roundout is unlikely to take place independent of modernizataion because of the need to improve efficiency to make any increase in shipments profitable. The $1,000 per ton modernization cost reflects this reality."

at the current 75/25 integrated/electric furnace production ratio.* The $1,000 figure includes any costs associated with meeting safety, and health, and environmental standards.

Staff Discussion. The $1,175 per finished ton replacement cost for integrated facilities is roughly comparable to other available estimates on the cost of replacing integrated capacity reviewed by the staff. However, these estimates varied by as much as 10 percent from the Orange Book's estimates.

The $500 per finished ton replacement cost for electric furnaces is less clear. It is a weighted average of the cost of replacing existing facilities which vary from mini-mills to maxi-mills. The staff has confirmed that replacement cost for these facilities can vary enormously. A review of annual reports of and discussions with several mini-mill steel companies indicate that a mini-mill could be built for $100 per ton. The industry staff indicated that some maxi-mills cost up to $800 per ton. Because of this wide disparity, the staff was unable to confirm the $500 per ton estimate. The Government staff also raised the point that the conversion of some existing integrated facilities to electric furnaces would continue.

Assuming the current 75/25 integrated/electric furnace production mix, and $1,175/ $500 integrated/electric furnace replacement

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* The Orange Book assumes that there will be expansion of which 50 percent will be electric furnace, so that by 1988, the production ratio would be 68/32 integrated/electric furnaces.

costs, a $1,000 per ton replacement cost would be appropriate. If one assumed an approximate 72/28 integrated/electric furnace mix could be obtainable in the next several years, and $1,100/$450 integrated/electric furnace replacement costs, the replacement cost per ton would be approximately $920.

Replacement Cycle

The Orange Book assumes that the industry must replace 4 percent of its steel capacity each year, i.e., a 25-year replacement cycle. With additional capacity and higher yields and capacity utilization, the Orange Book assumes 101.6 million tons of shipments in 1979 and 116.9 million tons of shipments by 1988. Four percent of the average annual shipments during the 1979-1988 period would equal 4.4 million tons of capacity. At $1,000 per finished ton, the average annual expenditure required to modernize the capacity existing within that period would be $4.4 billion.

Staff Discussion. The Orange Book does not explain its use of a 25-year replacement cycle and a 4 percent replacement rate. Other than coke ovens, steelmaking equipment is fairly long-lived (with continuous maintenance) although it can become obsolete much earlier as technology advances. The staff is in agreement that the industry has not invested in new technologies to the same extent or as rapidly as some of its foreign competitors. However, no consensus was reached on the appropriate replacement rate for the near or long term to enable the industry to incorporate existing and prospective technological advances without retiring profitable equipment, or whether the replacement cycle methodology was the way to determine modernization requirements. In this regard, key issues included the following:

- The 4 percent rate is considerably higher than the industry's replacement rate for any previous consecutive 10-year period in the history of the industry. In the 1960's, when the industry was relatively more profitable and in the midst of a modernization program, its replacement rate was only 3.4 percent. However, the Canadian and Japanese industries maintained a 5 percent rate over the past decade.

- To justify the 4 percent rate, the industry staff described technological advances in the previous 25 years, *e.g.*, continuous casters, larger blast and basic oxygen furnaces, and suggested that similar advances will occur at the same rate in the next 25 years. They also provided data which indicated that by 1988 at a 4 percent rate, versus a 5 percent rate in Japan, average industry operating costs could decline appreciably relative to those in Japan, so that the industry would be more competitive with the Japanese in the U.S. market (at given exchange rates and normal capacity utilization rates). However, this data also indicates that even with a 3.3 percent replacement rate, the industry's competitiveness in the U.S. market would improve significantly. The impact on operating costs of a 4 percent and a 3.3 percent replacement rate does not become significant until after the first ten years of any modernization program.

Average Data

A basic issue that arose throughout the analysis was the Orange Book's use of average operating cost and replacement data The use of average costs obscures the strengths and problems of the industry, individual firms, plants and regions, and presents problems for analysis.

Observations

Replacement Cycle Methodology. The accuracy of the replacement cycle methodology and the replacement rate required might be further assessed by a detailed examination of all, or at least some representative, steel plants to determine the nature and degree of modernization necessary. The actual modernization plans of some steel companies were used as background in arriving at the 4 percent replacement rate used in the Orange Book. However, this information was not available to the staff. The staff did examine the annual reports and 10-k's of several steel companies. These reports suggest that only the most profitable steel companies have approached a 4 percent replacement rate, while less profitable companies have replaced at much lower rates.

Modernization Conclusions

The $4.4 billion calculation in the Orange Book is an average cost of modernizing 4 percent of estimated annual shipments over a ten-year period, during which some capacity expansion was assumed. Using the Orange Book's methodology and the 4 percent replacement rate assumption, but focusing on existing capacity and the modernization requirements for the next several years, the annual replacement cost in the next several years would be between approximately $3.8 billion ($920 per finished ton replacement) and $4.1 billion ($1,000 per ton replacement cost). These figures are derived by using actual 1978 capacity and yields and assuming a 90 percent capacity utilization rate (101.6 million tons of shipments).

It should also be pointed out that the industry's capacity was 158 million raw tons in 1978. Its current capacity is estimated at 153 million raw tons and some further capacity rationaliation may occur. However, even at a 150 million ton raw-steel capacity, the industry would still have the ability to surpass the shipment levels achieved in 1978.

ENVIRONMENTAL CONTROL

The Orange Book estimates the industry's retrofit capital expenditures to meet EPA environmental control standards over the period 1979 to 1988 will be $7 billion, or $.7 billion per year.

This estimate is partially supported by detailed study. In a May 1978, report,* Arthur D. Little Co., acting as consultants for AISI, projected that compliance with EPA regulations through 1985 would require the industry to spend $4 billion. This estimate did not include the cost of satisfying post-1985 water and air standards and achieving zero discharge of water pollutants.** The latter are estimated by AISI at order of magnitude of $3 billion through 1988.

*"Steel and the Environment: A Cost Impact Analysis--1978"

**This is currently a statutory goal, but not a requirement.

<u>Discussion</u>. EPA and its contractors, Temple, Barker & Sloane, believe that AISI's estimates concerning the requirements of environmental control are reasonable based on the Scenario I assumptions of the Orange Book. However, of crucial importance in this Scenario are the assumptions as to market growth and the share of the market the American industry could supply.

SAFETY AND HEALTH STANDARDS

The Orange Book estimates that the annual capital expenditures required to meet safety and health standards for existing steel capacity would be $.1 billion. The staff was unable to obtain any alternative estimates.

STAFF CONCLUSIONS AND RECOMMENDATIONS

1. Based on the Orange Book's methodology and data, the capital required in the next several years to modernize the industry's 1978 steel capacity would be between $3.8-$4.1 billion (1978$). Annual capital expenditures to meet environmental and safety and health standards would be $.8 billion (1978$).

2. Public comment on the Orange Book's treatment of the modernization and capital formation issues should be requested for receipt prior to the next Group meeting.

3. Until any public comment has been considered, and the staff has completed its analysis of the Orange Book:

   a. No decision should be made on the need for an independent study of the industry's capital requirements and sources.

b. As a basis for critical discussion, the Group assumes \$4.6-\$4.9* billion (1978\$) as the annual capital requirement of the industry to modernize existing steel capacity and meet environmental and safety and health standards.

CAPITAL AVAILABILITY

It is contemplated that the next Group meeting will focus on the capital available to the industry to finance its gross requirements for modernization. The basic sources of capital are after-tax profits, depreciation, debt and new equity issues. The uses of capital other than capital expenditures are repayment of debt, increases in working capital, and dividends. The Orange Book assumes that the industry cannot borrow additional funds and its debt level should be reduced by \$400 million annually. It further assumes that no additional capital stock will be sold but dividends will remain at current levels, approximately 45 percent of net income.

The staff is reviewing the following issues among others as part of its study of capital availability:

1. Appropriate debt and working capital levels for the industry during the industry's modernization program.

2. Dividend levels in total and as a percentage of net income.

3. The ability of some steel companies to issue new equity.

4. The availability of additional capital through alternative

*Using the estimated GNP implicit price deflator for fixed non-residential investment, this would be \$4.9-\$5.3 billion in 1979\$.

debt financing methods (e.g., leasing, pollution control bonds).

5. A return on investment analysis.

6. The phase-in of a modernization program given capital and construction constraints.

7. A proposal by the Treasury staff for a case study of the actual returns on investment from, and capital available for, a modernization program, using two representative integrated companies at opposite ends of the profitability scale. If practicable, this would also test the Orange Book's average assumptions for the capital requirements, by reference to those firms.

Capital Availability: The Second Report to the Working Group on Modernization and Capital Formation

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June, 1980

SUMMARY

To provide the Steel Tripartite Committee with the assessment of the U.S. steel industry requested by the Committee, the Working Group on Modernization and Capital Formation designated a joint staff to analyze the steel industry's "Orange Book". In its first report, the staff concluded that the industry's average annual capital requirements in 1979 and the next several years to modernize and meet environmental requirements on its existing capacity would be $4.6 - 4.9 billion (1978 $). In this second report, the staff presents its conclusions on the amount of capital available to the industry to meet those requirements, and on whether this modernization program will provide an adequate return on investment.

The staff's availability analysis examined the period 1979 - 1983, using 1978 data and profits, assumed shipments at the 90% capacity utilization rate used in the Orange Book, and certain other agreed-on assumptions concerning profits, external financing, dividends, and operating costs.

The staff concluded that the industry's planned capital uses under the modernization program would exceed its planned sources by an average of approximately $1 - 1.2 billion (1978 $) annually over the period 1979 - 1983.

Based on industry cost estimates accepted by the staff, it appears that a 25-year modernization investment would earn annual returns of approximately 12 1/2% on investment, and over 17% on the incremental investment above a base maintaining level.

These general conclusions carry several qualifications:

-- shipments in 1979 and probably in 1980 will be substantially less than assumed in the analysis; this would increase the annual shortfall for the five-year period by approximately $300 million.

-- the shortfall identified does not include the cost of funding that shortfall.

-- if the annual analysis was extended over a ten-year period, the average shortfall could be as small as $200 million, indicating an industry "hump" problem in the early years of the program.

-- the analysis examines the industry as a whole and uses average data, which may distort the actual problems or circumstances of specific firms.

-- the analysis assumed that inflation would impact revenues and costs equally.

The first two staff reports leave unresolved several issues which the Group or Committee may wish to pursue:

- the industry's financing of steel investment from non-steel operations
- the effect of "10-5-3" or other depreciation proposals on the industry
- future U.S. and world steel supply and demand and its implications on the future adequacy of steel supply in the U.S.
- Given U.S. labor and environmental costs, the future competitive position of the U.S. in steelmaking, both with and without the proposed modernization program
- the effect of technology advances on capital requirements

INTRODUCTION

The Steel Tripartite Committee (the "Committee") established a Working Group on Modernization and Capital Formation (the "Group") to develop an assessment of the current status of the U.S. steel industry[1]/ in these areas. At the Group's organizational meeting on November 16, 1979, the Group decided initially to review the "Orange Book",[2]/ the industry's analysis of its capital needs and sources, rather than conducting its own de novo analysis. It adopted this approach as the most efficient way to define the issues and reach consensus within the Group. The Group, without concurring with the policy recommendations contained in the Orange Book, nevertheless used some of the Orange Book assumptions to examine the issues.

The 1977 Solomon Report stated that the industry's annual capital requirements in the next several years should average $4 billion (1977 $) and that with 1977 cash flows of no more than $2.2 billion there was a gap of $1.8 billion between the industry's cash flow and investment requirements.

For its analysis, the staff developed a three-step process. The first step would assess the Orange Book's treatment of industry's capital requirements; the second step would assess the capital available to the industry to meet the requirements identified in the first step; and the third step could analyze issues raised but not resolved in the first two steps and any other issues identified by the Group or Committee.

This is the second report of the joint industry, labor and government staff designated by the Group to analyze the Orange Book.

First Report

The staff presented its report on the first step (the "First Report") to the Group at the Group's March 14 meeting. The Orange Book identified the annual capital requirements of the industry as $7.0 billion. This aggregate amount was comprised of $.4 billion for debt reduction, $.1 billion for additional working capital, $.5 billion for expansion, $.8 billion for nonsteel, $.8 billion for environmental, and $4.4 billion for modernizing expanded capacity. The First Report covered only the capital

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1/ "Industry" as used throughout refers to U.S. companies for which a majority of revenues come from the manufacture of carbon, alloy and stainless steel products.

2/ Steel at the Crossroads: The American Steel Industry in the 1980s, American Iron and Steel Institute ("AISI"), January, 1980.

required for modernization and environmental expenditures and concluded that the annual capital expenditures required by the industry in the next several years would be $3.8 billion to $4.1 billion to modernize existing steel capacity and $.8 billion to retrofit that capacity to meet environmental[1] requirements. The $4.6 - 4.9 billion (1978$) staff estimate corresponds to a $4.0 (1977$) estimate in the Solomon Report. The First Report identified a number of issues on which the staff either could not reach complete agreement or did not analyze. The principal of these unresolved issues were:

-- future U.S. steel demand and supply, and the need, if any, for U.S. capacity expansion.

-- the appropriate industry debt and working capital levels.

-- the capital required for the industry's nonsteel operations.

-- the appropriate annual replacement rate for steel capacity.

These issues are important to the ultimate assessment of the industry's capital needs and any policy decisions which may be made by the Group or Committee.

<u>Second Report</u>

This Second Report reviews the Orange Book's treatment of the capital availability question, and the staff's assessment of the amount of capital which the industry should be able to raise to carry out the modernization program described in the Orange Book.

The Orange Book describes a twenty-five year modernization program. The First Report focused only on the modernization requirements in the next several years. This report will assess the capital available during a five-year period 1979-1983, and briefly comment on the subsequent five-year period. <u>As in the Orange Book, 1978 dollars are used throughout.</u>

The Orange Book's Scenario I assumed circumstances in which the industry could attain an average 90% capacity utilization over a twenty-five year period, although capacity utilization over the ten-year peiod 1969-1978 averaged only 85.0% (83.0% over five-year period 1974-1978). This Second Report projected year-to-year shipments and capital availability using 1978 as a data base, an assumption of a 90% capacity utilization, and industry estimates of the impact of the modernization program on operating costs.

1/ As used throughout this report, "environmental requirements" includes safety and health requirements.

In reality, 1980 shipments are not expected to be the 102 million tons projected but are expected to be 85 million tons or less. Demand for steel is highly cyclical (with sizable peak to trough amplitudes), and, in the longer term, such cycles may even out. However, a downturn at the beginning of the modernization program can pose special problems by severely constraining capital availability and may suggest a need to reassess the amount of capacity which could or should be replaced in any modernization program.

Third Report

In this report and the First Report, the staff identified a number of issues on which it was unable to reach any conclusions. Some or all of these issues could be the subject of a third-stage analysis and report by the staff. The more important of these issues are identified in the last section of this report: UNRESOLVED ISSUES.

The first two reports adopted many assumptions for analytical purposes, with express reservations. How these assumptions are actually dealt with will significantly affect the size of the industry's shortfall.

METHODOLOGY

The First Report represented primarily the staff's analysis of the Orange Book's data, assumptions, methodology and conclusions regarding the industry's capital requirements. The staff did not undertake an independent examination of the industry's capital requirement because of the time and resources required, and because the basic information source for such analysis would have been the same as the Orange Book's - AISI's member companies.

The availability analysis in this Second Report, however, involves an independent assessment of the industry's capital sources and uses. The independent assessment was necessary for several reasons.

- First, the Orange Book does not contain annual estimates of capital sources available during its proposed modernization program, and does not identify a capital "shortfall" susceptible to analysis. The shortfall defined in the Orange Book is the difference between real capital recovery and capital expenditures under current tax rules, as compared to the proposed Capital Cost Recovery Act1/, if the $6.5 billion annual capital expenditures recommended in the Orange Book were made. The Orange Book does not define a total shortfall of capital required versus that available from all other sources. The Orange Book does discuss various other sources of capital, including debt and reinvested earnings, but there are no detailed estimates of annual profits, dividends, and reinvested earnings if the modernization program is undertaken.

- Second, unlike the Orange Book, the First Report did not include an estimate for expansion or non-steel expenditures and used a five-year period for the analysis rather the twenty-five-year period used in the Orange Book. Differences in the timing, amount and purpose of expenditures affect the capital available for subsequent expenditures. Therefore, a separate analysis based upon the adjusted needs of the First Report was necessary.

- Third, in the First Report, the staff relied to a great extent on the industry's estimates of its modernization needs and costs in the capital requirements analysis. In assessing the industry's financial resources, however, the staff, because of its collective expertise in this area, was better able to make independent assumptions and estimates.

1/ The so-called "10-5-3" proposal, which would allow, after a five-year phase-in period, depreciation of buildings, equipment and vehicles over 10, 5 and 3 years, respectively, without regard to the useful lives of these assets.

ANALYSIS

To assess the capital available to the industry, the staff looked into the following key areas:

-- Return on investment: Whether the cost savings from the modernization program would justify the proposed investment.

-- Capital sources and uses: The key assumptions to be used to estimate available capital during the proposed modernization program.

-- Cash flows from the industry's nonsteel operations: To what extent can they be considered as a source of capital for steel modernization expenditures.

RETURN ON INVESTMENT

To analyze the reasonableness of the proposed modernization program, the staff assumed that the industry would only modernize if the return on investment ("ROI") was favorable. To do this, two sets of assumptions were considered: one based on the total investment of $960 per finished ton and the other based on incremental investment beyond a base maintaining level. $960 is the average of the $920 to $1000 per ton replacement cost range identified in the First Report.

The total modernization program assumed a $960 per ton investment spread over four years to reflect the standard steel plant construction cycle. The cost savings from the investment were based on the Orange Book estimates, assuming the minimum sized efficient plants (three to four million tons for integrated plants). Current profitability plus the cost savings due to modernization represent the cash inflows from the investment. Depreciation was taken over a 12-year life on an accelerated basis1/ and coordinated with the investment tax credit to maximize tax reductions.

The analysis indicated a return on investment from the complete modernization program of 12.4% (Attachment A)2/. The increased returns from modernization reflect the substantial changes in technology that have occurred in the steelmaking process in the last twenty-five years. Furthermore, substantial increases in energy costs in this energy-intensive industry, and the higher absolute and relative wages of the U.S. steel industry encourages companies to adopt new labor-and energy-saving technology as rapidly as possible.

The second analysis (Attachment B) examined the returns to the industry from pursuing incremental modernization beyond a base maintaining investment strategy. Based on industry estimates, the staff assumed that $560 per ton was required to maintain base operations, $400 per ton represented the incremental modernization investment, and the incremental investment results in 80% of the cost savings. The return on this incremental investment was 17.1% after tax. Furthermore, some individual modernization projects, such as coke ovens, blast furnaces, continuous casters, and plate and bar mills may have returns greater than 17%.

1/ Double-declining balance changing to sum-of-the-years digits after 1.5 years.

2/ The 12.4% assumes 100% equity financing and no working capital. However, if one assumes additional investment of $100 per ton for working capital and that 30% of the total capital required is borrowed at 10%, the 12.4% ROI becomes a 14.1% discounted cash-flow return on equity investment.

Discussion

The additional return from modernization is primarily due to two factors. First, a decrease in man hours per ton from the current 9 hours to a projected 5 hours, reducing labor costs from the approximate 1978 level of $129 per ton, to a projected $71 per ton. Labor savings are critical because labor costs represent approximately one-third of total 1978 production costs. Second, an improvement in energy efficiency of approximately 35%. Energy savings are critical because of rapidly increasing energy costs.

The staff discussed cost savings estimates with some U.S. steel company executives and attempted to compare these estimates to those of Canadian producers. Based on these discussions, these cost savings appear to be attainable; however, there is some disagreement among industry experts as to their precise magnitude. This is one area which the Committee may wish to pursue.

The above ROI analyses do not take into account future market conditions which could increase or reduce the ROI from the rates suggested by the above estimates. For example, a downturn in steel sales could idle the modernized plant, reducing the ROI; an increase in real revenues would result in a higher ROI.

The analysis assumed a $960 per ton modernization investment and current average industry operating costs. If a particular plant has higher-than-average operating costs, or the modernization cost is less than $960 per ton, the ROI would be higher.

KEY ASSUMPTIONS

To determine the capital available to the industry, the staff divided the industry into steel and non-steel segments and analyzed the industry's sources and uses of funds in each of these two segments for each year, 1979 - 1983. 1/ The analyses used 1978 industry profits and taxes, adjusted for each year based on certain assumptions with respect to the following: shipments, profits, taxes, external financing, dividends, asset sales and working capital. The assumptions were, for the most part, agreed to by the staff. The following discussion includes any unresolved disagreements and concerns by staff members with these assumptions.

USES

CAPITAL EXPENDITURES

For this report, it was assumed that the average annual capital expenditures during the period would be $4.755 billion, the mid-point of the $4.6 - 4.9 billion range identified in the First Report $.8 billion to meet environmental requirements, and between $3.8 billion and $4.1 billion to modernize existing steel capacity. These expenditures were assumed to be phased-in, beginning with $4.678 billion in 1979 and increasing to $4.832 billion by 1983.

Discussion

The First Report did not identify a specific annual replacement rate necessary to preserve a modern, competitive steel industry, although a 4 percent rate was adopted as a construct to compute the annual modernization requirement. The $3.8 billion and $4.1 billion figures reflect the staff's use of a range for estimating the costs of replacing a ton of finished steel capacity. Finally, the figures identified in the First Report were based on 1978 capacity, and to the extent that that capacity has been reduced through the plant closings -- which, presumably, were the least efficient plants with the highest modernization costs -- the modernization requirements, would also be reduced. On the other hand, the Orange Book estimate of environmental expenditures, accepted in the First Report, does not include the possibly substantial capital expenditures necessary to meet solid waste disposal requirements, which were only recently issued by EPA.

1/ The basic sources of funds are profits, non-cash expenses (depreciation and deferred taxes), net borrowing, and sales of assets and equity. The uses of funds are net working capital, dividends, and capital expenditures. A "shortfall" results if planned uses exceed planned sources.

DIVIDENDS

The analysis assumed that dividends each year will be either the 1978 level for the industry, $536 million, or 35% of after-tax profits, whichever is greater. 67% of this amount was allocated to steel operations , and 33% to nonsteel operations.

Discussion

The industry staff believes that despite the industry's poor profitability, the industry has a duty to maintain a consistent and reasonable level of dividends. Steel shareholders tend to minimize risk and rely on dividends. Dividends for the industry have eroded steadily since 1974 and the industry believes it cannot penalize its shareholders any more than has already been the case.

The Treasury staff believes that this undertaking of a major modernization program would require that the industry's historical dividend payout ratio, approximately 45% of after-tax profits, be reduced. Furthermore, this relatively high payout has not enabled the industry to issue any substantial amounts of new equity. The low ratio of stock prices to book value within the industry reflects the market's reaction to the industry's low profit levels despite the high payout ratio. A reduction in dividends, at least by some of the less profitable companies, will help finance the modernization program, which should result in increased profitability and increased value for steel equites. From the stockholders' point of view, capital gains from an increase in stock value may be more desirable than the ordinary income of stock dividends.

WORKING CAPITAL

The analysis assumes that the industry would need $.1 billion in additional working capital for steel operations each year. This is the figure identified in the Orange Book.

Discussion

The industry's current assets in 1978 were $18 billion, which includes $2 billion in cash and marketable securities and inventories on a current value basis; current liabilities were $10 billion, leaving $10 billion in net working capital or roughly $100 per finished ton. The staff believes $.1 billion is a reasonable estimate of the incremental working capital needed, given the increased volume projected. However, if the long-term shipment levels assumed do not materialize, working capital could be reduced to fund modernization expenditures.

SOURCES

PROFITS

The Second Report assumes profits each year to be equal to the 1978 profit, adjusted for increased shipments, the effects of the capital expenditure, and additional interest, depreciation and tax expenses. Revenues and costs (other than depreciation) were assumed constant, i.e., the inflation rate would be the same for all costs and revenues. Depreciation expense was deflated to compensate for the decreased value of historical cost depreciation due to inflation.

ADDED VOLUME

Steel shipments were assumed at the levels projected in the Orange Book, which assumed 90% capacity utilization: 101 million tons in 1979, increasing by 1 million tons each year thereafter. Each additional shipped ton above 1978 levels was assumed to provide an $80 variable profit.

REDUCED OPERATING COSTS

The assumed cost reduction from modernization was $113 per finished ton. Cost reductions were phased in with a two-year lag, with 4% of the total operating cost savings occurring by 1981, 10% by 1982, and 16% by 1983.

Discussion

The 6% annual increases in cost savings after 1981 are greater than the 4% replacement rate used in the Orange Book since it was assumed that the most cost-effective projects would be done first.

As previously indicated, the cost reduction and operating profit estimates were provided by AISI based on the industry average. These figures may vary considerably between individual firms. The lack of cost reductions during the first two years is the primary reason for the large capital shortfall in those years.

INCREASED ENVIRONMENTAL COSTS

Operating costs increases were assumed to occur each year because of environmental requirements. Annual increases used were provided by AISI, based on a 1980 study being prepared for AISI by Arthur D. Little Inc. By 1983, additional operating costs over 1978 levels were estimated to be $690 million. These estimates do not include the possibly substantial additional operating costs associated with meeting solid waste disposal requirements.

Discussion

The EPA representative on the staff advised that the AISI estimates were approximately the same as EPA's preliminary estimates and that EPA estimates should be forthcoming in August, 1980. The staff believes that if market conditions prevent the industry from passing on these additional operating costs through higher prices, these costs, together with the higher U.S. labor costs, may result in a gradual shift of carbon steel production to less developed countries which impose less strict environmental standards; and such a loss of comparative advantage will have an impact on the industry's future capacity and capital requirements.

TAXES

The analysis assumes an effective Federal and State increased tax rate for the industry of 32%. The assumption was based on an effective industry tax rate in 1978 of 34%, reduced by the 2% reduction in the Federal corporate tax rate for years beginning after January 1, 1979. The analysis also assumed a Federal investment tax credit of 10% of 90% of capital expenditures. The credit is available only for equipment, which the analysis assumed to be 90% of the modernization expenditures.

Discussion

The analysis was made on an actual tax basis and then converted to book basis. The results indicate that, other than a minimum tax liability of approximately $50 million per year, the industry's steel segment will pay no Federal taxes during the first five years of the modernization program.

BORROWINGS

The analysis assumed new borrowings at a rate of 49.5% of new equity (stock sales and reinvested steel earnings). This was the approximate debt/equity ratio of the industry at the end of 1978. It was assumed that new debt would be issued at a 9% interest rate, a composite corporate and tax-exempt rate based on 1978 interest rates and reflecting the relatively high level of pollution control financing by some of the larger integrated companies.

Also included as a source was an additional $300 million, an estimate of the amount of unexpended proceeds from pollution control debt issued prior to 1979.

Discussion

Because of low interest/earnings coverage and the cyclical nature of the industry, this could be viewed as a high level of debt. Nevertheless, it is believed that the industry can maintain this level during the early years of the modernization program. This debt level need not be permanent and could be reduced with the additional profits in the later years of the modernization program.

The industry staff argued that current debt ratios would be difficult to maintain unless there were a much higher degree of certainty introduced into the economy in general and the steel market specifically. High debt ratios are extremely risky for an industry with low profit rates -- such as is the case with steel. Even assuming 90% utilization is maintained, profit rates for the industry as a whole will not improve significantly during the initial years of the industry's modernization program. If 90% utilization is not maintained, profit rates in some years will be quite low.

ASSET SALES

$.1 billion per year was assumed to be available from the after-tax proceeds from the scrapping or sale of excess industry property. $81 million was allocated to steel operations.

Discussion

The estimate is based on historical data from the firms' annual reports and does not include sales of profitable non-steel operations.

PROJECT AND LEASE FINANCING

$.1 billion per year was included as an estimate of the additional financing for raw materials available through leasing, project financing and long-term guaranteed purchase contracts.

Discussion

Approximately $500 million of the annual capital expenditures identified is for raw materials development. The staff believes that at least $.1 billion of this could be financed through off-balance sheet financing.

Industry staff noted that approximately 20% of current financing is off-balance sheet and argued that additional use of this source is severely limited especially since use of off-balance sheet financing constrains on-balance sheet financing. The industry staff notes that sales of raw material properties with a guaranteed (take or pay) raw material buy-back provision are usually economically unsound -- steel companies assume all the risk, and sacrifice long term profits for current cash and the uncertainty associated with any capital investment. However, assuming conditions which reduce market uncertainty during the modernization program, the industry would agree that approximately $.1 billion per year could be available from this source.

NEW EQUITY

Stock sales were assumed to be $.1 billion annually. $67 million was allocated to steel operations, and $33 million to non-steel operations.

Discussion

The $.1 billion estimate is roughly equivalent to the new stock issued by the industry in recent years, chiefly through dividend reinvestment and employee stock purchase plans. The last major equity sale by a steel company in the market was a $71.3 million issue of common stock by Inland Steel in 1976. The modernization program should increase industry profits and make industry stock issues more attractive, so that new equity should become a much larger source of capital during the modernization program. However, at the current time, few companies can issue new equity and the small amount assumed reflects this reality.

NON-STEEL CASH FLOW

The First Report analyzed only the capital required to modernize the industry's steel operations.

For this analysis, the industry's steel and non-steel operations were analyzed separately. Cash from steel operations, and from non-steel operations in excess of that needed to maintain existing operations, was considered an "available" source of capital for steel operations.

Based on an AISI special survey of 12 member companies covering the years 1975 - 1978, it was assumed that 33% of the industry's gross income and dividends, and 19% of its depreciation, investment tax credits and interest expense was attributable to non-steel operations, and annual capital expenditures of $.5 billion would be necessary to maintain these operations assuming no expansion. The analysis of non-steel sources indicated that an average of approximately $400 million in non-steel cash could be available from non-steel sources for capital expenditures each year during the 1979 - 1984 period. This $400 million includes $250 million in non-steel reinvested earnings, and an additional $125 million nonsteel debt (assuming an unchanged debt/equity ratio) and $33 million in stock sales -- both made possible by the non-steel earnings.

The Treasury staff's view was that $400 million should be considered available for steel capital expenditures. The industry staff's view was that, given returns in steel equivalent to non-steel, possibly $200 million could be made available for steel.

Discussion

In developing the First Report, there was disagreement among the staff over whether non-steel expenditures should be included. Because of the Group's primary concern with steel plant modernization, non-steel expenditures were excluded.

The Treasury staff's view is that since the Group is attempting to assess whether the industry has sufficient financial resources of its own any capital "available" to the industry should be considered, regardless of the source. Therefore, any cash from non-steel in excess of that necessary to maintain those operations would be available for the modernization program. Whether these funds will be spent to modernize steelmaking facilities, expand steel-related operations to process steel made by itself or others, or diversify, is a decision to be made by each individual company, project-by-project, based on the relative investment returns available to that company. Any diversion of non-steel cash flows need only be temporary - to enable the industry to fund any capital shortfall in the early years of the modernization program; in later years, the large cost reductions identified by the industry in the ROI analysis will eliminate the need for non-steel cash. If, as the industry has indicated, as much as one-half of these "non-steel" operations are dependent on steel operations, some diversion must occur merely to preserve the non-steel profits.

Treasury staff also noted that the staff's separate analyses of steel and non-steel operations may understate and perhaps mischaracterize the excess non-steel cash flows, since tax losses from steel operations in the early years of the modernization program would be available to shelter non-steel projects.

Industry staff disagreed with splitting steel from non-steel in the First Report. Given this division, however, industry staff argued that it is unreasonable to expect the industry to divert funds from profitable non-steel operations to less profitable steel operations. The net effect of this would be to make the industry less profitable and thus doom the modernization program and insure greater cuts in steel operations. For some years non-steel cash flow has been supporting investment in steel in the amount of approximately $200 million per year, and this has permitted little expansion of non-steel activities. Unless conditions are forthcoming which improve rates of return for steel versus non-steel, and reduce the risk of investing in steel, the steel companies could not justify to their shareholders or employees continuation of such a policy.

Industry staff also noted that approximately one-half of the so-called non-steel activities are steel-related and include steel construction, fabrication, and steel service centers. The expansion of these steel-related "non-steel" activities is essential to the industry's modernization program. Thus, the industry staff believes the most that could be made available for steel from non-steel sources in a modernization program, even given ideal circumstances, would be $200 million per year. Assuming circumstances that reduce the risks of market volatility during the modernization program and provide rates of return for steel equivalent to those in non-steel, the industry staff agrees that possibly one-half of the "available" non-steel cash flow per year ($200 million) could be invested in steel.

SOURCES AND USES

Based on the foregoing assumptions, the staff's estimate of the industry's steel segment capital sources and uses for the 1979 - 1983 period is as follows.

Table 1

Sources and Uses for Steel Segment
($ Millions, 1978 $)

	1979	1980	1981	1982	1983	Average
Shipments	101	102	103	104	105	
Uses						
Capital Expenditures	4678	4717	4755	4794	4832	
Change in Working Capital	100	100	100	100	100	
Dividends	357	357	357	357	357	
Total	5135	5174	5212	5251	5289	5212
Sources						
Profit After Taxes	1021	862	978	1175	1418	
Non-cash Expenses	1654	1673	1876	2221	2543	
Net New Debt	383	308	365	462	583	
Use of Env. Borrowing		100	100	100		
Asset Sales	81	81	81	81	81	
Addition to Stock	67	67	67	67	67	
Off Balance Sheet	100	100	100	100	100	
Subtotal	3306	3191	3567	4206	4792	
Surplus from non-steel						
Treasury	387	398	407	413	426	
Industry	194	199	204	207	213	
Total						
With $400 Non-steel	3693	3589	3974	4619	5218	4219
With $200 Non-steel	3500	3390	3771	4413	5005	4016
Shortfall						
With $400 Non-steel	(1442)	(1585)	(1238)	(632)	(71)	(994)
With $200 Non-steel	(1635)	(1784)	(1441)	(838)	(284)	(1196)

Extending the analysis over a 10-year period (1979-1988) (Attachment C) indicates that the average annual shortfall could be as small as $200 million[1] and there would be no shortfall in the later years.[2] When viewed with the staff's incremental ROI analysis, this suggests two conclusions: substantial cost reductions will occur only with sustained modernization expenditures in excess of those required for base maintaining; and the industry must overcome a "hump" problem, *i.e.*, obtain the additional capital in the early years to produce the cost savings necessary to continue the program.

1/ This assumes existing environmental requirements. The industry's operating costs and capital requirements would increase if the goals in the Clean Air Act and Clean Water Act become requirements: based on a forthcoming A.D. Little Inc. study for AISI, the staff estimates that the industry's annual average shortfall over the 10-year period would increase by $350 million.

2/ The Orange Book's Scenario I assumed rates of modernization between the fifth and tenth years in excess of 4% per year. The staff assumed a constant 4% during this period. The Orange Book approach would mean larger capital requirements in the fifth through the tenth years than the staff approach and would thus lead to a larger "shortfall", but also a faster rate of return improvement. Both approaches would arrive at a competitive, profitable industry before the end of a 25-year modernization program.

CONCLUSIONS

The staff estimates that the industry would have had a capital "shortfall" averaging approximately $1 - 1.2 billion (1978 $) annually during the period 1979 - 1983 if it had undertaken the modernization program identified in the Orange Book and shipments were at the levels assumed in Table 1.1/

Based on cost savings estimates provided by the industry and accepted by the staff, it appears that the modernation program should, in the longer term, provide adequate returns on investment.

Several qualifications must be made with respect to these general conclusions.

The funding of any shortfall involves costs, regardless of the sources used. Assuming the shortfall were to cost the equivalent of a 10% interest rate per year, the shortfall range would be $1.25 to 1.5 billion annually.

This analysis looked at the industry as a single entity, using average or composite data which may not completely reflect the circumstances or problems of individual companies. Profit levels, management strategies, financing capabilities, modernization requirements, and degrees of diversification vary considerably among companies within the industry and even within the large integrated-producer segment of the industry.

Finally, this analysis assumed that a modernization program would begin in 1979, and that shipments would be 101 million tons in 1979, increasing 1 million tons each year until 1983. This did not happen. Shipments were 100 million tons in 1979 and are likely to be 85 million tons or less in 1980. If the 1979 and 1980 shipment projections were revised to reflect actual circumstances, the average unfunded shortfall would increase to $1.3 - $1.5 billion annually (see Attachment D), demonstrating the problem posed by cyclical downturns during the early years of any modernization program.

1/ The 1977 Solomon Report identified a $1.8 billion (1977 $) "gap":

> "Assuming that the industry spends $2.5 billion per year on maintenance and replacement, $1 billion on pollution control projects, and $0.5 on additional modernization projects, its annual capital requirements should average $4.0 billion (in 1977 dollars) over the next several years. Given that 1977 cash flow is likely to be no higher than $2.2 billion, there is a $1.8 billion gap between industry cash flow and investment requirements."

UNRESOLVED ISSUES

The staff believes that a separate complete study by the Group of the capital needs and sources of the industry is unnecessary at the present time. The Orange Book and the two staff reports to date should provide the Group with an adequate basis for the current assessment of the industry in the area of modernization and capital formation requested by the Committee.

The staff discussions in preparation of these reports brought to light several related issues which were never fully resolved or analyzed. Their resolution could substantially affect the capital needs and sources identified, and therefore may need to be addressed by the Group or Committee.

- Industry Profitability. Every company should and probably will invest where it believes it can, in the long run, obtain the highest returns. Available capital will flow to the most profitable companies and industries. Perhaps more important questions than the extent of the industry's capital shortfall are: whether the relative profits in steel in the long term justify additional investments; what management actions other than additional investment can or should be taken to increase those profits; and at what point, if any, will the lack of investment in domestic steelmaking present a problem which the government must address.

- The effect on the industry of the proposed Capital Cost Recovery Act or other liberalization of tax depreciation.

- Future U.S. and world steel demand and supply and their implications on the future adequacy of steel supply in the U.S.

- The future competitive position of the U.S. in steelmaking given U.S. labor and environmental costs.

- The effect of possible technology advances on estimated capital requirements.

ATTACHMENT A

CASH FLOW FOR MODERNIZING PLANT: CURRENT TAX LAW
(Constant 1978 $, Assuming No Inflation)

	1st Yr Out	1st Yr In	2nd Yr Out	2nd Yr In	3rd Yr Out	3rd Yr In	4th Yr Out	4th Yr In	5th Yr Out	5th Yr In	6th Yr Out	6th Yr In	7th—12th Yr Out	7th—12th Yr In	13th Yr Out	13th Yr In	14th Yr Out	14th Yr In	15th Yr Out	15th Yr In	16th Yr Out	16th Yr In	27th Yr Out	27th Yr In	Total
Investment	200		260		300		200																		
Operating Cost Savings (Before tax)						40		80		121		121		121		121		121		121		121		121	2903
Revenue—Operating Cost* (before tax)						80		120		161		161		161		161		161		161		161		161	3903
Deprec. (12-yr write-off but used when possible)								0		147		148		94		64		42		5		-		-	960
Taxable Income						80		120		14		13		67		97		119		156		161		161	2943
Tax Due (45%)						36		54		6		6		30		44		54		70		72		72	1314
ITC (10% but used as soon as possible)						36		54		6		-		-		-		-		-		-		-	96
Cash Recovery - After tax						80		120		161		155		131		117		107		91		89		89	2685
Net Cash Flow	-200		-260		-300	80	-200	120		161		155		131		117		107		91		89		89	1725
Internal Rate of Return (after tax)																									12.4%

*Revenue—Cost includes 1978 industry margins of $40 per ton ($435 revenue — $395 costs) and the operating cost savings.

ATTACHMENT B

INCREMENTAL CASH FLOW FOR MODERNIZATION: CURRENT TAX LAW
(Constant 1978 $, Assuming No Inflation)

	1st Yr		2nd Yr		3rd Yr		4th Yr		5th Yr		6th Yr		7th—9th Yr		10th—12th Yr		13th Yr		14th Yr		15th—27th Yr		Total
	Out	In	Out	In	Out	In	Out	In	Out	In	Out	In	Out	In	Out	In	Out	In	Out	In	Out	In	
Investment	75		125		125		75																400
Incremental Cost Savings (Before tax)						32		64		97		97		97		97		97		97		97	2327
Deprec. (12-yr write-off but used when possible								6		97		97		39		22		11		7		-	400
Taxable Income						32		58		-		-		58		75		86		90		97	1927
Tax Due (45%)						14		26		-		-		26		34		39		41		44	1872
ITC (10% but used as soon as possible)						14		26		-		-		-		-		-		-		-	40
Cash Recovery-After tax						32		64		97		97		71		63		58		56		53	1495
Net Cash Flow	-75		-125		-125	32	-75	64		97		97		71		63		58		56		53	1095
Internal Rate of Return (after tax)																							17.1%

*It is assumed that $560/ton shipment (this excludes any retrofit environmental or non-steel expenditures) must be spent to maintain existing plants and existing revenue-operating cost gaps. Therefore, of the total $960/ton shipments required to revitalize the American steel plants, $400/ton shipments is the incremental investment needed to make possible the operating cost improvements noted.

Attachment C

Sources and Uses for Ste-- Segment, 1979 to 1988:
Assuming No Environmental Requirements Beyond Those Currently Mandated

	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	Average
Shipments (90%)	101	102	103	104	105	106	107	108	109	110	
Uses											
Capital Expenditures	4678	4717	4755	4794	4832	4870	4209	4247	4286	4324	
Change in Working Cap.	100	100	100	100	100	100	100	100	100	100	
Dividends	357	357	357	357	357	357	357	500	725	1015	
Total	5135	5174	5212	5251	5289	5327	4666	4847	5111	5439	5145
Sources											
Profit After Taxes	1021	862	978	1175	1418	1643	1945	2265	2570	2875	
Non-cash Expenses	1654	1673	1876	2221	2543	2904	3375	3075	2830	2880	
Net New Debt	383	308	365	462	583	650	242	319	388	352	
Use of Env. Borrowing	-	100	100	100	-	-	-	-	-	-	
Asset Sales	81	81	81	81	81	81	81	81	81	81	
Addition to Stock	67	67	67	67	67	67					
Off Balance Sheet	100	100	100	100	100	-	-	-	-	-	
Subtotal	3306	3191	3567	4206	4792	5345	5643	5740	5869	6188	4785
Non-steel Sources											
Treasury	387	398	407	413	426	-	-	-	-	-	203
Industry	194	199	204	207	213	-	-	-	-	-	102
Total Sources (unfunded)											
Treasury	3693	3589	3974	4619	5218	5345	5643	5740	5869	6188	4988
Industry	3500	3390	3771	4413	5005	5345	5643	5740	5869	6188	4887
Shortfall (unfunded)											
Treasury	(1442)	(1585)	(1238)	(632)	(71)	18	977	913	758	749	(157)
Industry	(1635)	(1784)	(1441)	(838)	(204)	18	977	913	758	749	(258)

Attachment D

Sources and Uses for Steel Segment Only:
Below 90% Utilization 1979 and 1980, 90% Utilization Thereafter
($ millions, 1978 $)

	1979	1980	1981	1982	1983	Average
Shipments	100	85	103	104	105	
Uses						
Capital Expenditures	4678	4717	4755	4794	4832	
Change in Working Capital	100	100	100	100	100	
Dividends	357	357	357	357	357	
Total	5135	5174	5212	5251	5289	5212
Sources						
Profit After Taxes	981	185	994	1190	1433	
Non-cash Expenses	1615	1022	1891	2236	2557	
Net New Debt	364	-28	373	470	591	
Use of Env. Borrowing		100	100	100		
Asset Sales	81	81	81	81	81	
Addition to Stock	67	67	67	67	67	
Off Balance Sheet	100	100	100	100	100	
Subtotal	3208	1577	3606	4244	4829	3493
Surplus from non-steel						
Treasury	387	398	407	413	426	
Industry	194	199	204	207	213	
Total Sources (Unfunded)						
With $400 non-steel	3595	1975	4013	4657	5255	3899
With $200 non-steel	3402	1776	3810	4451	5042	3696
Shortfall (unfunded)						
With $400 non-steel	(1540)	(3199)	(1199)	(594)	(34)	(1313)
With $200 non-steel	(1733)	(3398)	(1402)	(800)	(247)	(1516)

Updated Capital Sources and Uses: The Third Report to the Working Group on Modernization and Capital Formation

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July, 1980

On June 18, 1980, the Tripartite Committee Working Group on Modernization and Capital Formation outlined directions in which staff work should proceed. In the two prior staff reports, the staff used the 90 percent capacity utilization figure and 1978 dollars identified in the Orange Book. The staff was instructed to update the capital availability and capital requirement estimates agreed upon on June 18 to 1980 dollars using "realistic" levels of projected shipments.

In its June 18 report on capital availability, the staff emphasized capital uses and sources in terms of the shipments levels which would exist assuming 90 percent capability utilization every year, and identified a shortfall of $1.0-$1.2 billion annually (uses: $5.2 billion; sources: $4.0 to $4.2 billion) for 1979-1983. The staff did, however, make an initial attempt to look at capital uses and sources taking into account current depressed market conditions by using more "realistic" levels of projected shipments. On this latter basis, the staff identified a shortfall of between $1.3 and $1.5 billion annually (uses: $5.2 billion; sources: $3.7 to $3.9 billion), for 1979-1983.

The simplest way to update the capital uses, sources and shortfall to 1980 dollars, would be to adjust the sources and uses for inflation. Using 8.5 percent inflation 1978-1979 and 9 percent inflation 1979-1980 (1980 data preliminary) [1] the capital uses would then be $6.1 billion per year while capital sources, recognizing current depressed market conditions, would then be between

1 G.N.P. Implicit Price Deflator, Nonresidential Investment

$4.1 and $4.4 billion (part of the capital sources -- depreciation of existing assets -- was not inflated), leaving an annual shortfall for the five-year period of between $1.7 and $2.0 billion.

The above approach to updating has the advantage of simplicity, but left the staff in the uncomfortable position of predicting the past. For this reason, the staff, based on the Group's instructions, decided to move the whole capital uses and sources analysis forward one year, using 1979 (rather than 1978) data as the base, and taking into account a more "realistic" assessment of shipments. The basic methodology is unchanged from that outlined in the June 18 capital availability paper. There are some minor changes in sources components -- largely because inflation impacts different sources unevenly. The analysis recognized that 1980 and 1981 shipments would be depressed but that within the five-year period, 1980-1984, market conditions could improve -- the year in which this would be most evident is uncertain, but 1983 was chosen to represent the likelihood of a good market year. The new estimates are based on 1979 financial data and all sources and uses were estimated in 1979 dollars -- see Attachment A. Aggregate sources and uses were then inflated to 1980 dollars (assuming 9 percent inflation for all categories subject to change with inflation) as illustrated in Attachment C.

The results of the above analysis are basically the same as were derived using the simple updating procedure, but cover the 1980-1984 period rather than 1979-1984 period. Based on projected shipments for 1980-1984, average projected annual capital uses for the five-year period are anticipated to be $6.1 billion while average annual capital sources range from $4.1 to $4.3 billion, leaving an average annual shortfall of between $1.7 and $2.0 billion (1980 dollars).

To some extent the shortfall estimates reflect the current cyclical downturn in steel demand. For example, were shipments over the next five years assumed at 90 percent utilization every year, the shortfall would be between $1.4 and $1.7 billion per year in 1980 dollars (see Attachments B and C).

For the ten-year period 1980-1989, capital uses (1980 dollars) would average $6.1 billion per year (assuming no additional capital requirements or increases in operating costs for environmental or health standards beyond those currently mandated). With projected shipments 1980-1984 and assuming 90 percent utilization thereafter, sources would average between $5.4 and $5.6 billion per year over the ten-year period, leaving an annual shortfall of between $.5 and $.7 billion (in 1980 dollars).

Capital Uses

The capital use estimates are for steel operations only. These estimates include meeting existing environmental and OSHA mandates, as well as requirements for modernizing 1979 raw steel capacity of 155.3 million tons at 4 percent per year and paying dividends. The modernization cost was estimated at $1,130.00 per ton of shipments (in 1980 dollars) by inflating the $960 per ton (1978) dollars) replacement cost estimate used in earlier reports to the Group. The capital uses exclude any expenditures for capacity expansion.

Annual, 1980-1984, capital uses are as follows:

Year	$ Millions (1980)
1980	$6,000
1981	6,045
1982	6,090
1983	6,135
1984	6,180
Average	$6,090

These 1980 results were calculated from Attachment A data (1979 dollars) assuming a 9 percent inflation factor.

Capital Sources

Capital sources estimates include cash flow from steel operations, with some transfer of funds from nonsteel as in the June 18 availability report to the Group. Detailed estimates were made using a 1979 data base (see Attachments A and B).

Based on projected 1980 shipments (85 million net tons respectively), and an average 90 percent utilization thereafter, annual capital sources are summarized as follows:

Year	$ Millions (1980 $)
1980	$2,373 - 2,617
1981	3,077 - 3,334
1982	4,175 - 4,427
1983	5,535 - 5,785
1984	5,490 - 5,745
Average	$4,130 - 4,382

The above 1980 dollars results were calculated from Attachment A data (1979 dollars), assuming a 9 percent inflation factor. The range reflects opinion difference on surplus funds available from nonsteel activities.

Shortfall

The resultant annual shortfall range is as follows:

Year	$ Millions (1980)
1980	$3,383 - 3,627
1981	2,711 - 2,968
1982	1,663 - 1,915
1983	350 - 600
1984	435 - 690
Average	$1,708 - 1,960

Attachment A

Sources and Uses for Steel Segment: Projected Shipments

(Millions of 1979 $)

	Yearly					5-Year
	1980	1981	1982	1983	1984	Average
Shipments	85	95	103	111	105	
Uses						
Capital Expenditures	5002	5043	5084	5126	5168	
Change in Working Capital	100	100	100	100	100	
Dividends	409	409	409	409	409	
Total	5511	5552	5594	5635	5677	5594
Sources						
Profit After Taxes	408	585	938	1459	1386	
Non-cash Expenses	1178	1541	2053	2650	2737	
Net New Debt	54	147	323	540	500	
Use of Env. Borrowing	100	100	100			
Asset Sales	81	81	81	81	81	
Addition to Stock	67	67	67	67	67	
[illegible] Balance Sheet	140	140	140	140	140	
Subtotal	2028	2661	3702	4937	4911	
Surplus from non-steel						
Treasury	464	484	474	477	461	
Industry	232	242	237	239	231	
Total						
With $470 Non-steel	2492	3145	4176	5414	5372	4120
With $235 Non-steel	2260	2903	3939	5176	5142	3884
Shortfall						
With $470 Non-steel	(3019)	(2407)	(1418)	(221)	(305)	(1474)
With $235 Non-steel	(3251)	(2649)	(1655)	(459)	(535)	(1710)

Attachment B

Sources and Uses for Steel Segment: 90% Utilization

(Millions of 1979 $)

	Yearly 1980	1981	1982	1983	1984	5-Yr. Average
Shipments	101	102	103	104	105	
Uses						
Capital Expenditures	5002	5043	5085	5126	5168	
Change in Working Capital	100	100	100	100	100	
Dividends	409	409	409	409	409	
Total	5511	5551	5594	5635	5677	5594
Sources						
Profits After Taxes	1047	850	918	1158	1370	
Non-cash Expenses	1791	1796	2034	2362	2722	
Net New Debt	373	279	313	426	495	
Use of Env. Borrowing	100	100	100			
Asset Sales	81	81	81	81	81	
Addition to STock	67	67	67	67	67	
Off Balance Sheet	140	140	140	140	140	
Subtotal	3599	3313	3653	4234	4875	
Surplus from non-steel						
Treasury	464	484	474	477	461	
Industry	232	242	237	234	231	
Total						
With $470 Non-steel	4063	3797	4127	4711	5336	4407
With $235 Non-steel	3831	3555	3890	4468	5106	4170
Shortfall						
With $470 Non-steel	(1448)	(1755)	(1467)	(924)	(341)	(1187)
With $235 Non-steel	(1680)	(1997)	(1230)	(1167)	(571)	(1424)

Attachment C

"Shortfall" in Millions of 1980 Dollars

A. Based on Projected Shipments

Year	Projected Shipments	Uses	Sources	Shortfall
1980	85	6000	2373-2617	3383-3627
1981	95	6045	3077-3334	2711-2968
1982	103	6090	4175-4427	1663-1915
1983	111	6135	5535-5785	350- 600
1984	105	6180	5490-5745	435- 690
Average		6090	4130-4382	1708-1960

B. Based on 90 Percent Utilization Every Year

Year	Projected Shipments	Uses	Sources	Shortfall
1980	101	6000	4023-4266	1734-1977
1981	102	6045	3768-4025	2020-2277
1982	103	6090	4123-4375	1715-1967
1983	104	6135	4781-5041	1094-1354
1984	105	6180	5463-5710	470- 717
Average		6090	4432-4683	1407-1658

Impact of Changes in Tax Law and Increases in Real Revenue on Steel Industry Cash Flow: The Fourth Report to the Working Group on Modernization and Capital Formation

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July, 1980

The earlier reports to the Working Group on Modernization and Capital Formation identified a five-year shortfall of between $1.7 and $2.0 billion (1980 dollars) per year. These results are premised on a projection of 85 million tons of shipments (76 percent utilization) in 1980 and shipment levels which average 90 percent of capacity utilization 1981-1984. This brief paper analyzes the impact on the shortfall of policy alternatives selected to represent a wide range of possibilities (other possibilities are being considered by other working groups). The setting forth of these alternatives does not represent the policy positions of any of the parties in the working group.

The Analytical Method

The impact of the various alternatives selected, on the steel segment, is illustrated in Table 1. This table shows uses of funds (for modernization, environmental, working capital and dividends), sources of funds (internal to steel segment, borrowing and nonsteel), the shortfall, and changes in the shortfall from the base case -- current tax law (A-1). Also shown in Table 1 (as capital recovery/ capital expenditures) is the percentage of capital expended covered (i.e., funded) by capital recovered (depreciation, deferred taxes) in each period. In all cases the uses exclude any funds for expansion or for any changes in environmental standards above those stated in the current law, and assumes dividends of $450 million per year, 1980-1984, and 35 percent of profits thereafter. Annual average data for three five-year periods have been used to demonstrate the impact of the policy alternatives.

A. Impact of Changes in Depreciation Schedules

The base case (A-1) demonstrates that given projected shipments, an annual cash flow shortfall exists 1980 and 1984 but that a small cash flow surplus exists 1985 to 1989 and a larger cash flow surplus 1990 to 1994. The first group of policy alternataives (A) illustrates the impact of changes in depreciation rates (depreciable lives) for the steel segment. For example, the proposed 10-5-3 (A-2) is contrasted to the current tax law and, as shown, results in significant improvements in capital recovery after 1985. However, industry profit rates are currently low, and will not improve under the modernization program for at least the first five years. Hence, 10-5-3 will not reduce the first five-year shortfall but does significantly improve cash flow after the first five years.

Steel industry assets are 85 to 90 percent equipment and 10 to 15 percent buildings. The changes to a three-year life for some assets and the ten-year life for buildings has little impact on cash flow. For this reason, 35-year building lives were assumed in combination with alternative equipment lives (A-3 to A-5). A nine-year life for equipment (A-3) versus the current 12 (A-1) improves cash flow slightly after 1984. A seven-year life for equipment (A-4) has still greater impact on past-1984 cash flow, and a five-year life (A-5) generates significantly more cash flow after 1984 and gives results not unlike that with 10-5-3. Faster capital recovery for equipment significantly improves steel segment cash flow and industry capital recovery ratios after the first five years of the modernization program.

Inadequate profitability during the first five years of the modernization program precludes the steel segment of the industry from utilizing improved capital recovery allowances during this period. Faster capital recovery allowances improve cash flow after the first five years and also improves longer-term rates of return.

None of the faster capital recovery alternatives reduce the shortfall in the initial five-year period. However, the faster capital recovery does improve return on investment for new facilities. This is demonstrated in Attachments A and B. Where the current tax law gives a 12.65 percent rate of return over a 25-year period, 10-5-3 would result in a 14.58 percent rate of return for the same facilities over the same period. Attachments A and B were calculated in 1979 dollars (not 1980 dollars) but this should not affect the rates of return derived.

Faster capital recovery for all industries would result in additional steel shipments, especially since steel consumers are largely capital intensive. These increased shipments would have an immediate and favorable impact on the industry's steel segment profits. No attempt was made in this paper to quantify these effects.

However, the question remains -- what policy alternatives will offset the initial five-year shortfall?

B. Elimination of Minimum Taxes

One alternative in the above regard is elimination of the minimum tax (B). This generates an additional $50 million per year and while not significant, has a positive effect on cash flow.

C. Impact of Changes in the ITC

Other policy alternatives considered were changes in the Investment Tax Credit (C). The alternatives illustrated are 20 percent ITC on all new investment (C-1), and a 10 percent ITC on nonenvironmental investment combined with a 25 percent ITC on environmental capital expenditures (C-2). There are many other investment tax credit alternatives that could have been considered. The range of alternatives varies depending upon: the rate selected (e.g., 10 to 50 percent ITC); whether or not rates differ between types of investment; whether or not the ITC is only on new investment or is retroactive; the length of carryforward and carryback, etc.

For purposes of estimating the impact of the two ITC alternatives selected, it was assumed that unlimited ITC carryforward was possible. If the current five-year ITC carryforward had been assumed, the cash flow increases from improved ITC rates would have been very much smaller than those indicated for C-1 and C-2, since most of the ITC would have been lost. Current limits not only on ITC carryforwards, but on loss carryforwards, could substantially reduce cash flow in an industry undergoing a long and costly modernization in which increased profits result only after a long period of time.

The two alternatives illustrated improve cash flow 1985-1989 -- indeed the 20 percent ITC alternative is similar to 10-5-3 in the 1985 to 1989 period. The 20 percent ITC alternative (C-1) has a greater impact on cash flow than the combined 10 percent ITC and

25 percent environmental ITC alternative (C-2). [1] Both alternatives have less impact on cash flow after 1990 than in the 1985 to 1989 period. Neither C-1 nor C-2 reduces the 1980-1984 shortfall. Because of low profitability 1980-1984, changes in the investment tax credit will not reduce the shortfall.

D. Impact of Refundability Options

The above demonstrates that tax polices can be of little benefit in the short run unless some form of refundability is considered. Refundability in this context refers to a payment by the Government to a company equivalent to its unused investment tax credit. D-1 and D-2 illustrate two short-term refundability alternatives. Refundability is most advantageous for an industry which is not paying any taxes. During the initial years of the modernization program (e.g., five to eight years), the steel segment will be paying minimum taxes only. Ten percent refundability for five years was assumed. This would substantially increase cash flow for the industry 1980-1984. Refundability would generate an average of approximately $670 million per year over the five-year period ($550 million per year from new investments and, in addition, approximately $120 million per year for five years from outstanding unused credits as of the beginning of 1980). Ten percent ITC, with refundability for five years, combined with current tax law would decrease the shortfall only in 1980-1984 (by approximately

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1 In calculating the 25 percent ITC environmental alternatives, capital expenditures of $870 million per year for environmental retrofit (1980-1984) were used plus an estimated additional $500 million per year of environmental costs included in the modernization expenditures.

1/3, see D-1). The 10 percent five-year refundable ITC combined with 10-5-3 improves cash flow in all three periods and significantly reduces the capital shortfall 1980-1984.

E. Impact of Real Revenue Changes

The staff also analyzed the effect of real revenue increases. [1] Two alternatives were considered: real revenue increases to balance increased environmental operating costs (B-1); and $16.50 per ton real revenue increase for the first five years only (E-2). Alternative E-1 shows the impact on the shortfall and cash flow of the environmental cost offset. As illustrated, with both current tax law and 10-5-3, net cash improves and the 1980-84 shortfall is reduced. 10-5-3 provides much faster capital recovery after 1984.

A $16.50 per ton real revenue increase for five years only with current tax law (E-3) largely offsets the 1980-1984 shortfall, by making it possible to utilize available capital recovery provisions earlier. This is demonstrated by the improvements in the capital recovery/capital expenditure ratio from 36 percent (A-1) to 44.5 percent (E-3) 1980-1984, with a $16.50 revenue increase. The $16.50 real revenue increase for five years combined with 10-5-3 (E-4) eliminates the 1980-1984 shortfall, while also significantly improving capital recovery after 1984. The elimination of the shortfall in part reflects the ability, with increased real revenue, to utilize 10-5-3 earlier -- the capital recovery/capital expenditure ratio improved from 36 percent (A-2) to 49.5 percent (E-4) 1980-1984.

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1 Increases in real revenue refer, in this paper, to increases in the pre-tax margin between revenues and costs.

Conclusions

Alternative E-4 ($16.80 per ton real revenue increase combined with 10-5-3) is the only alternative which eliminates the 1980-1984 shortfall and also provides long-term improved cash flow for steel. Alternative D-2 (10 percent ITC refundability combined with 10-5-3) reduces the 1980-1984 shortfall by about 1/3 (to $1.0 to $1.3 billion) while also improving longer term cash flow for steel.

It should be noted that while the conclusions herein are generally consistent with those in other studies by the Treasury Department, the numbers identified herein may differ from those generated by the Department. This is because this analysis was based on the constructs in the earlier staff reports and on public accounting data collected by AISI, rather than on the actual tax position of individual firms within the industry.

TABLE 1

Impact of Policy Alternatives on Cash Flow
In the American Steel Industry
Five-Year Comparisons of Annual Averages

(Billions of 1980 $)

	Uses (a)	Sources	Shortfall	Changes In Shortfall from Current Law (b)	Capital Recovered/ Capital Expended (c)
A. Impact of Changes in Depreciation Schedules Only: Based on 1979 profitability					
1. Current Tax Law (35-12)					
1980-84	6.1	4.1 to 4.4	-2.0 to -1.7		36.0%
1985-89	6.0	6.7	+.7		70.5%
1990-94	6.7	8.4	+1.7		64.0%
2. 10-5-3					
1980-84	6.1	4.1 to 4.4	-2.0 to -1.7		36.0%
1985-89	6.0	7.5	+1.5	+ .8	86.0%
1990-94	6.7	9.1	+2.4	+ .7	77.0%
3. 35-9					
1980-84	6.1	4.1 to 4.4	-2.0 to -1.7		36.0%
1985-89	6.0	7.0	+1.0	+ .3	78.0%
1990-94	6.7	8.5	+1.8	+ .1	66.0%
4. 35-7					
1980-84	6.1	4.1 to 4.4	-2.0 to -1.7		36.0%
1985-89	6.0	7.3	+1.3	+ .6	83.0%
1990-94	6.7	8.6	+1.9	+ .2	68.0%
5. 35-5					
1980-84	6.1	4.1 to 4.4	-2.0 to -1.7		36.0%
1985-89	6.0	7.5	+1.5	+ .8	86.0%
1990-94	6.7	8.9	+2.2	+ .5	74.0%

	Uses (a)	Sources	Shortfall	Changes In Shortfall from Current Law (b)	Capital Recovered/ Capital Expended (c)
B. Elimination of Minimum Tax in Current Tax Law					
1980-84	6.1	4.15 to 4.45	-1.95 to -1.65	+ .05	36.0%
1985-89	6.0	6.72	+ .72	+ .02	70.5%
1990-94	6.7	8.4	+1.7		64.0%
C. Impact of Changes in the ITC					
1. 20% ITC (unlimited carry forward assumed)					
1980-84	6.1	4.1 to 4.4	-2.0 to -1.7		36.0%
1985-89	6.0	7.5	+1.5	+ .8	86.5%
1990-94	6.7	8.9	+2.2	+..5	73.0%
2. 10% and 25% (Environmental) ITC on New Investment (unlimited carry forward assumed)					
1980-84	6.1	4.1 to 4.4	-2.0 to -1.7		36.0%
1985-89	6.0	7.05	+1.05	+ .35	78.5%
1990-94	6.7	8.55	+1.85	+ .15	67.5%
D. Impact of Refundability Options					
1. 10% 5-yr. ITC Refundability (including outstanding unused) and Current Tax Law					
1980-84	6.1	4.77 to 5.07	-1.33 to -1.03	+ .67	49.5%
1985-89	6.0	6.35	+ .35	- .35	62.5%
1990-94	6.7	8.4	+1.7		64.0%
2. 10% 5-yr. ITC Refundability (including outstanding unused) and 10-5-3					
1980-84	6.1	4.77 to 5.07	-1.33 to -1.03	+ .67	49.5%
1985-89	6.0	8.4	+1.4	+ .7	84.5%
1990-94	6.7	8.8	+2.1	+ .4	72.6%

	Uses (a)	Sources	Shortfall	Changes In Shortfall from Current Law (b)	Capital Recovered/ Capital Expended (c)
E. Impact of Real Revenue Changes					
1. Environmental Operating Cost Offset and Current Tax Law					
1980-84	6.1	4.9 to 5.2	-1.2 to - .9	+ .8	42.0%
1985-89	6.0	7.1	+1.1	+ .4	66.5%
1990-94	6.7	8.9	+2.2	+ .5	64.0%
2. Environmental Operating Cost Offset and 10-5-3					
1980-84	6.1	4.9 to 5.2	-1.2 to - .9	+ .8	42.9%
1985-89	6.0	8.2	+2.2	+1.5	88.5%
1990-94	6.7	9.4	+2.7	+1.0	73.0%
3. $16.50/ton Real Revenue Increase for 5 yrs. Only and Current Tax Law					
1980-84	6.1	5.7 to 6.0	- .4 to - .1	+1.6	44.5%
1985-89	6.0	6.2	+ .2	- .5	64.0%
1990-94	6.7	8.2	+1.5	- .2	64.0%
4. $16.50/ton Real Revenue Increase for 5 yrs. Only and 10-5-3					
1980-84	6.1	5.9 to 6.2	- .2 to + .1	+1.8	49.5%
1985-89	6.0	7.1	+1.1	+ .4	82.0%
1990-94	6.7	8.7	+2.0	+ .3	73.0%

(a) Modernization and currently mandated environmental only (excludes expansion, solid waste requirements, etc.) plus dividends (at 35% of profits after 1984) and working capital of approximately $100 million per year.

(b) A "+" represents an increase in cash flow.

(c) Percentage of average annual capital expended covered (funded) by capital recovered (depreciation, deferred taxes) during the respective periods.

Definitions of Policy Alternatives in Table 1

A-1	Current Tax Law:	35 years for buildings, 12 years (with 20% ADR for steel equipment and 10% ITC.
A-2	10-5-3:	10-year life for buildings, 5-year life for most equipment, 3-year life for mobile equipment.
A-3	35-9:	Current life for buildings, 9-year life (e.g., 40% ADR) for equipment.
A-4	35-7:	Current life for buildings, 7-year life (e.g., 53% ADR) for equipment.
A-5	35-5:	Current life for building, 5-year life (e.g., 67% ADR) for equipment.
B	Minimum Tax:	Applicable when no or little tax is paid and employed as an offset against items of tax preference (depletion allowances).
C-1	20% ITC:	20 percent Investment Tax Credit with an assumed unlimited carryforward (rather than the current 5-year limitation).
C-2	10% and 25% ITC:	10 percent ITC on nonenvironmental expenditures, 25 percent on new environmental expenditures, with an assumed unlimited carryforward (rather than the current 5-year limitation).
D-1	10% 5-Year ITC Refundability and Current Tax Law:	10 percent iTC, with refundability terminating after 5 years, including refundability on outstanding ITC. Steel companies have $600 million in outstanding unused ITC which was used within 5 years (for an average of $120 million per year), $550 million is the refundable ITC on new capital expenditures.
D-2	10% 5-Year ITC Refundable and ITC:	10 percent ITC with refundability for 5 years combined with 10-5-3.
E-1	Environmental Operating Cost Offset and Current Tax Law:	Real revenue increases assumed to balance operating cost increases (for 15 years) resulting from environmental expenditures, combined with current tax law.

Definitions of Policy Alternatives in Table 1

E-2	Environmental Operating Cost Offset and 10-5-3:	Real revenue increase assumed to balance operating cost increases (for 15 years) resulting from environmental expenditures, combined with 10-5-3.
E-3	$16.50 per ton real revenue increases for 5 years only and current tax law:	Once and for all real revenue increase for 5 years followed by a reversal, combined with current tax law.
E-4	$16.50 per ton real revenue increase for 5 years and 10-5-3:	Once and for all real revenue increase for 5 years followed by a reversal, combined with 10-5-3.

Attachment A

Cash Flow for Modernizing Plant: Current Tax Law*
(Constant 1979 dollars per ton, Assuming No Inflation)

	Yr. 1	Yr. 2	Yr. 3	Yr. 4	Yr. 5	Yr. 6	Yr. 7	Yr. 8	Yr. 9	Yr. 10	Yr. 11	Yr. 12	Yr. 13	Yr. 14	Yr. 15	Yr. 16	Yr. 17	Yr. 18	Yr. 19	Yr. 20	Yr. 21	Yr. 22	Last Five Yrs.	Total
Investment	218	280	325	217																				1040
Total Benefits**			82	126	170	170	170	170	170	170	170	170	170	170	170	170	170	170	170	170	170	170	850	4110
Depreciation			87	159	138	125	112	98	85	72	59	46	33	20	6									1040
Taxable Income			(5)	(33)	32	45	58	72	85	98	111	124	137	150	164	170	170	170	170	170	170	170	850	3078
Tax (at 49%)			(2)	(16)	16	22	28	25	42	48	54	61	67	74	80	83	83	83	84	83	83	83	417	1508
Investment Tax Credit (10%)	22	28	32	22																				104
Net Cash Flow	(196)	(252)	(209)	(53)	154	148	142	135	128	122	116	109	103	96	90	87	87	87	86	87	87	87	433	1674
Internal Rate of Return (after tax)																								12.65%

* Negative taxes in this plant assumed offset against taxes due in other plants of the same enterprise. Data not updated to 1980 dollars -- this will not affect the rate of return.

** Cost reductions plus $40 per net ton industry margin.

Attac . D

Cash Flow For Modernizing Plant: 10-5-3*

(Constant 1979 dollars per ton, Assuming No Inflation)

	Yr. 1	Yr. 2	Yr. 3	Yr. 4	Yr. 5	Yr. 6	Yr. 7	Yr. 8	Yr. 9	Yr. 10	Yr. 11	Yr. 12	Yr. 13	Yr. 14	Yr. 15	Yr. 16	Yr. 17	Yr. 18	Yr. 19	Yr. 20	Yr. 21	Yr. 22	Last Five Yrs.	Total
Investment	218	280	325	217																				1040
Total Benefits**			82	126	170	170	170	170	170	170	170	170	170	170	170	170	170	170	170	170	170	170	850	4118
Depreciation (Five-Year)			208	333	250	166	83																	1040
Taxable Income			(126)	(207)	(80)	4	87	170	170	170	170	170	170	170	170	170	170	170	170	170	170	170	850	3078
Tax (at 49%)			(62)	(101)	(39)	2	43	83	83	83	84	83	83	83	84	83	83	83	84	83	83	83	417	1508
Investment Tax Credit	22	28	32	22																				104
Net Cash Flow	(196)	(252)	(149)	32	209	168	127	87	87	87	86	87	87	87	86	87	87	87	86	87	87	87	433	1674

Internal Rate of Return (after tax) 14.58%

* Negative taxes in this plant assumed offset against taxes due in other plants of the same enterprise. Data not updated to 1980 dollars -- this will not affect the rate of return.

**Cost reductions plus $40 per net ton industry margin.

TESTIMONY OF WILLIAM J. DE LANCEY, CHAIRMAN, AMERICAN IRON AND STEEL INSTITUTE

I am William De Lancey and am appearing before the Committee in my capacity as chairman of American Iron and Steel Institute, whose member companies accounted for 93 percent of U.S. raw steel production in 1979 and employed 453,000 people in various steel activities.

Currently, employment in the steel industry is at the lowest level in 47 years. We estimate that over 80,000 employees are laid off and an additional 30,000 are on reduced working schedules. The operating rate of the industry is approximately 55 percent.

Shipments of finished steel this year could be as low as 80 million tons as compared to 100.3 million tons in 1979. As a result, the cash flow urgently needed to maintain investment in our industry could decline $2 billion or more from the 1979 level. Although our business is projected to improve in 1981, the advance overall is expected to be modest. In short, we are looking at two very weak years in a row.

This outlook underscores the importance of acting promptly to approve the two tax measures which I am pleased to have this opportunity to recommend to the Committee today. I have filed a more detailed written statement with the Committee staff which I would like included in the official record of these hearings.

The first measure arises from the fact that the tax laws have played a significant role in constructing the funds needed for investment in new steel plants and facilities.

Over the past 10 years the steel industry's capital investment has averaged about $2.1 billion per year, far less than what was needed. In our view the rate of industry investment must be more than doubled in this decade in order to maximize productivity, provide job security and decrease energy usage. A study jointly prepared by the Treasury Department and the steel industry issued this month by the Steel Tripartite Committee confirms a shortfall in the industry's capital requirements of $1.7 to $2 billion annually over the next 5 years.

U.S. tax depreciation policy has over-emphasized the physical life of steel plant facilities and along with governmental policies in other areas has seriously impeded the industry's ability to take advantage of advancing technology. Depreciation regulations reflect the so-called "useful life" concept and ignore the devastating effect of inflation on an industry whose inherent capital intensity has been aggravated by heavy environmental requirements.

The steel industry is required to write off the original cost of its plants and equipment over a period which is far too long. Prior to 1979 the industry had to write off facilities for tax purposes over 15 years on average. This was reduced to 12 years in 1979 but, even so, steel was left with one of the longest capital recovery periods in American industry.

No other major industrialized nation has a longer capital recovery period; most countries permit a shorter cost recovery. We are very much aware of the contrasting effect of Canadian versus U.S. tax policy. In Canada full capital recovery is permitted in 2½ years, and was undoubtedly a significant factor in permitting the largest Canadian steel company to bring on stream this year an ultra-modern and highly efficient steel plant on the north shore of Lake Erie, while United States Steel Corporation cannot justify expenditures to undertake its highly publicized proposed plant on the south shore of Lake Erie, some 50 miles away.

Without substantial additional investment for modernization and replacement of existing facilities, steel capacity in this country will decline significantly. This was documented in the recent steel industry study entitled "Steel At The Crossroads." The shrinkage of the U.S. steel industry should be assessed in terms of its adverse effects in various areas:

On declining employment in steel and related industries,

On customers forced to become heavily dependent on foreign sources and the premium prices they would exact in tight markets,

On the economy of the nation as inflated by monstrous trade deficits in steel,

On local communities suffering plant shutdowns, and

On national defense.

The steel industry strongly supports S. 1435 (the Capital Cost Recovery Act), which would open a new era of governmental cooperation with industry with special recognition of the need to improve productivity. Indeed the very enactment of this legislation would be an encouraging signal which would be of great benefit to the steel industry at this time in lifting business confidence from its low recessionary level. Over time this legislation would of course help the steel industry generate the cash flow it needs for the facilities which ought to be installed to prevent the capacity decline to which I referred.

S. 1435 does not, however, provide near-term tax benefits for the steel industry and hence does not address the fact that the decline in cash flow during the recession threatens the cancellation or deferment of the installation of facilities needed by steel companies to advance productivity and to comply with environmental requirements. Accordingly, we recommend that Congress provide for the refundability of investment tax credits to help forestall such a setback.

Substantial investment in recent low steel profit years has resulted in the accumulation of unused tax credits estimated at about $600 million. Legislative action to authorize the accelerated use of unutilized investment tax credits through refundability would provide immediate cash to most steel companies.

Regrettably, the net effect of the investment tax credit in times like these is that it discriminates against capital-intensive industries with low earnings, such as steel. The credit should not be more beneficial to higher profit, less capital-intensive industries than to those industries which have made the capital expenditures but which are without current tax liability. In terms of the realization of benefits for the steel industry and all those dependent on it, refundability will be immeasurably more advantageous than if there must be a delay until the return of our industry to the requisite profitability.

Although the steel industry has been hit hard by the recession, at the core it is still strong and can and will build for the future if governmental policies will shift to take better advantage of the dynamics of the private enterprise system. The benefits of such a move would be those accruing from a vibrant and healthy steel industry and should be contrasted with the adverse consequences resulting from a shrinkage in steel capacity.

The tax measures we recommend would help significantly to achieve the desired objective. It is not inappropriate in these circumstances to talk in terms of a return on investment, and I would suggest that the return to the nation would overwhelmingly justify this tax investment. Our request is that the Committee approve these two measures to be effective in January 1981.

Written Statement Submitted by American Iron and Steel Institute

Mr. Chairman and members of the Committee on Finance, I am William De Lancey, chairman of Republic Steel Corporation. I am appearing before the Committee in my capacity as chairman of American Iron and Steel Institute. The 64 member companies of the Institute accounted for 93 percent of U.S. raw steel production in 1979 and employed 453,000 men and women in various steel activities.

In order to provide perspective for the views of the Institute, I should add these facts . . . currently employment in the nation's steel industry is at the lowest level since we began keeping detailed statistics on employment in 1933. We estimate that over 80,000 employees are laid off and an additional 30,000 are on reduced working schedules. The operating rate of the industry is approximately 55 percent of capacity.

Shipments of finished steel this year could be as low as 80 million tons as compared to 100.3 million tons in 1979. We estimate that for every million tons of shipments which are lost, we experience a decline of at least $100 million in industry cash flow. Accordingly, in 1980 the cash flow which we need so urgently to maintain investment in our industry could decline $2 billion or more from the 1979 level. Although we expect that our business will be improving in 1981, the advance overall is expected to be modest. In short, we are looking at two very weak years in a row.

This outlook underscores the importance of acting promptly to approve the two tax measures which I am pleased to have this opportunity to recommend to the Committee today.

The first measure arises from the fact that the tax laws have played a significant role in constricting the funds needed for investment in new steel plants and facilities.

Over the past 10 years, the domestic steel industry's investment for productive facilities has averaged about $2.2 billion per year. In the light of declining productivity and advancing technology, it is clear that level is inadequate. It is also clear to us that the rate of industry investment must be more than doubled in this decade in order to maximize productivity, provide job security and decrease energy usage.

A study jointly prepared by the Treasury Department and the steel industry, issued this month by the Steel Tripartite Committee, confirms and shortfall in the industry's capital requirements of $1.7 to $2 billion annually over the next 5 years. This study is included for the record of this hearing.

In our opinion U.S. tax policy relating to depreciation in steel has overemphasized the physical life of steel plant facilities and, along with governmental policies in other areas, has seriously impeded the industry's ability to take advantage of advancing technology. In order to achieve optimum productivity and competitiveness with the most efficient foreign producers, U.S. steel companies must replace some existing facilities before they are worn out (e.g., some primary mills should be replaced with slab casters even though the primary mills can still be used).

Steel mill facilities must be built to handle large tonnages of heavy materials and by necessity these facilities must be durable and long lasting. regrettably this characteristic has unduly distorted tax policy, and the steel industry has been heavily penalized as a result. Depreciation regulations reflect the so-called "useful life" concept and ignore the devastating effect of inflation on an industry whose inherent capital intensity has been aggravated by heavy environmental requirements.

Facilities in the industry prior to 1979 had to be written off over 15 years on average. In 1979 this was reduced to 12 years, but even so steel was left with one of the longest capital recovery periods in American industry. For example, 12 years for steel compares with 6.5 years for electronic equipment, 7.5 years for chemicals, 8 years for wood products and 9.5 years for fabricated metal products.

No other major industrialized nation has a longer capital recovery period; most other countries permit shorter cost recovery. In Canada, for example, full capital recovery is permitted in two-and-a-half years. It has been estimated that Canada's more rapid capital recovery would lead to a return on investment for a new steel plant at least one-third higher than for a similar steel plant built in the U.S.

We are very much aware of the contrasting effect between Canadian versus U.S. tax policy. This shorter capital recovery period was undoubtedly a significant factor in permitting the largest Canadian steel company to bring on stream an ultramodern and highly-efficient steel plant on the north shore of Lake Erie while United States Steel Corporation cannot justify expenditures to undertake its highly-publicized proposed plant on the south shore of Lake Erie, some 50 miles away.

The adverse consequences of the Federal tax depreciation policy are magnified and aggravaed by three other factors:

The very fact that steelplants must handle large quantities of heavy materials means that individual facilities must be well built and will of course be costly.

Environmental requirements tremendously increase the base cost of replacing vital facilities such as coke batteries.

Heavy inflation has factored up the current day cost of all these facilities to the point where the companies are no longer able to justify investments needed to maintain existing capacity.

Without substantial additional investment for modernization and replacement of existing facilities steel capacity in this country will decline significantly. This was documented in the recent steel industry study entitled "Steel At The Crossroads." This shrinkage of the U.S. steel industry should be assessed in terms of its adverse effects in various areas:

On declining employment in steel and related industries,

On customers forced to become heavily dependent on foreign sources and the premium prices they would exact in tight markets,

On the economy of the nation as inflated by monstrous trade deficits in steel,

On local communities suffering plant shutdowns and,

On national defense.

We believe this outlook mandates adoption now of governmental policies which will permit our industry to invest adequately to meet this nation's steel needs now and in the future. Enactment S. 1435 (the Capital Cost Recovery Act) is urgently needed. This measure would stimulate capital formation and investment, protect and create jobs for American men and women over wide areas of the country, improve productivity and thus lower costs which should help mitigate future increases in inflation.

Enactment of S. 1435 would signal the opening of a new era of governmental recognition of the importance of improving productivity. This act would be of great benefit to the steel industry for it would strengthen business confidence and business investment in these difficult times.

The steel industry strongly supports S. 1435 (the Capital Cost Recovery Act) which would open a new era of government cooperation with industry with special recognition of the need to improve productivity. Indeed, the very enactment of this legislation would be an encouraging signal which would be of great benefit to the steel industry at this time in lifting business confidence from its low recessionary level. Over time this legislation would, of course, help the steel industry generate the cash flow it needs for the facilities which ought to be installed to prevent the capacity decline to which I referred.

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S. 1435 does not, however, provide near-term tax benefits for the steel industry and hence does not address the fact that the decline in cash flow during the recession threatens the cancellation or deferment of the installation of facilities needed by steel companies to advance productivity and to comply with environmental requirements. Accordingly, we recommend that Congress provide for the refundability of investment tax credits to help forestall such a setback.

This severe recession constricts cash flow from steel operations and this tends to force the suspension of steps which should be taken to install facilities needed for the future viability of the industry. The recession highlights the debilitating process which has been going on for an extended period of time and forces us to also give special attention to short-term remedies to stop the current erosion of the steel industry. Accordingly, we urge this Committee to approve a provision authorizing refundability of the investment tax credit, as a companion proposal, supplementing the longer-term objectives of S. 1435. Legislative action to authorize the accelerated use of current as well as unutilized investment tax credit carryovers through refundability would provide immediate cash to most steel companies.

Because of low profits in recent years, large unused investment tax credits have been accumulated by many steel companies. The refundability of the unused credits would make cash available for investment in productive facilities during the interim period when the Capital Cost Recovery Act, if enacted, would have little direct benefit for the steel industry. A recent AISI study estimates that the steel industry has approximately $600 million of unused credits as of December 31, 1979.

Obviously, full refundability of investment tax credits involves certain costs. We believe, however, that these costs are far outweighed by the benefits which would accrue to the steel industry and the nation.

The ITC discriminates against capital intensive industries with low earnings such as steel. Investment tax credits are generated by expenditutes for capital goods. Similar expenditures by corporations without current tax liabilities equally create capital formation, as much as to those with higher incomes and tax liabilities. The credit should not be more beneficial to higher profit, less capital-intensive industries than to those industries that have the greatest need for the ITC. Providing investment tax credit refundability will permit the steel industry to obtain tax benefits from its capital expenditures in parity with those other corporations currently able to utilize the investment tax credit. The availability of immediate cash is critical to the American steel industry, and the refundability of investment tax credits would substantially benefit the steel industry now at a most crucial time.

Although the steel industry has been hit hard by the recession, at the core it is still strong and can and will build for the future if governmental policies will shift to take better advantage of the dynamics of the private enterprise system. The benefits of such a move would be those accruing from a vibrant and healthy steel industry and should be contrasted with the adverse consequences resulting from a shrinkage in steel capacity.

The tax measures we recommend would help significantly to achieve the desired objective. It is not inappropriate in these circumstances to talk in terms of a return on investment, and I would suggest that the return to the nation would overwhelmingly justify this tax investment. Our request is that the Committee approve these two measure to be effective in January 1981.

Mr. NELSON. We will start then with the next panel, consisting of Mr. Hugh Smith, American Express Co., on behalf of the Ad Hoc Service Group; Mr. James Dale Davidson, chairman of the National Taxpayers Union; Mr. William Shaker, executive vice president, National Tax Limitation Committee.

Senator BRADLEY. Do we have Mr. Hugh Smith, Mr. James Davidson, and William Shaker present?

VOICE FROM THE FLOOR. Mr. Shaker appears to be missing.

Senator BRADLEY. OK, Mr. Smith.

STATEMENT OF HUGH H. SMITH, WASHINGTON, D.C., REPRESENTATIVE, THE AMERICAN EXPRESS CO., ON BEHALF OF THE AD HOC SERVICE GROUP

Mr. SMITH. Thank you, Mr. Chairman. I am Hugh H. Smith, Washington representative of the American Express Co. I am appearing today, however, on behalf of the Ad Hoc Service Group. It is a diverse group of companies whose common denominator is that all are members of the service sector of the economy.

While the service sector has become the largest sector of the economy since the mid-1950's, we find that in many instances Government policy ignores its size and overall importance. One of the objectives of the group is to find ways to alleviate this both within and without Government.

Another objective is to assure that the debate on tax policy includes discussion of measures which take into account the relative importance of the service sector.

Thus, Mr. Chairman, we appreciate very much the opportunity to appear before you. You and the members of this committee know the nature and severity of the problems confronting our economy.

Productivity is declining, unemployment is rising, and we have both double-digit interest rates and inflation. In my remarks today I would like to focus on a policy proposal that we believe can contribute to the solution of these problems; that is, the Bradley-Gephardt proposal.

I want to make clear, however, that in discussing its merits we do not reject other meritorious types of remedial action. Our view is that no single action is going to solve all the prevailing economic maladies. We do believe that the Bradley-Gephardt social security tax cut plan possesses some very attractive features that make it especially well-suited for the problems of the day, but certainly other types of action may also be warranted.

I would like to begin by describing what the Bradley-Gephardt proposal is, and by so doing correct what I believe is a common misconception.

It would provide income tax credits with the amount of the tax reductions keyed to the size of worker or business contributions to social security. It does not call for reductions in contributions to the social security system. The social security system would itself be unaffected by enactment of the proposal.

The integrity of the social security system is, of course, very important. As the U.S. population grows relatively older, the number of people drawing social security benefits is increasing relative to the number making contributions. Social security funding is, therefore, becoming an increasingly difficult matter for policymakers and many people are already upset that amounts they contribute for social security are growing so rapidly.

There is widespread recognition that Congress is soon going to have to address this problem.

One benefit of the Bradley-Gephardt plan is that it would take some of the pressure off workers and businesses faced with rapidly rising payroll taxes. As you know, another increase in payroll taxes is scheduled for January 1, 1981.

For the 2 years Bradley-Gephardt would be in effect, increases in social security contributions would be offset somewhat by decreases in Federal income taxes. It would provide some immediate tax relief without threatening the integrity of the social security system. It would provide some breathing room so that Congress can focus on the longer term problems faced by the social security program and carefully consider structural changes that will be required.

We are in the midst of a severe recession, while inflation continues at unacceptably high rates. I believe the Bradley-Gephardt proposal provides a way to reduce unemployment and minimize the human and monetary costs of the recession, while simultaneously reducing the rate of inflation. Since this seems to be aruging that we can actually "have our cake and eat it," let me spell out the reasoning that leads to this conclusion: Like other types of tax cuts, the Bradley-Gephardt proposal will stimulate aggregate demand by increasing the after-tax income of individuals and businesses. As aggregate demand grows, more jobs will be created. The proposal is, however, superior to other types of tax cuts in this respect since it directly reduces the cost of employing workers.

Business treats social security taxes as a cost. In recent years social security taxes have been rising rapidly and, as I mentioned previously, a substantial new increase is slated for January 1, 1981. At that point social security taxes will be increased from 6.13 to 6.65 percent for both employers and employees and workers will be taxed on the first $29,700 of income instead of the present $25,900.

The Bradley-Gephardt proposal grants a 10 percent income tax credit against such payments so that a very significant labor cost will be reduced. The Bradley-Gephardt proposal will, therefore, stimulate job creation directly since it reduces the cost of employing workers. Businessmen will be immediately encouraged to utilize more labor resources because of reduced labor costs.

An income tax cut keyed to social security contributions will generate additional jobs not only by stimulating aggregate demand but also by reducing the cost of employment.

This is a key point, since it explains why this kind of tax cut can be expansionary without being inflationary. Unlike other tax cut proposals, the Bradley-Gephardt proposal would immediately reduce the cost of producing goods and services by an amount equal to the size of social security credits earned by American businesses.

The feature of the proposal that gives it an advantage over other tax cut proposals in terms of expanding employment opportunities is precisely what makes it noninflationary. It lowers the cost of producing goods and services by lowering the cost of employing labor. By lowering the cost of employing workers, Bradley-Gephardt encourages businesses to increase employment. In a period of inflation and recession this proposal strikes me as a very appropriate policy prescription.

Let me point out some additional advantages of the plan. Unlike some other proposals for tax relief, Bradley-Gephardt would offer benefits to businesses operating in all sectors of the economy. Our economy is increasingly oriented toward the production of services. Since the mid-1950's the service sector has been larger than the manufacturing sector and the gap between these two segments of our economy has been growing. The service sector currently employs about one-half of all American nonagricultural workers and is composed of many industries that are quite labor intensive.

While manufacturing has become increasingly automated and capital intensive, the service sector has played an important role in keeping American workers employed. Many jobs in the service sector require only minimal training and education. More advanced skills are acquired on the job. These service businesses have had an enviable record in terms of employing women, teenagers and members of minority groups.

A recent analysis of employment patterns within the service sector reveals that 12 percent of its employees are members of racial minorities. Forty-seven percent of the service sector's employees are women, and women's participation in service sector employment has been rapidly increasing. Because of the nature of the service sector, the Bradley-Gephardt proposal will have more impact on creating jobs in that area than in others.

Bradley-Gephardt will stimulate the service sector most because an increase in sector revenues of only $20,000 to $40,000 will create an additional job.

To create a job in manufacturing requires on average new revenues in excess of $100,000.

Enactment of the Bradley-Gephardt proposal will, therefore, create jobs for many and, significantly, for those who have the most tenuous grip on employment because they have to battle against discrimination in order to participate in America's work force.

The Bradley-Gephardt proposal is a progressive tax cut because its benefits represent a larger fraction of the incomes of the poor and middle class and a smaller fraction of the incomes of those with larger salaries. The social security tax rate is the same for all employees but it only applies to the first $25,900 of annual income.

Those fortunate enough to earn larger salaries have no further tax liability and pay a smaller payroll tax per dollar on income than those below the social security ceiling.

Senator BRADLEY. Excuse me. Although I would like to hear the rest of your testimony, from the standpoint of time I think we should move on. So, do you have any summarizing comments?

Mr. SMITH. In summary, my view is that the Bradley-Gephardt proposal represents a responsible approach for dealing with a number of serious problems that confront our economy at this time. By reducing the cost of labor to employers, it would have a significant favorable impact on the unemployment rate as well as the rate of inflation.

It is a progressive tax cut that offers benefits to workers and businesses in all sectors of the economy. It would help offset the large payroll tax increases scheduled for 1981, while maintaining the integrity of the social security system. It would give Congress additional time to focus on the longer term problems faced by the social security program.

It is, in short, a plan for tax relief that is especially well suited for the problems of today. Thus, Mr. Chairman, should the committee decide to recommend a tax cut, we strongly urge the inclusion of the Bradley-Gephardt proposal as part of that cut.

STATEMENT OF JAMES DALE DAVIDSON, CHAIRMAN, NATIONAL TAXPAYERS UNION

Mr. DAVIDSON. Thank you very much.

I appreciate the opportunity to discuss the advisability of a reduction of the increase in Federal taxes. I assume the remarks will be put in the record as is the usual case, so I don't have to speak like an auctioneer in a tobacco auction.

Senator BRADLEY. Well, if you do that, you can have that option.

Mr. DAVIDSON. I appear representing 450,000 family members of the National Taxpayers Union in all 50 States.

These citizens, like most Americans, are anxious to see America's economy strengthened. If higher taxes truly contributed to the goal of a stronger economy, I believe that most taxpayers would be willing to fork over ever-larger shares of their incomes for Government to spend.

However, higher taxes are not the basis of a higher standard of living; indeed, the deterioration of our competitive position in world markets, the decline of the dollar and inflationary recession at home are all in some measure consequences of rising taxes.

To put our economy on sound footing we must develop a long-term strategy to encourage the growth of productive capacity in America.

A key element of such strategy must be to make it rational once again for Americans to produce, save, and invest to the degree to which they are capable. That means reducing the harsh disincentives which now characterize our tax laws. It also means instituting stringent controls on Federal spending, through a constitutional amendment, which will help Congress resist pressures to maintain full employment by expanding Federal spending.

A constitutional amendment mandating a balanced budget also would relieve much of the pressure on the dollar in world money markets and thus reduce interest rates by establishing clearly that our future fiscal policy will be one of restraint.

In such a context, any revenue loss from slowing the rate of tax increases would be interpreted in light of a perception of a stronger American economy and a stronger dollar in the future.

The many foreign holders of dollar claims would then have a reason to invest those dollars in America rather than dumping them for gold or trading them for claims on assets in better managed economies.

To put our current tax picture in proper perspective, we must recognize that most of the proposals before Congress to cut taxes will not really cut taxes. They will, at most, reduce the increase in Federal taxes.

From fiscal year 1977 to fiscal year 1981 individual income and social security tax collections have increased in real terms by more than 25 percent.

Another feature of this picture which bears notice is the fact that Federal spending is claiming an increasing share of the gross national product. Just before the last recession, Federal spending amounted to 19.9 percent of the GNP. As we entered the current recession, Federal spending reached 23 percent of GNP.

The National Taxpayers Union feels that the most urgent tax reform is a reduction of the distortions of the tax system caused by inflation. As noted economist Michael J. Boskin has written, "The economic and political harm done by an unindexed tax system which continually accrues revenues which are in excess of real income growth cannot be overestimated."

These destructive effects of inflation can be alleviated in two ways short of basic reform of the system: One, either taxes should be indexed or a series of future tax reductions should be implemented now.

Yearly discretionary tax cuts will not suffice. This is because good economic decisions by individuals on their choice of jobs, savings and investment cannot be made without a full knowledge of future tax rates.

Fortunately, the Congress has begun to realize this. Well over half of the Congress has sponsored the 10-5-3 plan for liberalizing depreciation allowances. Clearly, depreciation reform is needed and the National Taxpayers Union fully supports such reform, with the reservations noted in my prepared text.

Although the consensus seems to be clear for reducing the distortions caused by inflation for business depreciation, there is an unexplained reluctance on the part of some for reducing the distortions caused by inflation in the personal income tax.

Clearly, the proposals for liberalization of the depreciation allowances are nothing more than indexing. Likewise, it is just as necessary to immediately index the personal income tax system.

The National Taxpayers Union strongly supports S. 12 and S. 211; both bills would adjust the personal income tax rates to inflation by indexing the bracket amounts and the personal exemptions to the Consumer Price Index.

We believe any tax bill passed by Congress this year should include a provision for indexing.

There is another——

Senator BRADLEY. Can you summarize at this point?

Mr. DAVIDSON. This will be like Mr. Fuller's one sentence biography in "Who's Who," if I do that.

Senator BRADLEY. Welcome to the Finance Committee.

Mr. DAVIDSON. I would like to say there are a number of other points that bear notice here. One, I think, is quite important, in addition to the fact that we make specific recommendations which are in the text of my remarks, and that is the fact that indexing will both reduce the incentives which Government has to cause inflation, which I think are considerable, and also that it reintroduces something which you should be appreciative of, given your stint at Oxford where the curriculum always considered such constitutional questions as accountability in Government, and that is, under the current system of tax increases, caused automatically by inflation, the entire political process is put in a different context than it ought to be.

Taxes are automatically raised each year with no legislative action or public debate. There is no congressional hearing; no recorded votes come on the issue either in the committee or on the floor. Those of us who believe that the budget should be balanced through higher taxes, if there are such, rather than tighter stewardship on spending, should be willing to vote openly for such tax increases, rather than allowing them to be made in effect in the board rooms of the Federal Reserve System down the street.

I believe that this is a matter which is not attributable to consideration and that if we have a concern for the constitutional varities which have been given to us, that we ought to be willing to say, yes, we will index the tax system, which does not reduce tax revenues whatever to the Federal Government, but merely eliminates the unscheduled increases which haven't been voted on, and then let those members who believe taxes should be increased come out of the closet, as it were, and vote openly for these propositions.

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

I think you have given us a lot of food for thought. I appreciate your testimony very much.

And let me also express to Mr. Smith how much I appreciate his testimony. I suppose that there have been few people who have appeared before the committee with whom I agree more fully.

I would like to thank both of you for your testimony. Your complete statements will appear in the record. I think that we are now at a circumstance where I have 4 minutes to get over and vote. I have less than that, so we will stand in recess until Senator Neson returns.

[The prepared statements of Messrs. Smith and Davidson follow:]

STATEMENT OF HUGH H. SMITH, AMERICAN EXPRESS CO.

SUMMARY

The Bradley-Gephardt proposal represents a responsible approach for dealing with a number of serious problems that confront our economy at this time. By reducing the cost of labor to employers, it would have a significant, favorable impact on the unemployment rate as well as the rate of inflation. It is a progressive tax cut that offers benefits to workers and businesses in all sectors of the economy. It would help offset the large payroll tax increases scheduled for 1981, while maintaining the integrity of the Social Security system. It would give Congress additional time to focus on the longer-term problems faced by the Social Security program. It is, in short, a plan for tax relief that is especially well-suited for the problems of today. Thus, should the Committee decide to recommend a tax cut, we strongly urge the inclusion of the Bradley-Gephardt proposal as part of that cut.

Thank you, Mr. Chairman. I am Hugh H. Smith, Washington Representative of the American Express Company. I am appearing today, however, on behalf of the Ad Hoc Service Group. It is a diverse group of companies whose common denominator is that all are members of the service sector of the economy.

While the service sector has become the largest sector of the economy since the mid-1950's we find that in many instances, government policy ignores its size and overall importance. One of the objectives of the group is to find ways to alleviate this both within and without government. Another objective is to assure that the debate on tax policy includes discussion of measures which take into account the relative importance of the service sector.

Thus, Mr. Chairman, we appreciate very much the opportunity to appear before you. You and the members of this Committee know the nature and severity of the problems confronting our economy. Productivity is declining, unemployment is rising and we have both double-digit interest rates and inflation. In my remarks today I would like to focus on a policy proposal that we believe can contribute to the solution of these problems—that is the Bradley-Gephardt proposal. I want to make clear, however, that in discussing its merits we do not reject other meritorious types of remedial action. Our view is that no single action is going to solve all the prevailing economic maladies. We do believe, however, that the Bradley-Gephardt Social Security tax cut plan possesses some very attractive features that make it especially well-suited for the problems of the day, but certainly other types of action may also be warranted.

I would like to begin by describing what the Bradley-Gephardt proposal is, and by so doing, correct what I believe is a common misconception. It would provide income tax credits with the amount of the tax reductions keyed to the size of worker or business contributions to Social Security. It does not call for reductions in contributions to the Social Security system. The Social Security system would itself be unaffected by enactment of the proposal.

The integrity of the Social Security system is, of course, very important. As the U.S. population grows relatively older, the number of people drawing Social Security benefits is increasing relative to the number making contributions. Social Security funding is, therefore, becoming an increasingly difficult matter for policy makers, and many people are already upset that amounts they contribute for Social Security are growing so rapidly. There is widespread recognition that Congress is soon going to have to address this problem. One benefit of the Bradley-Gephardt plan is that it would take some of the pressure off workers and businesses faced with rapidly rising payroll taxes. As you know, another increase in payroll taxes is scheduled for January 1, 1981.

For the two years Bradley-Gephardt would be in effect, increases in Social Security contributions would be offset somewhat by decreases in Federal income taxes. It would provide some immediate tax relief without threatening the integrity of the Social Security system. It would provide some breathing room so that Congress can focus on the longer-term problems faced by the Social Security program and carefully consider structural changes that will be required.

We are in the midst of a severe recession, while inflation continues at unacceptably high rates. I believe the Bradley-Gephardt proposal provides a way to reduce unemployment and minimize the human and monetary costs of the recession, while simultaneously reducing the rate of inflation. Since this seems to be arguing that we can actually "have our cake and eat it," let me spell out the reasoning that leads to this conclusion.

Like other types of tax cuts, the Bradley-Gephardt proposal will stimulate aggregate demand by increasing the after-tax income of individuals and businesses. As aggregate demand grows, more jobs will be created. The proposal is, however, superior to other types of tax cuts in this respect since it directly reduces the cost of employing workers. Business treats Social Security taxes as a cost. In recent years Social Security taxes have been rising rapidly and, as I mentioned previously, a substantial new increase is slated for January 1, 1981. At that point Social Security taxes will be increased from 6.13 to 6.65 percent for both employers and employees, and workers will be taxed on the first $29,700 of income instead of the present $25,900.

The Bradley-Gephardt proposal grants a 10 percent income tax credit against such payments so that a very significant labor cost will be reduced. The Badley-Gephardt proposal will, therefore, stimulate job creation directly since it reduces the cost of employing workers. Businessmen will be immediately encouraged to utilize more labor resources because of reduced labor costs. An income tax cut keyed to Social Security contributions will generate additional jobs not only by stimulating aggregate demand, but also by reducing the cost of employment.

This is a key point since it explains why this kind of tax cut can be expansionary without being inflationary. Unlike other tax cut proposals, the Bradley-Gephardt proposal would immediately reduce the cost of producing goods and services by an amount equal to the size of Social Security credits earned by American businesses. The feature of the proposal that gives it an advantage over other tax cut proposals in terms of expanding employment opportunities is precisely what makes it noninflationary. It lowers the cost of producing goods and services by lowering the cost of employing labor. By lowering the cost of employing workers, Bradley-Gephardt encourages businesses to increase employment. In a period of inflation and recession, this proposal strikes me as a very appropriate policy prescription.

Let me point out some additional advantages of the plan. Unlike some other proposals for tax relief, Bradley-Gephardt would offer benefits to businesses operating in all sectors of the economy. Our economy is increasingly oriented toward the production of services. Since the mid-1950's the service sector has been larger than the manufacturing sector, and the gap between these two segments of our economy has been growing. The service sector currently employs about one-half of all American non-agricultural workers and is composed of many industries that are quite labor intensive. While manufacturing has become increasingly automated and capital intensive, the service sector has played an important role in keeping American workers employed. Many jobs in the service sector require only minimal training and education. More advanced skills are acquired on the job.

These service businesses have had an enviable record in terms of employing women, teenagers and members of minority groups. A recent analysis of employment patterns within the service sector reveals that twelve percent of its employees are members of racial minorities. Forty-seven percent of the service sector's employees are women, and women's participation in service sector employment has been rapidly increasing.

Because of the nature of the service sector the Bradley-Gephardt proposal will have more impact on creating jobs in that area than in others. Bradley-Gephardt will stimulate the service sector most because an increase in sector revenues of only $20,000 to $40,000 will create an additional job. To create a job in manufacturing requires, on average, new revenues in excess of $100,000. Enactment of the Bradley-Gephardt proposal will, therefore, create jobs for many and, significantly, for those who have the most tenuous grip on employment because they have to battle against discrimination in order to participate in America's work force.

The Bradley-Gephardt proposal is a "progressive" tax cut because its benefits represent a larger fraction of the incomes of the poor and middle class and a smaller fraction of the incomes of those with larger salaries. The Social Security tax rate is the same for all employees, but it only applies to the first $25,900 of annual income. Those fortunate enough to earn larger salaries have no further tax liability and pay a smaller payroll tax per dollar on income than those below the Social Security ceiling. The Bradley-Gephardt proposal reduces the effective Social Security tax rate for lower income and middle class workers whose incomes do not exceed $25,900. Although higher paid employees also gain, their benefits are smaller per dollar of income because much of their income is not subject to payroll tax. At a time when the incomes of unskilled and semiskilled workers are ravaged by inflation and at a time when the jobs of those workers are threatened, a progressive tax cut represents wise and humane public policy.

Finally, I think it is important to note that while the Bradley-Gephardt proposal helps both business and labor, its benefits flow more to workers than their employers. Workers receive a dollar for dollar reduction in income taxes equal to 10 percent of their annual payroll taxes. Businesses also receive a 10 percent tax credit, but since their tax deductible expenses are also reduced, about 46 percent of the benefit is offset. This reflects the fact that taxable profits rise as tax expenses are reduced.

In summary, my view is that the Bradley-Gephardt proposal represents a responsible approach for dealing with a number of serious problems that confront our economy at this time. By reducing the cost of labor to employers, it would have a significant, favorable impact on the unemployment rate as well as the rate of inflation. It is a progressive tax cut that offers benefits to workers and businesses in all sectors of the economy. It would help offset the large payroll tax increases scheduled for 1981, while maintaining the integrity of the Social Security system. It would give Congress additional time to focus on the longer-term problems faced by the Social Security program. It is, in short, a plan for tax relief that is especially well-suited for the problems of today. Thus, Mr. Chairman, should the Committee decide to recommend a tax cut, we strongly urge the inclusion of the Bradley-Gephardt proposal as part of that cut.

Mr. Chairman, I would like to submit to the Committee as an appendix to my statement additional statistical materials from a variety of governmental sources. These materials show the growing importance of the service sector and suggest that job stimulation in service industries would represent a wise application of governmental policy.

TABLE I.—*Cost per additional job, service-producing industries versus goods-producing industries*

Service producing:	
Hotels and motels	$20,261
Personal services	22,333
Motion pictures	32,062
Automotive services	47,654
Telephone and telegraph services	51,654
Retail trade	54,204
TV and radio broadcasting	57,206
Average service and producing	40,768
Goods producing:	
Computing and calculating equipment	69,600
Building materials	72,600
General industrial equipment	74,300
Steel	95,000
Primary metals	105,600
Plastics materials and resins	196,900
Motor vehicles	239,000

Source: "1979 U.S. Industrial Outlook," Industry and Trade Administration, U.S. Department of Commerce.

TABLE II.

ANNUAL AVERAGE NUMBER OF EMPLOYEES IN SERVICE-PRODUCING INDUSTRIES vs. GOODS-PRODUCING INDUSTRIES: 1959, 1969, 1976-1979 IN PERCENTS

	SERVICE-PRODUCING							GOODS-PRODUCING 3/	TOTAL 4/
Year	Tourist Industry 1/	Transportation and Public Utilities	Finance, Insurance and Real Estate	Services	Retail Trade	Wholesale Trade	Total 2/		
1959	5.1	8.9	5.6	15.7	17.8	6.8	54.8	45.2	100.0
1969	6.0	7.6	6.0	19.2	18.6	6.7	58.1	41.9	100.0
1976	7.5	7.1	6.6	22.6	20.5	7.0	63.8	36.2	100.0
1977	7.5	7.0	6.6	22.7	20.5	7.0	63.8	36.2	100.0
1978	8.0	6.9	6.7	22.7	20.6	7.0	63.9	36.1	100.0
1979 (Jan-Aug)	8.0 5/	6.9	6.7	22.9	20.4	7.0	63.9	36.1	100.0

1/ Includes: Interhighway Transportation and Transporation by Air data which is included in Transportation and Public Utilities; Eating and Drinking Places data which is included in Retail Trade; and Hotels, Tourist Courts and Motels data which is included in Services.

2/ Excludes: Government.

3/ Includes: Mining, Construction and Manufacturing.

4/ Excludes: Agriculture, Forestry and Fisheries.

5/ Average of January - June.

Sources: Employment and Earnings, Bureau of Labor Statistics, U.S. Dept. of Labor: Table "B-1: Employees on Non-Agricultural Payrolls by Industry Division, 1919 to Date", 9/79, Vol. 26 #9; Table "B-2: Employees on Non-Agricultural Payrolls by Industry", 9/79, Vol. 26 #9; 8/79, Vol. 26 #8; 7/79, Vol. 26 #7; 6/79, Vol. 26 #6; 5/79, Vol. 26 #5; 4/79, Vol. 26 #4; 3/79, Vol. 26 #3.

TABLE III.

COMPENSATION OF EMPLOYEES AND
AVERAGE PER CAPITA COMPENSATION OF EMPLOYEES IN
SERVICE-PRODUCING INDUSTRIES vs. GOODS-PRODUCING INDUSTRIES:
1959, 1969, 1976-1978

	1959	1969	1976	1977	1978
SERVICE-PRODUCING					
HOTELS & OTHER LODGINGS 1/					
Compensation ($ Mil)	1,595	3,538	6,398	6,998	8,120
Avg. Per Capita ($)	3,253	5,251	7,407	8,097	8,888
TRANSPORTATION & PUBLIC UTILITIES					
Compensation ($ Mil)	24,161	42,280	81,434	91,384	103,672
Avg. Per Capita ($)	6,024	9,518	17,773	19,460	21,336
FINANCE, INSURANCE & REAL ESTATE					
Compensation ($ Mil)	12,905	27,985	55,072	61,813	70,866
Avg. Per Capita ($)	5,063	7,968	12,894	13,884	15,155
SERVICES					
Compensation ($ Mil)	27,983	67,145	147,988	167,435	191,759
Ave. Per Capita ($)	3,948	6,012	10,170	10,980	12,001
RETAIL TRADE					
Compensation ($ Mil)	28,161	55,562	102,282	113,131	127,434
Avg. Per Capita ($)	3,500	5,146	7,743	8,201	8,791
WHOLESALE TRADE					
Compensation ($ Mil)	17,017	33,603	68,132	75,720	86,050
Avg. Per Capita ($)	5,521	8,601	14,987	15,121	17,568
TOTAL 2/					
Compensation ($ Mil)	110,227	226,575	454,908	509,483	579,781
Avg. Per Capita ($)	4,449	6,698	11,052	11,879	12,910
GOODS-PRODUCING 3/					
Compensation ($ Mil)	116,402	219,222	355,752	401,427	456,512
Avg. Per Capita ($)	5,703	8,999	15,234	16,528	17,986
TOTAL 4/					
Compensation ($ Mil)	226,629	445,797	810,660	910,910	1,036,293
Avg. Per Capita ($)	5,016	7,661	12,566	13,560	14,743

FOOTNOTES TO TABLE III.

1/ Hotels and Other Lodgings data is included in Services.

2/ Excludes Government.

3/ Includes: Mining, Construction and Manufacturing.

4/ Excludes: Agriculture, Forestry and Fisheries.

Sources: Table "6.1: Compensation of Employees by Industry", The National Income and Product Accounts of the U.S., 1929-1974, Bureau of Economic Analysis, U.S. Dept. of Commerce. Table "6.5: Compensation of Employees by Industry", Survey of Current Business, 7/79, Vol. 59 #7, Bureau of Economic Analysis, U.S. Dept. of Commerce. Employment and Earnings, Bureau of Labor Statistics, Dept. of Labor. Table "B-1: Employees on Non-Agricultural Payrolls, by Industry Division, 1919 to Date", 9/79, Vol. 26 #9.

TABLE IV.

NUMBER OF BLACKS AND OTHERS AND THEIR PERCENT OF TOTAL EMPLOYED IN SERVICE-PRODUCING INDUSTRIES vs. GOODS-PRODUCING INDUSTRIES: 1977 - 1978

	1977	1978
SERVICE-PRODUCING		
TOURIST INDUSTRY 1/		
% of Total Employed	13.0	13.5
# Blacks and Others (000)	693	767
TRANSPORTATION & PUBLIC UTILITIES		
% of Total Employed	12.0	12.3
# Blacks and Others (000)	700	756
FINANCE, INSURANCE & REAL ESTATE		
% of Total Employed	8.0	9.0
# Blacks and Others (000)	403	487
SERVICES		
% of Total Employed	14.0	14.1
# Blacks and Others (000)	4288	4467
RETAIL TRADE		
% of Total Employed	7.7	8.4
# Blacks and Others (000)	1163	1313
WHOLESALE TRADE		
% of Total Employed	7.2	7.2
# Blacks and Others (000)	259	260
TOTAL 2/		
% of Total Employed	11.3	11.7
# Blacks and Others (000)	6813	7283
GOODS-PRODUCING 3/		
% of Total Employed	10.2	10.3
# Blacks and Others (000)	2737	2930
TOTAL 4/		
% of Total Employed	11.0	11.2
# Blacks and Others (000)	9550	10,213

1/ Includes: Interhighway Transportation and Transportation by Air data which is included in Transportation and Public Utilities; Eating and Drinking Places data which is included in Retail Trade; and Hotels, Tourist Courts and Motels data which is included in Services.

2/ Excludes: Government

3/ Includes: Mining, Construction and Manufacturing.

4/ Excludes: Agriculture, Forestry and Fisheries.

Source: Table "30: Employed Persons by Detailed Industry, Sex and Race," Employment and Earnings 1/78 & 1/79, Vols. 25 & 26 #1, Bureau of Labor Statistics, Department of Labor.

TABLE V.

ANNUAL AVERAGE NUMBER OF WOMEN EMPLOYEES IN
SERVICE-PRODUCING INDUSTRIES vs. GOODS-PRODUCING INDUSTRIES: 1969, 1976-1979
IN PERCENTS

	SERVICE-PRODUCING							GOODS PRODUCING 3/	TOTAL 4/
Year	Tourist Industry 1/	Transportation and Public Utilities	Finance, Insurance and Real Estate	Services	Retail Trade	Wholesale Trade	Total 2/		
1969	8.9	4.5	9.0	29.3	24.2	4.3	71.3	28.7	100.0
1976	10.5	4.0	9.6	32.9	25.6	4.2	76.3	23.7	100.0
1977	10.5	4.0	9.7	33.2	25.3	4.1	76.4	23.6	100.0
1978	10.8	4.0	9.7	33.2	25.1	4.4	76.4	23.6	100.0
1979 (Jan-June)	10.8	4.1	9.7	33.4	24.8	4.4	76.5	23.5	100.0

1/ Includes: Interhighway Transportation and Transportation by Air data which is included in Transportation and Public Utilities; Eating and Drinking Places data which is included in Retail Trade; and Hotels, Tourist Courts and Motels data which is included in Services.

2/ Excludes Government.

3/ Includes: Mining, Construction and Manufacturing

4/ Excludes: Agriculture, Forestry and Fisheries.

Sources: Employment and Earnings, Bureau of Labor Statistics, U.S. Dept. of Labor: Tables: "B-3: Women Employees on Non-Agricultural Payrolls, by Industry", 3/70, Vol. 16 #9; 3/78, Vol. 25 #3; 3/79, Vol. 26 #3, 6/79, Vol. 26 #6; 7/79, Vol. 26 #7; 8/79, Vol. 26 #8; 9/79, Vol. 26 #9; 3/77, Vol. 24 #3.

WOMEN IN SERVICE-PRODUCING INDUSTRIES and GOODS-PRODUCING INDUSTRIES AS A PERCENT OF TOTAL NUMBER OF EMPLOYEES IN SERVICE-PRODUCING INDUSTRIES and GOODS-PRODUCING INDUSTRIES: 1969, 1976-1979

	SERVICE-PRODUCING							GOODS-PRODUCING 3/	TOTAL 4/
Year	Tourist Industry 1/	Transportation and Public Utilities	Finance, Insurance and Real Estate	Services	Retail Trade	Wholesale Trade	Total 2/		
1969	52.0	20.6	52.2	53.5	45.8	22.2	43.0	24.0	35.0
1976	54.0	21.5	55.7	56.2	48.2	22.9	46.0	25.2	38.5
1977	54.2	22.1	56.7	56.7	47.8	23.0	46.4	25.3	38.8
1978	53.5	23.0	57.5	57.8	48.3	24.8	47.4	25.9	39.6
1979 (Jan-June)	54.1	23.9	58.1	58.3	48.7	25.2	47.9	26.1	40.0

1/ Includes: Interhighway Transportation and Transportation by Air data which is included in Transportation and Public Utilities; Eating and Drinking Places data which is included in Retail Trade; and Hotels, Tourist Courts and Motels data which is included in Services.

2/ Excludes: Government.

3/ Includes: Mining, Construction and Manufacturing.

4/ Excludes: Agriculture, Forestry and Fisheries.

Source: Employment and Earnings, Bureau of Labor Statistics, U.S. Dept. of Labor.

Table "B-1: Employees on Non-Agricultural Payrolls by Industry Division, 1919 to Date," 9/79, Vol. 26 #9.
Table "B-2: Employees on Non-Agricultural Payrolls by Industry," 9/79, Vol. 26 #9; 8/79, Vol. 26 #8; 7/79, Vol. 26 #7, 6/79, Vol. 26 #6; 5/79, Vol. 26 #5; 4/79, Vol. 26 #4; 3/79, Vol. 26 #3.
Table "B-3: Women Employees on Non-Agricultural Payrolls, by Industry," 3/70, Vol. 16 #9; 3/78, Vol. 25 #3; 3/79, Vol. 26 #3; 6/79, Vol. 26 #6; 7/79, Vol. 26 #7, 8/79, Vol. 26 #8; 9/79, Vol. 26 #9; 3/77, Vol. 24 #3.

Statement of James Dale Davidson, Chairman, National Taxpayers Union

SUMMARY

1. Urges a long term strategy to encourage economic growth. Such a strategy should include real tax cuts to reduce harsh tax disincentives to produce, save, and invest. Federal spending should also be controlled through enactment of a constitutional amendment.

2. Shows that tax cuts under consideration will probably only partially offset tax increases and that federal spending has continued to rise.

3. Urges immediate adoption of indexation of personal income tax rates. Also supports further reduction of capital gains tax, reform of business depreciation allowances, reduction of taxes on savings and repeal of the "marriage tax."

4. Concludes that if a constitutional amendment to balance the budget or limit spending was in effect, enactment of genuine tax cuts would not cause inflationary fears because federal spending would be controlled.

Mr. Chairman and distinguished Members of the Committee, thank you for the opportunity to discuss a reduction of the increase in federal taxes.

I appear representing 450,000 family members of the National Taxpayers Union in all 50 states.

These citizens, like most Americans, are anxious to see America's economy strengthened. If higher taxes truly contributed to the goal of a stronger economy, I believe that most taxpayers would be willing to fork over ever-larger shares of their incomes for government to spend. However, higher taxes are not the basis of a higher standard of living. Indeed, the deterioration of our competitive position in world markets, the decline of the dollar and inflationary recession at home are all, in some measure, consequences of rising taxes. To put our economy on sound footing, we must develop a long-term strategy to encourage the growth of productive capacity in America.

A key element of such strategy must be to make it rational once again for Americans to produce, save and invest to the degree to which they are capable. That means reducing the harsh disincentives which now characterize our tax laws. It also means instituting stringent controls on federal spending, through a constitutional amendment, which will help Congress resist pressures to maintain full employment by expanding federal spending. A constitutional amendment mandating a balanced budget also would relieve much of the pressure on the dollar in world money markets, and thus reduce interest rates, by establishing clearly that our future fiscal policy will be one of restraint. In such a context, any revenue loss from slowing the rate of tax increases would be interpreted in light of a perception of a stronger American economy and a stronger dollar in the future. The many foreign holders of dollar claims would then have a reason to invest those dollars in America rather than dumping them for gold or trading them for claims on assets in better managed economies.

To put our current tax picture in proper perspective, we must recognize that most of the proposals before Congress to "cut" taxes will not really cut taxes. They will, at most, reduce the increase in federal taxes. From fiscal year 1977 to fiscal year 1981 Individual Income and Social Security tax collections have increased, in real terms, by more than 25 percent. Expressed in another way, Individual Income and Social Security taxes have increased from 12.4 percent of gross personal income in 1975 to an estimated 15.2 percent in 1981.

Taxes are scheduled to increase by another $86 billion in fiscal year 1981, including $50 billion of new taxes. This is the largest peacetime tax increase in the nation's history. We doubt the wisdom of enacting such massive tax increases in the face of a recession.

New taxes scheduled for fiscal year 1981 in billions of dollars

Income tax increase (caused by inflation bumping people into higher tax brackets)	$15
Social security tax increases scheduled for 1981	11
Windfall profit tax	18
Miscellaneous tax increases	6
Total	50

Clearly, any tax cut for 1981 will only partially offset the tax increases due to occur in 1981 and the tax increases that have already occurred in the last 4 years.

Despite claims of fiscal austerity, federal spending is still outpacing the rate of inflation. Federal spending is also claiming an increasing share of the Gross National Product (GNP).

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Just before the last recession, federal spending amounted to 19.9 percent of GNP. As we entered the current recession federal spending amounted to approximately 23 percent of GNP.

FEDERAL SPENDING

	Fiscal year—			
	1978	1979	1980 (estimate)	1981 (estimate)
Outlays (billions)	$461.2	$506.1	$594.9	$655.5
Outlays, percentage increase	12.1	9.7	17.5	10.2
CPI percentage increase	9.0	12.8	12.0	9.8
GNP deflator percentage increase	8.2	9.0	10.1	9.7
Outlays as percentage of GNP	21.7	21.4	23.3	23.2

Budget deficits should be reduced through reductions in spending, not massive tax increases.

Taxpayers still clearly want lower taxes. This November, taxpayer initiatives will be on the ballot to limit and reduce taxes in at least 8 states. The amount of effort involved in qualifying these initiatives is hard to underestimate. Countless hours of planning and organizing were involved and millions of signatures were gathered.

The Congress has a unique opportunity to revitalize America's economic growth. For too long, tax experts have been pre-occupied with the incidence of taxation rather than considering how tax policies and the tax burden stifles economic growth. The current high marginal tax rates stifle incentives to work, to save, and invest.

The National Taxpayers Union feels that the most urgent tax reform is a reduction of the distortions of the tax system caused by inflation. As noted economist Michael J. Boskin has written, "the economic and political harm done by an unindexed tax system which continually accrues revenues which are in excess of real income growth cannot be overestimated."

Inflation causes the following distortions and hidden tax increases:

1. Inflation automatically increases personal income tax rates by bumping people into higher tax brackets even though their real income has not increased.

2. It erodes the value of depreciation deductions for business equipment and buildings. These inadequate depreciation deductions have resulted in an increase in the effective tax rate on businesses during periods of high inflation.

3. Inflation causes taxation of fictitious capital gains. Many capital gains are really losses. Investors who lose purchasing power still have to pay capital gains tax.

4. Inflation causes over taxation of interest income. Interest income from personal savings is largely a reflection of the inflation rate. But since the tax system treats all interest income as real income, the result is that it is nearly impossible to achieve a positive real rate of return on personal savings after taxes.

The distinctive effects of inflation on the tax system can be alleviated two ways, short of basic reform of the system. Either taxes could be indexed, or a series of future tax reductions could be implemented now.

Yearly discretionary tax "cuts" will not suffice. This is because good economic decisions by individuals on their choice of jobs, savings and investment cannot be made without knowledge of future tax rates.

Fortunately, the Congress has begun to realize this. Well over half of the Congress has sponsored the 10-5-3 plan for liberalizing depreciation allowances. Clearly depreciation reform is needed and the National Taxpayers Union fully supports such reform. (3) We are concerned, however, that the 10-5-3 proposal may introduce a distortion in the tax law by favoring structures over equipment. Although it is impossible to design a simple depreciation system that is not distorted by inflation, we feel that it is desirable to make depreciation allowances as neutral as possible.

Ideally, the best system would be present value replacement cost depreciation. Under this system, the annual depreciation deductions would vary with the interest rate to ensure that the present value of deductions equalled the real cost of the investment.

The proposal by Alan J. Auerbach and Dale W. Jorgenson for a first year capital cost recovery system has merits. It would reduce the distortions of inflation by allowing deduction of the full present value of depreciation in one year. Since the depreciation allowance could be deducted immediately, inflation could not erode its value. It also avoids the distortions of 10-5-3.

Although the consensus seems to be clear for reducing the distortions caused by inflation for business depreciation, there is an unexplained reluctance on the part of some for reducing the distortion caused by inflation in the personal income tax. Clearly, the proposals for liberalization of depreciation allowances are nothing more than indexing. Likewise, it's just as necessary to immediately index the personal income tax system.

As a worker's income increases in an attempt to keep up with inflation, he is forced into higher tax brackets—whether or not his real income has increased. The result is that the taxpayer pays a larger percentage of his income in taxes—without an increase in real buying power. This is known as "bracket creep" or "taxflation."

Indexing the personal income tax system would solve this problem. It is simple to do and it will not make it more difficult for taxpayers to fill out their tax forms.

The National Taxpayers Union strongly supports S. 12 by Senator Robert Dole and S. 211 by Senator Gary Hart. Both bills would adjust the personal income tax rates to inflation by indexing the bracket amounts and the personal exemption to the Consumer Price Index. We feel that any tax cut bill passed by Congress this year should include a provision for indexing.

The chart compares tax liabilities under indexed and unindexed tax systems over a five year period where inflation averages 9 percent.

EFFECT OF INFLATION ON INDIVIDUAL INCOME TAX LIABILITY

[Constant 1979 dollars]

Income	1979 tax	1984 tax indexed	1984 tax unindexed
Family of 4, joint return:			
10,000	378	378	840
14,000	1067	1067	1469
18,000	1693	1693	2223
25,000	2895	2895	3848
35,000	5057	5057	6684
Single taxpayer:			
6,000	427	427	663
10,000	1182	1182	1562
14,000	2092	2092	2488
18,000	2988	2988	3545
25,000	5078	5078	5751
35,000	8850	8850	9907

Alternatively, Congress could enact a series of future tax cuts which reduce the marginal personal income tax rates and then later index the individual income tax. Either way, individuals could better plan for the future.

Indexing would help curtail inflationary pressures.—One of the recognized causes of increased costs is the expectation that the cost of living will increase. Once it is made clear that taxes will not continue to rise automatically labor could afford to moderate wage demands. A factor of the "inflationary psychology"—the assumption of ever rising taxes—would be eliminated.

In addition, indexing would moderate the government's vested interest in maintaining inflation. Currently, the federal government receives a tax windfall during inflationary periods. For every 10 percent of inflation, personal income taxes rise 16 percent. It makes sense that we should remove the incentives the federal government has to cause inflation.

Indexing would help slow the growth of government spending.—By removing the ability to raise effective tax rates without an explicit vote, indexing would provide an incentive to discipline spending. Funds for expanded programs would have to come from increased efficiency, cutbacks in ineffective programs, or real economic growth, not unlegislated tax increases.

Indexing will reduce fiscal drag.—The continued effects of bracket creep and reducing incentives for people to work, save and invest. Not only does inflation undermine the value of each dollar earned, but a larger portion of these earnings is being taxed away. Savings and investment also decrease because taxflation causes expectations of rising future marginal tax rates. A study published by the Joint Economic Committee agrees, stating that the lack of indexing "is likely to produce stagflation." The study also concluded that "indexed taxes would have moderated the (economic) collapse of 1974."

Indexing will increase government accountability.—Currently, the entire political process is sidetracked. Taxes are now raised automatically each year with no legislative action or public debate. There are no Congressional hearings and no recorded votes on the issue, either in committee or on the floor of Congress.

Opponents claim that the current method of periodic tax cuts have succeeded in offsetting inflation. Although discretionary tax cuts have partially adjusted the system for inflation, they are not the answer. Tax cuts made in the last two decades have not been able to keep up with inflation. According to a study by Rudolph Penner, Director of Tax Policy Studies at the American Enterprise Institute, all wage earners with taxable incomes from $12,500 to $150,000 (1979 dollars) have experienced actual increases in marginal tax rates since 1960.

An extensive study completed for the Brookings Institution revealed that the actual income tax burden in 1975 was over 13 percent higher than it would have been if indexing had been adopted in 1965, even though several tax "cuts" had been adopted. Despite three more cuts, income taxes have continued to increase in every year since 1975. Income tax totalled 9.6 percent of personal income in 1975, but over 10.6 percent in 1979. This figure will jump to 11.8 percent in 1981. Clearly, discretionary cuts have not offset the effects of inflation.

One of the most common myths about indexing is that it cuts taxes. The truth is that indexing does not cut one penny off federal revenue. All it does is prevent unlegislated increases in taxes. Revenues would not decrease at all. In fact, if the economy grows, revenues would still rise faster than the rate of inflation. For instance, if real income increased by 10% during the next five years, income taxes would grow 16%. This is in addition to proportionate growth caused by inflation. Rather than cutting revenue, indexing would allow for increased revenues—but only due to an actual increase in the standard of living, not inflation.

Indexing does not restrict Congress' power to increase taxes. The difference is that this would be done through positive action by Congress, not automatically by "taxflation."

It is also frequently argued that automatic tax increases should be retained, as they act as an automatic stabilizer in times of inflation. The "automatic stabilizer" view holds that increasing taxes in times of inflation is necessary to cool off the economy. Several recent studies have shown the weakness of this approach. A study published by the Brookings Institution put simulated indexed and non-indexed economies through various shocks. They concluded that "there is simply no evidence that indexing the tax system would be harmful to economic stability . . . In light of the undesirable effects that inflation has on the tax system, it would appear from our results that indexing should be adopted."

Not only will indexing not cause instability, it may help stabilize the economy.

One of the least convincing arguments against indexing is that if it is adopted we may weaken the desire to bring inflation under control. This argument assumes that indexing would somehow insulate taxpayers from inflation. The truth is that indexing taxes will not guarantee that wages or salaries keep up with inflation. All it does is assure that wage earners will not lose even more ground to inflation due to automatic tax increases. It is ridiculous to say that this will make people apathetic about inflation. People would still feel inflation every day in their food bills, in their gas bills, and in their rent payments. They don't need another reminder through a hidden tax hike.

CAPITAL GAINS TAXES SHOULD BE REDUCED

Gains from capital are now simply measured as the difference between the original price of an asset and the nominal price at which it is sold. The problem is that the "gain" may have been partly, if not wholly, due to inflation, and not an increase in purchasing power.

For example, imagine a person who buys a stock in 1967 at $100. In 1978, after a period where prices doubled, the stock is sold for $200. Under the current system, a capital gain of $100 is recognized. However, there is no real gain. The $200 received in 1978 could buy only as much as the $100 could in 1967. The investor is taxed for breaking even.

This is not a problem that only affects the rich. It would affect anyone who sells an asset or receives capital gains.

Extensive research on inflation and capital gains has been conducted by Martin Feldstein and Joel Slemrod. According to their calculations, the national total of $4.6 billion in capital gains reported on corporate stock in 1973 represented a real capital loss of $0.9 billion. Yet in that year, Americans paid $1.138 billion of capital gains tax on corporate stock. Had capital gains been measured in real terms, the tax liability would only have been $661 million.

This problem can be alleviated by further reducing capital gains taxes and extending a rollover provision—such as that which applies for housing. It should completely exempt all gains from taxation so long as they are reinvested in productive enterprise. At the same time, the distinction between short and long term gains should be eliminated. There is not one substantive reason for the distinction between short and long term rates. The effect of this provision is to lock capital into current uses and hinder the efficient operation of markets. This protects dominant corporations from competition and depresses the stock market. I personally have never been able to understand why anyone, excepting perhaps the managers of the largest, least efficient business concerns, would want to create incentive to immobilize capital. Nonetheless, that is what the current laws do.

To reduce the tax bias against personal savings, tax rates should be reduced here as well. There are several alternatives to reducing taxes on savings that we would support. We would support a larger exclusion of interest and dividend income. Alternatively a tax free rollover of interest and dividend income would address the problem as well. Yet another possibility is to have a tax table for non-wage income. In that way, marginal tax rates on interest and dividend income would not start at high marginal tax rates. Instead, after a certain exclusion, there would be a separate schedule of tax rates for interest and dividend income.

REPEAL THE MARRIAGE TAX

The marriage tax penalty affects couples in which both husband and wife work. Contrary to popular perception, two earner couples today now outnumber one earner couples. But the tax laws still reflect the old-fashioned view of a married couple where the husband worked and the wife stayed at home. It has been estimated that as many as 38 million individuals pay a marriage tax.

The "marriage tax" exists because of our progressive income tax. When a two-earner couple's income is combined it reaches into higher tax brackets that it would if they were single and paying taxes separately.

The Natioanl Taxpayers Union supports S. 336, by Senator Charles McC. Mathias. It would eliminate the marriage tax by allowing married couples to file returns as if they were single.

We have long urged that Congress enact measures for increased federal fiscal responsibility. A strongly worded statute, followed by passage of a Constitutional Amendment, to balance the budget and limit federal taxes and spending would put to rest the fears of inflationary fiscal policies.

Instead of hesitating whether or not to pass tax "cuts" to merely partially offset tax increases, we could really cut taxes without fear of inflation.

If such measures were enacted now, it would immediately improve the prospects for our economy. Everyone at home and abroad, would know that spending would be reduced and that our budget would be balanced over the years to come. People could be confident that the government was going to bring inflation under control. And there would be more confidence than is possible today that tax rates would be lower in the future.

If we had an amendment to balance the budget or limit federal spending, our economy could afford real and substantial tax cuts to restore the incentives to work, save and invest. These genuine tax cuts would not fuel inflation because Congress would be unable to let spending run out of control.

[Brief recess.]

Senator NELSON. Given the legislative situation near the end of the session, there is no way to avoid these rollcalls during the hearings, so we regret that.

You may proceed in any manner that you desire. There will continue to be votes, so if you can summarize your main points, your full statement will be printed in the record. Also, if you could avoid repeating points that have already been made, it would be helpful in moving along since we have a total of 23 witnesses.

STATEMENT OF RICHARD V. MINCK, EXECUTIVE VICE PRESIDENT, AMERICAN COUNCIL OF LIFE INSURANCE

Mr. MINCK. I am Richard Minck, executive vice president of the American Council of Life Insurance. Our 504 member companies write virtually all the life insurance and insured pension plans in force in the United States.

Thank you for the opportunity to present the views of the council. We are vitally concerned with the proper functioning of the economy, and we are especially concerned about the adverse impact that inflation is having on the lives of all Americans.

Our prepared statement contains a number of specific comments—some of which I would like to highlight. We would also appreciate having our full statement included in the record.

The first priority among economic objectives should be given to reducing the inflation rate which threatens the economic well-being of the entire Nation. Earlier this year, inflation reached an annual rate of 18 percent. The consequences included reduced purchasing power for the American people, major disruptions in financial markets and widespread alarm among foreign holders of U.S. dollars.

The program of correctives introduced in mid-March by the Federal Reserve helped to offset some of the inflationary forces, and subsequent trends have allowed these special measures to be lifted in recent weeks. However, the battle against inflation is far from over, with the current inflation rate running around 10 percent.

It is against this background that we oppose passage of a tax cut this year. Such action would be widely interpreted as a signal that the battle against inflation has been relegated to a secondary position. This signal could have severe adverse effects in foreign exchange markets, on decisions of consumers, and on pricing decisions of producers.

Of course, we don't oppose tax reductions as such. We do oppose tax reductions at this time, in the present inflationary situation. Our testimony emphasizes the pressing need at an appropriate time to restructure our tax system to encourage greater capital investment in order to modernize plant and equipment and to reverse the declining trend of productivity.

It also emphasizes the fact that the effective tax rate on individuals has increased because inflation has pushed wage earners into higher tax brackets, without gains in real purchasing power. However, legislation dealing with these problems should be deferred until we are moving toward a better balance in the Federal budget and until inflation has subsided to much lower levels.

Our statement also presents our views regarding social security.

We oppose any proposal to reduce social security payroll taxes and to use, instead, general revenues to finance a substantial part of the cost of the social security system.

In the present setting of economic recession, a reduction in social security taxes is being urged to stimulate the economy. Putting aside the question of whether this is or is not the right time to cut taxes, we have several objections to the reduction of social security taxes for economic purposes. These taxes have always had the clear single purpose of financial social security. If Congress were to adjust them for countercyclical economic purposes, it would create uncertainties about the system, particularly if the adjustment involves payroll tax reductions that cannot be justified on the basis of the costs of the program.

We think that it might also give a signal that we are not willing at this time to face up to the hard issues involved in putting social security on a sound financial footing.

Our third point, and this is the most important, is to urge that employee retirement savings contributions be made deductible for tax purposes. We think that it is important to maintain a favorable environment for the growth of pension plans and other private savings for retirement. If you do that, you will at the same time, I think, reduce the pressures to increase the burdens on social security.

Therefore, we urge that when tax reduction legislation becomes appropriate, as we think it will in the future, it include incentives for increased employee retirement savings. This would have a double benefit for the economy. First, it would increase the retirement income security program of the country, at the same time it would provide a pool of long-term capital for investment in the economy.

Specifically, we urge the adoption of an employee retirement savings deduction program under which employee contributions to qualified pension plans would be treated as tax deferred income up to present individual retirement account limits.

The key reasons for including that in a tax reduction program are:

First, it would result in increased savings; second, it would result in increased capital formation; third, it would be an efficient sort of tax cut, because a tax cut that encourages savings and contributes to capital resources of the Nation, will generate much less inflationary pressures than other tpes of individual tax cuts which might create greater consumption.

Finally, we think that it has broad support among the people in the pension business, employers, and the eventual recipients.

We have previously testified in favor of, and we continue to support S. 557, a bill introduced by Senator Bentsen. We think it needs some technical and mechanical changes to improve its operation, and would be happy to work with the committee and staff in the development of appropriate provisions.

Thank you, sir. I will be happy to answer any questions.

Senator NELSON. Thank you, sir.

[The prepared statement of Mr. Minck follows:]

Summary of Principal Points

Statement by Richard V. Minck,
On Behalf of American Council of Life Insurance
Before Senate Finance Committee
on Tax Reduction Legislation
July 31, 1980

--In view of the continuing high rate of inflation throughout the U.S. economy, the American Council of Life Insurance is strongly opposed to the enactment of a substantial cut in income taxes at the present time, even if the effective date of such legislation were delayed. We believe such a cut will be perceived as a relaxation of the battle against inflation.

--The Council is opposed to proposals to reduce the scheduled Social Security payroll taxes and to use general revenues to finance the Social Security system.

--When tax reduction legislation is appropriate, the Council urges the inclusion of an employee retirement savings deduction to encourage people to save for their retirement. This proposal has the dual objective of providing a meaningful supplement to the Nation's retirement security program and of providing, in a real way, new long-term capital, one of the necessities for economic growth.

STATEMENT BY RICHARD V. MINCK ON BEHALF OF THE AMERICAN COUNCIL OF LIFE INSURANCE BEFORE THE SENATE FINANCE COMMITTEE ON THE SUBJECT OF TAX REDUCTION LEGISLATION

July 31, 1980

I am Richard V. Minck, Executive Vice President of the American Council of Life Insurance. The Council has a membership of 504 life insurance companies which, in the aggregate, have 95 percent of the life insurance in force in the United States and hold 99 percent of the assets of insured pension plans and 97 percent of the assets of all United States life insurance companies.

Summary of Position

I am pleased to have the opportunity to present the views of the Council because the life insurance business is vitally concerned with the proper functioning of the economy and the tremendous adverse impact the current high rate of inflation is having on the lives of all Americans. Let me summarize our position:

-- In view of the continuing high rate of inflation throughout the U.S. economy, we are strongly opposed to the enactment of a substantial cut in income taxes at the present time, even if the effective date of such legislation were delayed. We believe such a cut will be perceived as a relaxation of the battle against inflation.

-- We are opposed to reductions in the scheduled Social Security payroll taxes and to the use of general revenues to finance the Social Security system.

-- When tax reduction legislation is appropriate, we urge the inclusion of an employee retirement savings deduction to encourage people to save for their retirement. This proposal has the objective of providing a meaningful supplement to the Nation's retirement security program and of providing, in a real way, new long-term capital, one of the necessities for economic growth.

Specific Comments

Legislation Should Not Be Enacted Now To Reduce Corporate and Individual Income Taxes

In our view, the first priority among economic objectives must be given to bringing down the current high inflation rate which threatens the economic well-being of the entire Nation. Earlier this year, inflation soared to an 18 percent annual rate, eroding the purchasing power of the American people, triggering major disruptions in financial markets, producing widespread alarm among foreign holders of U.S. dollars, and arousing concern over our ability to manage domestic economic policies. The program of correctives that was introduced in mid-March by the Federal Reserve helped to overcome some of these inflationary forces, and subsequent trends have allowed these special measures to be lifted in recent weeks. However, the battle against inflation is far from over, with the current inflation rate hovering around the 10 percent level even today.

Our opposition to enactment of a tax cut at this time arises from a deeply felt concern that such an action would serve to worsen our inflationary psychology. If there is a widespread expectation that spending power in the domestic economy is soon to be pumped up by a major tax cut, this prospect will thwart the tendency on the part of producers to reduce prices in the face of weaker demand in a time of recession. Moreover, passage of a tax cut this year would be widely interpreted as a signal that the battle against inflation has been abandoned, or at least relegated to a secondary position. This signal could have severe adverse effects in our foreign exchange markets, as well as on decisions of consumers to spend or to save.

It should be understood that the life insurance business is not opposed to tax reduction as such, but rather is against tax reductions at this time, in the present inflationary environment. We recognize clearly the genuine need to restructure our tax system in a way that will encourage greater capital investment to modernize plant and equipment and to reverse the declining trend of productivity. We further recognize that the effective tax rate on individuals has increased because inflation has pushed wage earners into higher tax brackets, without gains in real purchasing power. However, correction of these problems must be deferred until the time when we are moving toward a better balance in the federal budget and inflation has subsided to more tolerable levels.

Finally, we are concerned that the political pressures of an election year do not provide the proper environment in which tax revisions can be properly considered as to their long-term validity and their consequences for broader economic objectives.

Let me now turn to a brief discussion of our views regarding Social Security.

Social Security Taxes Should Not Be Reduced

The life insurance business has supported the Social Security program ever since the inception of this program in 1935. We firmly believe that Social Security performs a vital and indispensable function in providing income for retired or disabled workers and for the survivors of deceased workers.

We therefore believe it is especially important that the Social Security system function properly and be financed adequately. Our long-standing position has been that the system should be financed solely through payroll taxes paid by covered workers and employers. Such payroll taxes enable covered workers and employers to share the cost of the program in a responsible fashion. Payroll taxes have the capability of producing the large sums necessary to finance Social Security. Moreover, payroll taxes have the virtue of being highly visible, which helps to maintain the vital link between an employee's benefits and his contributions.

We are concerned about proposals being made to provide a tax cut through reducing Social Security payroll taxes and using general revenues to finance a substantial part of the cost of the Social Security system. Some of the proposals would do this directly by providing for outright reductions in payroll taxes from levels scheduled under present law and for the infusion of general revenues into the Social Security system. Others would produce the same result indirectly by granting an income tax credit for Social Security tax payments--for example, by allowing taxpayers to credit a specified percentage of their Social Security taxes against their income taxes. Since such tax credits reimburse each taxpayer precisely--dollar for dollar--for the specified portion of Social Security taxes, the Federal government rather than the taxpayer pays the cost, and the net result is the same as if Social Security taxes were reduced and the corresponding amount of Social Security costs were paid directly out of general revenues.

We believe that the infusion of general revenues into Social Security would be extremely undesirable, and we strongly recommend that the Congress reject the proposals to provide such general revenue financing. The use of general revenues to finance Social Security would weaken the link between Social Security benefits and costs.

We realize, of course, that higher taxes are never popular and that, at the present time, some taxpayers are reacting adversely to the prospect of increased Social Security taxes. However, the Social Security tax increases imposed by the 1977 law are considerably smaller than is generally assumed. For example, the $227 billion tax increase said to represent the additional Social Security taxes imposed by the 1977 legislation over the 10 years following its adoption is, in the aggregate, only about a 14 percent increase in the taxes that would have been paid under prior law.

Moreover, while the Social Security taxes of individuals with high earnings will generally be substantially increased under the new law, the worker with average earnings, or even somewhat above average earnings, will pay only about 6.5 percent more in taxes over the next decade than under previous law.

In the present setting of economic recession, a reduction in Social Security tax burdens is being urged to stimulate the economy. However, such proposals are inconsistent with the historic role of Social Security as a separate, self-financed program which concentrates on the objective of providing income needed by the retired, the disabled, and the families of deceased workers and which avoids extraneous considerations. Putting aside the question of whether this is or is not the right time to cut taxes, it would be wrong to reduce Social Security taxes for counter-cyclical economic purposes. The purpose of these taxes is to finance Social Security and any attempt to use them to reduce economic fluctuations would interfere with this objective. In fact, adjusting Social Security taxes for counter-cyclical economic purposes would be likely to reduce confidence in the Social Security system since it involves reducing payroll tax burdens at times when such reductions cannot be justified on the basis of Social Security costs.

Perhaps most disturbing of all, a reduction in Social Security tax burdens now, whether provided directly by reducing Social Security taxes or indirectly through income tax credits, would be widely construed as a sign that we are not willing to face up to the hard issues involved in placing Social Security on a sound financial footing. Social Security has financial problems which have made it necessary for the Senate to pass legislation providing for a reallocation of tax rates between the OASI and DI funds for 1980 and 1981. As the next step toward placing Social Security on a sound financial basis, the payroll tax rates scheduled under present law for future years should be allowed to go into effect. This includes rejecting proposals which indirectly reduce Social Security tax burdens by providing income tax credits for specified portions of Social Security tax payments.

Employee Retirement Savings Contributions Should Be Deductible For Tax Purposes

As an essential element in placing the Social Security system on a long-range stable financial foundation, it is extremely important to maintain a favorable environment for the growth of pension plans and other private savings for retirement because these savings will reduce the pressures for placing increased burdens on Social Security. To this end, we urge that, when tax reduction legislation becomes appropriate, it include incentives for increased employee retirement savings. As I previously mentioned, such a savings incentive would have a double benefit to our economy; it would significantly increase the retirement income security program of this Nation and at the same time provide a pool of long-term capital for investment in our economy.

Specifically, we urge adoption of an Employee Retirement Savings Deduction program under which employee contributions to qualified pension plans would be treated as tax deferred income up to present Individual Retirement Account limits. In other words, such employee pension plan contributions would be deductible for federal income tax purposes when made, and retirement income flowing from these contributions would be taxable when received. If an employer does not elect to provide for employee contributions to his qualified plan, then his employees would, under the proposal, be permitted to make the tax deductible contributions to an IRA.

There are several key features to the Employee Retirement Savings Deduction which argue strongly for its inclusion in any tax reduction program.

Increased Savings. Preliminary estimates for 1979 indicate that personal savings by U. S. citizens as a percentage of disposable income was only 4.5 percent, which is lower than the rate in other major industrial countries. The evidence of the last three decades is that an increase in pension fund savings--the goal of the Employee Retirement Savings Deduction--will result in a net increase in the total volume of individual savings rather than a mere shifting of savings from one form to another.

Increased Capital Formation. Retirement savings are an important source of long-term investment capital for the capital goods so essential for a growing and dynamic economy. At present, $363 billion in pension investments are at work in the Nation's economy, helping to create jobs and improve productivity--the Employee Retirement Savings Deduction would increase this pool of capital. A broad segment of the economy would be aided as retirement savings are managed and invested by all major financial institutions including life insurance companies, commercial banks, mutual funds and savings and loans.

Reduced Pressures on Social Security. By stimulating persons to save more for their retirement and encouraging employers to establish qualified pension plans, the Employee Retirement Savings Deduction will alleviate the escalating pressures on the Social Security system. The pressures will otherwise become very burdensome on workers as the ratio of workers to retirees drops in the future.

Efficient Tax Cut. By encouraging savings and thus contributing to the capital resources of the Nation, the Employee Retirement Savings Deduction would create less inflationary pressures than would other types of individual tax cuts. Moreover, the proposal will be of particular benefit to middle-income workers where inflation and higher taxes have had a significant impact; and where the potential for increased savings is substantial.

Broad Support. The Employee Retirement Savings Deduction has the support of not only the life insurance business, but also commercial banks, pension consultants, administrators and actuaries, large and small employers, retired persons and others.

I would now like to briefly discuss some of the details of the proposed Employee Retirement Savings Deduction.

Limits Should Be Uniform and Simple. Under the program, employees would be permitted to deduct their contributions to qualified pension plans (or to an IRA where the plan does not provide for contributions) subject to the same limits that apply to IRAs, e.g., 15 percent of compensation up to a maximum annual deduction of $1,500. Present law grants no tax allowances for employee pension contributions to qualified plans.

Maximum Flexibility Should Be Provided. The deduction would be available, regardless of whether the employee contributions are voluntary or mandatory under the plan. A deduction for mandatory contributions would make it feasible for many employers, especially small ones, to establish plans they could not otherwise afford by having their employees share in the costs of their retirement program, or make it possible for them to improve benefits in situations where the employers would, themselves, be unable to pay the full cost of the benefit improvement.

<u>The Employee Retirement Savings Deduction Should Be Available To All Employees</u>. The deduction should not be phased out at a specified income level or completely denied to a specified group. Such a phase-out or other limitation would impact hardest on middle income employees, a group that should clearly be encouraged to provide for their retirement. Moreover, if the decision to establish a plan is in the hands of an individual who would not qualify for the incentive, one of the purposes of allowing the deduction would be lost on the very person who has the power to establish a plan. In this regard, it is important to note that the maximum annual tax savings to any one individual is only $750.

* * * * *

We have previously testified in favor of, and continue to support, S. 557, a bill introduced by Senator Bentsen. However, we believe it needs additional technical and mechanical provisions which will insure its efficient operation. We would be happy to work with the Committee and its staff in developing these provisions.

<u>Conclusion</u>

I appreciate having the opportunity to present the views of the American Council of Life Insurance. I would like to emphasize again that in view of the continuing high rate of inflation, we oppose the enactment of a substantial reduction in income taxes at this time, even if the effective date of such action is delayed until next year. However, when a tax reduction bill becomes appropriate, I would also reiterate the importance of creating a favorable environment for additional retirement savings in order to strengthen the Nation's retirement security, supply the capital needed for a dynamic economy and reduce the pressures on the Social Security system. The proposal I have just outlined would make an important contribution toward these vital objectives. Lastly, I would again stress our opposition to any reduction in Social Security taxes, either directly or through a tax credit.

I would be happy to attempt to answer any questions the Committee might have and to furnish any additional information the Committee might desire.

Senator NELSON. We will recess for 10 minutes.

[Recess.]

Senator BRADLEY [presiding]. I understand we were in the middle of this panel.

Given the parliamentary circumstances on the floor, there is going to be fractured attendance here. So if you could be brief and summarize your statements, they will be placed in the record in full. Let's just go down the row.

STATEMENT OF RICHARD B. TAYLOR, ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS

Mr. TAYLOR. Mr. Chairman, I am Richard B. Taylor. I am a member of the board of directors of the Association of Private Pension and Welfare Plans, and chairman of the Small Employer Plans Committee. I am pleased to have this opportunity to represent APP's views today to this committee on what we consider to be one of the highest priorities in any tax cut proposal, and that is a deduction for employee contributions for retirement savings to company-sponsored plans.

Our association feels strongly that people will save if they can achieve a goal. The savings goal which is clearly understood by the people of this country is the need to save for their retirement security.

A study conducted by Johnson & Higgins leaves no doubt about the concern of our citizens. Pension plans are high on their list of priorities. Today our older citizens would advise younger people to commence retirement planning early, and save for retirement, and urge that they seek employers who have pension plans.

The survey shows that our fellow citizens are concerned about inflation impact on retirement. Most significantly, over two-thirds of those interviewed would be willing to contribute to a plan if such contributions would increase the benefits, and they would receive a tax deduction.

This study also demonstrates that there are grave doubts among many people that the Social Security system will provide the benefits currently promised. The vast majority of those interviewed favored a retirement system outside of Social Security.

With these attitudes, and the record of the private pension sector, we believe that the creation of capital will occur more rapidly, grow larger, encompass more economic segments of our population, accomplish more societal goals and produce an everexpanding capital source, if this committee recognizes the retirement aspirations and expectations of our people by providing for a deduction for retirement savings.

Today, the private retirement system covers approximately one-half of the Nation's work force. Each year, contributions to the system have exceeded disbursements. This creates an everexpanding pool of capital. According to a 1977 report by the SEC, the total private pension assets of insured and noninsured plans have grown dramatically.

The updated data demonstrates as of 1978 that there are $320 billion in assets held by pension plans of private employers. It constitutes the Nation's largest institutional pool of long-term capital for industry and commerce.

The private pension system provides the single most important and reliable mechanism for the growth of savings available for long-term investment because of the long-term nature of pension plans. We need to expand this essential capital pool by covering employees currently participating in the private retirement system and encourage the improvement of their coverage.

Your committee can provide the means to accomplish this by permitting active partipants in qualified plans to make tax deductible contribution to the plans or to IRA's. This necessary but missing element is acceptable to the citizens of our country, as shown in the Johnson & Higgins report.

The essential concept is also acceptable to Congress. The House of Representatives in 1976 passed a provision which would allow deductible contributions as part of that Tax Reform Act. The Senate also voted to adopt the concept in the Revenue Act in 1978. Numerous bills are pending now in the Congress on this very subject.

This concept has been studied for several years, and has been endorsed by numerous organizations, including the U.S. Chamber of Commerce, the ERISA Industry Committee, American Council of Life Insurance, American Society of Pension Actuaries, American Association of Life Underwriters, American Association of Retired Persons, the National Automobile Dealers Association, the Investment Company Institute, and many other companies and organizations.

In designing a tax proposal to create an incentive for retirement savings, we suggest the following items be included:

The deduction should be simple, equitable, easily administerable;

There should be no discrimination standards because qualified plans properly must meet such standards;

Employee contributions should be treated the same as employee voluntary, and a tax credit for retirement savings should at most be an alternative to the limited deduction;

The employer must be permitted to decide whether to accept the contribution, and the amount deductible should be the same as that for IRA's.

In summary, we pointed out a number of reasons why we support legislation. We believe the present bills pending before Congress, particularly S.557 of Senator Bentsen, incorporate the proper policy to achieve the goals. We also support many of the aspects of Senator Dole's bill, S.75. We believe that these bills could be combined, and we would be happy to provide assistance in doing that.

Adoption of such a bill by the committee will, among other things, encourage the development of new plans, and increase the capital base.

I will be happy to answer any questions you might have.

Senator BRADLEY. Thank you very much.

[The prepared statement of Mr. Taylor follows:]

STATEMENT OF THE ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS, INC.

SUMMARY

One of the highest priorities in any tax cut proposal should be a deduction for employee retirement savings.

Such a deduction is consistent with the desire of most employees to save for their retirement security.

Moreover, contributions for retirement savings will enhance the Nation's pool of long-term capital for industry and commerce.

The deduction for retirement savings is desired by the public and has been embraced by many organizations and other groups.

Congress has previously considered and accepted a deduction for employee contributions.

Our Association strongly urges the adoption of a provision permitting deductible employee contributions which is single, equitable and easily administrable.

STATEMENT

Mr. Chairman and members of the committee, my name is Richard B. Taylor. I am a member of the Board of Directors of the Association of Private Pension and Welfare Plans and serve as the Chairman of the Committee on Small Employer Plans.

The Association of Private Pension and Welfare Plans is a non-profit organization which was founded in 1967. The Association's approximately 600 members represent the full spectrum of employers, unions, plan sponsors and professionals involved with the maintenance and continued well-being of every type of private pension or welfare plan being maintained in America today. Our nationwide membership includes employers, unions, accounting firms, attorneys, banks, insurance companies, investment firms and counselors, and pension and welfare plan administrators and consultants.

I am pleased to have this opportunity to appear before you today to present APPWP's views on what the Association believes should be one of the highest priorities in any tax cut proposal—a deduction for employee retirement savings.

Our Association feels strongly that people will save if they can achieve a goal. The savings goal which is clearly understood by the people of this country is the need to save for their retirement security.

A study, commissioned in 1979 by Johnson & Higgins and conducted by Louis Harris and Associates, leaves no doubt about the concern of our citizens. Pension plans are high on their list of priorities. Today our older citizens would advise the younger people to commence retirement planning early, save for retirement and urge that they seek employers with a good pension plan. The survey shows that our fellow citizens are concerned about inflation's impact on their retirement. Most significantly, over two-thirds of those interviewed would be willing to contribute to a pension plan if such contributions would increase their benefits. This study also demonstrates there are grave doubts that the social security system will provide the benefits currently promised. A vast majority of those interviewed favored a retirement system outside of Social Security.

With these attitudes and the record of the private pension sector we believe that the creation of capital will occur more rapidly, grow larger, encompass more economic segments of our population, accomplish more societal goals and produce an ever-expanding capital source, if this Committee recognizes the retirement aspirations and expectations of our people by providing for a deduction for retirement savings.

Today, the private retirement system covers approximately one-half of the Nation's work force. Each year, contributions to the system have exceeded disbursements. This creates an ever expanding pool of capital. According to a 1977 report of the Securities and Exchange Commission the total private pension assets (both insured and non-insured) have grown dramatically.

The up-dated data demonstrates that $320 billion in assets are held by pension plans of private employers at the end of 1978 and this constitutes the nation's largest institutional pool of long-term capital for industry and commerce.

The private pension system provided the single most important and reliable mechanism for the growth of savings available for long-term investment because of the long-term nature of pension plans. We need to expand this essential capital pool by covering employees currently participating in the private retirement system and encourage the improvement of their coverage. Your Committee can provide the means to accomplish this by permitting active participants in qualified retirement plans to make tax deductible contributions to employer sponsored plans or IRAs. This necessary, but missing, element is acceptable to the citizens of our country as shown in the Johnson & Higgins Report. The essential concept is also acceptable to Congress and its members. The House of Representatives passed a provision which permitted deductible contributions in the Tax Reform Act of 1976. The Senate also voted to adopt the concept in the Revenue Act of 1978. Numerous bills are now pending in this Congress which would give a deduction to the employee for his contributions toward his retirement savings. This is the concept that has been studied for several years. It has been endorsed by numerous organizations, including the U.S. Chamber of Commerce, ERISA Industry Committee (ERIC), American Council of Life Insurance, American Society of Pension Actuaries, American Association of Life Underwriters, American Association of Retired Persons, the National Automobile Dealers Association, the Investment Company Institute, and many other companies and organizations and as noted previously has in different Congresses been adopted by both the Senate and the House.

The need for such legislation is basic and its justification simple. As shown by the statistics on current private retirement plans, the system works. However, stronger and better pension programs can be provided if the employee and employer participate together to fund the benefit. As the cost of pensions continue to escalate, it becomes ever clearer that the employee's retirement security must depend on a cooperative effort of the employer, the employee and the Government.

In this regard it is interesting to note the factors which decide whether a particular dollar of compensation will be devoted to pensions, immediate wages or some other alternative. It is important ot understand that the choice of providing pensions or the amount thereof is not exclusively an employer's decision. Quite often the amount devoted to pensions is left strictly to the employees (perhaps through their union).

In determining how resources are allocated whether for pensions or current compensation, one employee's motives will be different than his fellow employee. The older employee will be concerned about his retirement security, but the younger employee will want a larger portion of the employer's compensation costs allocated to immediate cash payments which are available for the needs of his young and growing family. If the employees must collectively determine to allocate the proposed wage increase either to current compensation or the pension plan, then either the young or older employee is going to be disadvantaged. However, the contributory pension plan can accommodate these different needs by permitting the employee to vary his contributions—to contribute a lesser amount in his early years and more as he grows older.

In reality, the only distinctions between the contributory and non-contributory plans are the immediate tax effects and the fact that in some contributory plans employees have a degree of choice (precluded by IRS rules from being discriminatory in favor of the highly paid) as to how much of their income to allocate to their future retirement.

Recognizing that the importance of pension benefits to a particular individual varies through his lifetime and may conflict with individual desires of his fellow employees, the tax considerations relative to funding should be neutral. The President's Commission on Pension Policy in its Interim Report, recognized that the tax treatment of employee and employer contributions to pension plans and earnings should be the same. At the present time, however, this is not the case, because employer contributions are made on a pre-tax basis for the employee while employee contributions must be made on an after-tax basis. In fact, the recent changes in the law such as the introduction of the IRA, although good in themselves, have had adverse effects on pension coverage because individuals who are not covered by employer sponsored plans are given the opportunity to adopt an individual retirement account (IRA), on a pre-tax basis. The effects of this change have been: (1) to encourage employees to cease participation in contributory qualified pension plans; (2) to attract employees to IRAs for the benefit of an immediate available tax deduction, but resulting in the employee's loss of: (a) vesting in the employer funded portion; (b) disability and life insurance benefits provided in the pension plan; (c) participation in any future grants of additional retirement credit for prior years of plan participation; and (3) to threaten the qualification and loss of the benefits of the qualified plan to employees participating therein, thereby accelerating their taxation and essentially defeating their retirement expectations.

The main purpose of the foregoing has been to point out the conflicts fellow employees experience in allocating the compensatory dollar, the important role employee contributions to pension plans can play, and the problem created by the current tax discrimination against them. Elimination of that discrimination would encourage further use of this valuable benefit structuring tool.

While the current tax law has produced factors negative to the further development and maintenance of qualified plans, perhaps even more important is the financial impact of inflation in escalating the costs of pensions. For instance, if an employer instituted a final pay plan expecting 3 percent inflation and the economy experienced 7 percent, the original costs the employer expected would increase 159 percent in a final pay plan. If he had instituted even a career average plan, his expected cost would have increased by 73 percent.

Can the employer bear the entire cost of a final pay plan? The answer to that question will vary with employers. Some already do. For others, it would be financially impossible particularly the majority of small employers. However, the number who would undertake final pay plans would increase significantly if the employees also contributed to fund the pension benefits.

For example, assume a 40 year-old individual initially making $15,000 works until retirement in 25 years. His salary increases follow the assumed inflation. His pension is 2 percent of pay for each particular year of service in the career average plan and 2 percent of final pay for each year of service in the final pay plan. His annual pension at different assumed inflation rates would be:d

	Inflation note		
	3 percent	6 percent	7 percent
Career average plan	$10,938	$16,459	$18,975
Final pay plan	15,703	32,189	40,706

Upon retirement the individual would be making approximately $71,000 if inflation had been 7 percent. The final pay plan would provide 57.3 percent of preretirement income as opposed to only 26.7 percent for the career average plan.

Employers, however, are hard pressed to adopt final average pay plans or improve such plans because of the recent years of heavy inflation. One way to encourage adoption of this type of plan or to provide for additional benefits in these plans would be to allow for contributory supplements by employees. Such supplements would, of course, be much more practical if employee contributions could be made on a tax-deferred basis. By providing this attraction, Congress would be encouraging the growth of the private pension system and thereby alleviating some of the pressure on public pension programs (Social Security in particular).

It should also be stressed at this point that the kind of supplementation we are referring to here does not imply that the cost of existing benefits would be shifted back to employees. What we mean here by supplements are provisions to allow employees to increase their existing retirement package without foregoing other employer planned compensation increases. In many cases, such supplementation would be voluntary, thus allowing the employees most desirous of and in need of additional pension benefits to elect to purchase them.

Another interesting and important feature of the employee purchased portion of a pension plan is that under ERISA rules these benefits are fully and immediately vested in the employee. If the employee accounts were made totally tax deductible, these accounts could be rolled over into an IRA or a successor employer's plan upon an employee's termination, thus providing a totally portable pension.

Thus the frequent complaints relative to vesting would be minimized. If an employee expected that he would frequently rotate jobs he could emphasize his own deductible contributions for retirement purposes and the employer could still provide adquate pensions for his long-term employees by proper structuring of the pension plan. Deductibility of employee contributions would help resolve the conflict between the short-term employees desire for immediate compensation and the long-term employees desire to maximize retirement income.

In designing the tax proposal to create the incentive for retirement savings we suggest that the following items be included:

(i) The deduction should be simple, equitable and easily administrable.

(ii) There should be no discrimination standards because qualified plans presently must meet such standards.

(iii) Employee mandatory contributions should be treated the same as employee voluntary contributions.

(iv) A tax credit for retirement savings should, at most, be an alternative to the limited deduction. The primary problem with a tax credit is the complexity of taxing distributions.

(v) The employer must be permitted to decide whether to accept employee contributions.

(vi) The amount deductible should be the same as the limits for individual retirement accounts.

In summary, we have pointed out a number of reasons why we support legislation to end tax discrimination against employee contributions to pension plans. We believe of the present bills pending before Congress, that S. 557, which was introduced by Senator Bentsen, incorporates the proper policy to achieve our goals. Furthermore, we also support many of the aspects of the bill introduced by Senator Dole (S. 75). We believe that these bills may be combined and we would be happy to provide assistance in this regard. Adoption of such a bill by the Committee will, among other things, encourage the development of new qualified plans which is necessary to the health of the private pension system.

Senator BRADLEY. The next witness.

STATEMENT OF JERRY L. OPPENHEIMER, ERISA INDUSTRY COMMITTEE

Mr. OPPENHEIMER. Mr. Chairman, I am Jerry L. Oppenheimer, a member of the law firm of Mayer, Brown & Platt, here in Washington. I am pleased to appear today on behalf of the ERISA Industry Committee, whose 100 members include half the Nation's 50 largest industrial companies, and represent a broad cross section of the Nation's largest retailers, utilities, banks, and insurers.

As the two previous witnesses have suggested, and I am sure you well know, Mr. Chairman, under existing law, if an employee is covered by a qualified retirement plan, he cannot contribute to an IRA, and no employee contributions to a qualified plan are deductible. ERIC strongly urges that any tax reduction allow employees to deduct retirement savings contributions to qualified plans or to IRA's.

Deductible retirement savings contributions would enhance capital formation, increase employees' retirement security, foster the growth and improvement of private plans, encourage self-reliance through private savings, and relieve pressure on social security.

We believe that by encouraging longer term individual savings this proposal would be less inflationary than other proposed forms of individual tax reduction. In addition, unlike other proposals to encourage capital formation, the amounts deducted plus all investment income earned on them would be taxed when distributed.

Hence the Treasury will be compensated for the present drop in tax receipts by larger collections in later years, without regard to the favorable economic effects of adding to the country's capital base. In the long run, therefore, this proposal is not a true tax cut, but a deferral of the time of tax collection.

Mr. Taylor, the prior witness, has reminded the committee that a similar proposal was passed by the Senate in 1978, and that a more restricted proposal was passed by the House in 1976. Neither was enacted, principally because of the then anticipated short-term revenue consequences. But if there is now to be tax reduction, we believe it should include deductions for retirement savings contributions.

Of the many bills now pending, we prefer Senator Bentsen's proposal, S. 557. It would encourage the broadest possible participation by private sector employees and employers. We believe that it would be the simplest to administer and would avoid the unnecessary costly and counterproductive complexity unfortunately presented by some of the other proposals.

We note with satisfaction that Senator Dole's bill, which was cosponsored by Senator Nelson, S. 75, is appropriately more detailed than the Bentsen proposal, but is very similar in concept. It does, however, in our view contain some features which we think are undesirable.

We would really like to see the best of these two bills combined, and obviously we would be pleased to have an opportunity to assist in that regard.

The Bentsen proposal would allow an employee in a qualified plan to deduct the same amount that can be contributed to an IRA. Uniform limits would be simplest for the public to comprehend and easiest for the Internal Revenue Service to administer. For example, the service would not have to question whether persons who claim a deduction participate in qualified plans, or in IRA's to which different limits may apply.

Uniform limits would also avoid problems for persons who are covered under a qualified plan for only part of a year. If different limits were adopted, refunds and adjustments of previous contributions might have to be made. Ready comprehension by employees is, of course, an important aspect of any voluntary contribution program.

Unfortunately, Senator Dole's bill would limit deductions to a lesser amount than that applicable to IRA's, thus it would fail to provide the very desirable simplicity which flows from uniform limitations. I must also note that, unfortunately, Senator Dole's bill would impose additional discrimination tests which we strongly believe are unnecessary, costly, and perhaps most importantly, counterproductive.

Our detailed reasons for opposing those tests were presented in April 3, 1979, testimony before Senator Bentsen's subcommittee, and I will not take the committee's time to repeat those arguments today.

Let me also note with strong approval that neither of these bills would require an employer to do anything. This is very important. Some employers will not wish to assume the responsibility for administering or investing employee contributions. Although we expect that many employers would decide to accommodate deductible employee contributions in their plans, this would not be necessary, and the employee would always have the option to contribute to his own IRA. We believe this flexibility is important and appropriate.

Senator BRADLEY. Excuse me, Mr. Oppenheimer, we have to be fairly rigid here, and we must move on.

[The prepared statement of Mr. Oppenheimer follows:]

STATEMENT OF JERRY L. OPPENHEIMER ON BEHALF OF THE ERISA INDUSTRY COMMITTEE

SUMMARY

Any tax cut legislation should allow workers to make deductible contributions for retirement savings to Individual Retirement Accounts (IRAs) or, if the individual participates in a qualified retirement plan that accepts deductible contributions, to that plan.

By deferring tax, deductible retirement savings contributions would foster capital formation, enhance retirement security, encourage self-reliance through long-term personal savings, and relieve pressures on Social Security.

By encouraging individuals to save, deductible retirement savings contributions would be less inflationary than other individual tax cut proposals that would significantly add to funds available for current consumption.

By deferring tax rather than forgiving tax on contributions, and by taxing ultimately all investment income derived from deductible retirement savings contributions, the principal effect would be less tax now and more tax later, with little long-term revenue effect, without regard to the stimulative effect on the economy.

By being optional, deductible retirement savings contributions would not force burdens on employers or employees.

By being consistent with the IRA limits on deductions, deductible retirement savings contributions would be simple to understand and to administer.

Mr. Chairman, I am Jerry L. Oppenheimer, a member of the law firm of Mayer, Brown & Platt, here in Washington. I appear today on behalf of The ERISA Industry Committee (ERIC). ERIC's some 100 members include half of the nations' fifty largest industrial companies and represent a broad cross-section of the nation's largest retailers, utilities, banks and insurers. Participants in pension plans sponsored by ERIC members represent about 20 percent of all participants in private pension plans.

As you well know, Mr. Chairman, under existing law, if an employee is covered by a qualified pension plan, he cannot contribute to an IRA, and no employee contributions to a qualified plan are deductible. ERIC strongly urges that any tax reduction allow employees to deduct retirement savings contributions to qualified plans or to IRAs.

Deductible retirement savings contributions would enhance capital formation, increase employees' retirement security, foster the growth and improvement of private plans, encourage self-reliance through private savings, and relieve pressure on Social Security.

We believe that, by encouraging longer-term individual savings, this proposal would be less inflationary than other proposed forms of individual tax reduction. In addition, unlike other proposals to encourage capital formation, the amounts deducted, plus all investment income earned on them, would be taxed when distributed. Hence, the Treasury will be compensated for the present drop in tax receipts by larger collections in later years, without regard to economic considerations of the favorable effects of adding to the country's capital base. In the long run, therefore, this measure is not a true tax cut but a deferral of the time of tax collection.

Mr. Chairman, you will remember that a similar proposal was passed by the Senate in 1978 and that a more restrictive proposal was passed by the House in 1976. Neither was enacted, principally because of the anticipated short-term revenue cost. If there is to be tax reduction, we believe it should include deductions for retirement savings contributions.

Employees and employers—large and small—support the concept. It is supported by a broad group which includes small businesses, large employers, banks, retired persons, insurance companies, automobile dealers, retailers, manufacturers, and pension consultants, administrators and actuaries.

Personal savings are disturbingly low, whether judged by historical American levels or by current levels in other industrialized countries. this is particularly so among middle-income Americans who are hard pressed by high inflation, higher Social Security taxes, and higher taxation due to "bracket-creep". By deferring taxes, this proposal would encourage employees to save for longer periods and to help themselves to provide a more secure retirement.

Of the several bills now pending, we prefer Senator Bentsen's proposal (S. 557). It would encourage the broadest possible participation by private sector employees and employers, would be the simplest to administer, and would avoid the unnecessary, costly, and counterproductive complexity unfortunately presented by some of the other proposals. We note with satisfaction that Senator Dole's bill (S. 75) is appropriately more detailed and is very similar in concept, but it contains some undesirable features. We would like to see the best of the two bills combined and would be pleased to have the opportunity to assist in this regard.

Senator Bentsen's bill would allow an employee in a qualified plan to deduct the same amount that can be contributed to an IRA. Uniform limits would be simplest for the public to comprehend and easiest for the Internal Revenue Service to administer. For example, the Service would not have to question whether persons who claim a deduction participate in qualified plans or in IRAs to which different limits may apply.

Uniform limits would also avoid problems for persons who are covered under a qualified plan for only part of a year. If different limits were adopted, refunds and adjustments of previous contributions might have to be made. Ready comprehension by employees is, of course, an important aspect of any voluntary contributory program. Unfortunately, Senator Dole's bill would limit deductions to a lesser amount than that applicable to IRAs; thus, it would fail to provide the very desirable simplicity which flows from uniform limitations.

We note with approval that Senator Bentsen's bill would cover all workers, including self-employed individuals. A major criticism of the current tax treatment of private plans is the different treatment of the self-employed. Covering the broadest possible range of individuals avoids any increased disparity and should result in greater capital formation and savings.

It is also appropriate that both bills would permit deductions for employee contributions that are mandatory under a qualified plan. This will assist in both the creation of new plans and the improvement of inadequate benefits in existing plans.

Mr. Chairman, I must also note that, unfortunately, Senator Dole's bill would impose additional discrimination tests which ERIC believes are unnecessary, costly, and counterproductive. ERIC's detailed reasons for opposing these tests were presented in its April 3, 1979, testimony before the Subcommittee on Private Pension Plans and Employee Fringe Benefits, and I will not take the Committee's time to repeat them here.

Let me also note with strong approval that neither Senator Bentsen's bill nor Senator Dole's would require an employer to do anything. Some employers will not wish to assume the responsibility of administering or investing employee contributions. Although we expect that many employers would decide to accommodate deductible employee contributions in their plans, this would not be necessary, and the employee would always have the option to contribute to his own IRA. We believe this flexibility is important and appropriate.

Similarly, in order to achieve maximum voluntary participation, it is important to keep the system as simple as possible and administrative burdens at a minimum. Accordingly, we antiticpate that the legislation would contemplate very simple reports by employers and employees.

I will be happy to try to answer any questions you may have.

Senator BRADLEY. We will go to the next witness. In case you do not know, you have 5 minutes to present your statement.

STATEMENT OF RONALD BEAN, PRESIDENT, COUNCIL OF POLLUTION CONTROL FINANCING AGENCIES

Mr. BEAN. I am Ronald Bean, president of the Council of Pollution Control Financing Agencies, and director of the Illinois Environmental Facilities Financing Authority. With me here today is H. Lawrence Fox, who is a member of the council's board of directors.

My testimony today concerns the failure of the Department of the Treasury to implement the provisions of section 103(b)(4) of the Internal Revenue Code which provides for taxes on bonds issued to finance pollution control facilities. Restrictive policies and the resulting IRS regulations have severely crippled the usefulness of what our member agencies feel is an important element in any present day economic development efforts in this age of increased environmental consciousness.

Because our appeals to the Treasury have failed to produce any response, we turn to the Congress to reassert its original intent. We think that this can be done by technical amendments which adopt provisions already elsewhere in the law.

First let me discuss what we call the realized pollution test, whereby the Treasury, in its proposed regulations, fails to recognize the eligibility of equipment which can prevent pollution, instead of merely controlling it. The Treasury thus skewers investment decisions toward the end of the pipe control and away from preventative measures for process changes, even when these are the remedies prescribed by environmental regulatory agencies.

The most important single effect of this policy is to deny eligibility to coal-washing facilities. While a precipitator to capture sulfur dioxide as it leaves the smokestack is eligible, the more sophisticated approach of prior removal of sulfur from coal is not eligible.

In Ohio, where a statewide coal-washing proposal is being considered, the ineligibility of this form of pretreatment is a serious barrier to small producers or consumers of coal. Increasingly, pretreatment and process change are the more environmentally sound alternatives, while public policy provides disincentives for them due to the restrictive implementation of the law.

The council urges the Congress to make clear in the law that facilities for air and water pollution control mean facilities for prevention as well as the black boxes at the end of the pipe.

From a public policy point of view, the question of hazardous waste is the most pressing and most frightening issue. We are about to find out that facilities simply do not exist to adequately store and treat the volume of toxic and hazardous materials which until now have been quietly hidden in the "Love Canals," or "Valleys of the Drums."

Yet the Treasury refuses to recognize that the latest amendment to the Solid Waste Disposal Act passed in 1976 added an entire title to deal with hazardous waste. Instead, their definition of a solid waste facility cleaves to the previous act, and disqualifies liquid, semisolid, and other toxic wastes which the 1976 act was meant to encompass.

The council urges the Congress to make clear in the law that solid waste facilities are facilities for the collection, storage, transportation, treatment, et cetera, of solid waste as defined in the current law. The exclusion of hazardous waste and other restrictions has already thrown up major barriers to implementation of State or metropolitan areawide plans for handling such waste.

In conclusion, I wish to emphasize a most important characteristic of this provision for tax exemption of pollution control financing, which is the proportionately greater advantage to smaller businesses.

Industries without access to capital at the prime, and hard pressed to meet the goals of the ambitious national environmental agenda, are going to find that this provision makes the difference between staying in business, and closing up shop.

Public authorities trying to establish regional treatment facilities face their own stumbling through Treasury's unwillingness to permit financing of intermediary equipment such as the pipes to transport waste water to the public treatment facility, or special vehicles for hazardous waste transportation.

The Environmental Protection Agency has recognized these same problems, and last September EPA sent a detailed critique of Treasury regulations to the Commissioner of the IRS. A copy of this accompanies our written statement. To date he has not answered back.

Compared to the hundreds of millions under the oil backout bill targeted to pollution control for a handful of firms, or compared to the billions being spent for municipal waste water treatment, this incentive is powerful, efficient, and cost effective.

We urge the committee to assure that in the future the intent of the Congress is reflected in the administration of this provision, so that it may equally apply to the full range of relevant pollution control needs.

Thank you.

Senator NELSON. Thank you very much.

[The prepared statement of Mr. Bean follows:]

COUNCIL OF
POLLUTION CONTROL FINANCING AGENCIES

Consideration of a Tax Bill for 1980

WRITTEN TESTIMONY

Presented to

The Senate Finance Committee

July 31, 1980

On behalf of The Council of Pollution
Control Financing Agencies

by

Ronald Bean
Appearing as President
The Council of Pollution Control Financing Agencies
and
Executive Director
Illinois Environmental Facilities Financing Authority

H. Lawrence Fox
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Summary

1. Sections 103(b)(4)(E) and (F) of the Internal Revenue Code provide the only meaningful tax incentive in the Code for the acquisition of solid waste disposal or air or water pollution control facilities. Unfortunately the availability of tax exempt financing is restricted under proposed Treasury regulations which, notwithstanding EPA's objections, define pollution control facilities as only those devices that operate at the end of the production process. The rule is that any system that eliminates the creation of pollution is not for air or water pollution control. This "realized pollution" test disregards the fact that state or local governmental units and corporate citizens are designing nonproductive pollution control facilities pursuant to EPA mandate and modern technology. Further the regulations are contrary to the standards required for treating hazardous waste under RCRA.

2. The Council of Pollution Control Financing Agencies, as well as EPA, has concluded that the Service's interpretations are counter productive to the nation's environmental and energy policies. Since Treasury and the Service have ignored all requests for change, Congress must enact technical amendments to Section 103(b) that will insure tax exempt financing for companies and local government units which acquire pollution control and/or solid waste disposal facilities.

3. Since 1970, governmental units and corporations, in an effort to support the nation's environmental and energy goals have spent billions of dollars for air and water pollution control and the treatment of solid wastes. These expenses will continue into the 1980's, particularly because of the treatment of hazardous wastes required under RCRA.

4. Since the Treasury regulations do not recognize the treatment of hazardous waste as being for the control of air or water pollution or solid waste, such expenditures are denied, arbitrarily, the benefits of tax exempt financing. Further, since all potential polluters are adopting technology for eliminating pollution rather than designing facilities that operate on pollutants at the end of a pipe, they are precluded from fully utilizing Section 103(b)(4)(F). This denial is unfair -- the tax incentive already exists -- and adds to the costly burden of acquiring nonproductive assets.

5. The proposed regulations penalize governmental units and corporations for being good citizens.

6. Congress should enact technical amendments to Sections 103(b)(4)(E) and (F) to guarantee that those who comply with the nation's environmental and energy standards will obtain the existing statutory tax incentives.

Introduction

The Council of Pollution Control Financing Agencies is a Section 501(c)(3) organization devoted toward the education of the public through an annual symposium, workshop programs and publications of the nation's environmental standards including analyses of regulatory actions. Its voting members are state or local government agencies charged with aiding either state or local government units or companies in financing their environmental compliance programs. Attached hereto as Exhibit A is a more complete description of the Council.

Its non-voting members consist of public members such as investment bankers, law firms and companies. This broad based membership has allowed the Council to establish a liaison with officials with policy responsibilities affecting pollution control financing at the Environmental Protection Agency, Council on Environmental Quality, Treasury Department, Securities and Exchange Commission, and Small Business Administration.

The combination of Council policy and membership affords the Council a unique position within our system. It is from this broad base of experience that the Council has learned of a serious problem relating to pollution control financing caused by the Internal Revenue Service and proposed Treasury Regulations. Further, the Council believes the harmful effects of the regulations will be exacerbated by reason of the need for compliance under RCRA. Accordingly, the Council appears before this Committee to suggest that it act immediately to clarify Sections 103(b)(4)(E) and (F) as discussed below. Since the Service and Treasury have ignored both EPA and the Council's comments that the regulations are contrary to Congressional intent, inconsistent with national environmental and energy policies and detrimental to both state and local governmental agencies charged with financing environmental protection systems and companies efforts to finance nonproductive facilities, Congress must intervene.

Present Law

Industrial development bonds, i.e., bonds defined in Section 103(b) of the Code as being issued by or on behalf of states or their political subdivisions for the benefit of private businesses, generally do not bear tax exempt interest under Section 103(a). However, where the proceeds of the bonds will be used for certain "exempt activities" (e.g., air or water pollution control facilities, solid waste disposal facilities, etc.) the bonds will bear tax exempt interest.

Realized Pollution Test

The Treasury and the Internal Revenue Service have promulgated and proposed various definitions of the types of facilities that may be regarded as being pollution control and solid waste disposal facilities. Many of these rules so narrowly restrict the types of facilities qualifying for tax exempt bond financing that they are contrary to the underlying statute and to some of the policies of the EPA.

In particular, Proposed Reg.§§1.103-8(g)(2)(ii), (iii) and (iv) adopt a "realized pollution" test. This test holds that facilities which prevent pollution are not for the control of pollution. Thus only "end of pipe devices" qualify for tax exempt financing. Excluded by the regulatory definition of air

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or water pollution control are such facilities, even if acquired pursuant to EPA mandate under the Clean Air Act, the Federal Water Pollution Control Act, or RCRA, that treat hazardous waste, eliminate the creation of a pollutant through process changes, control a "nuisance", or are used "traditionally or customarily" by an industry. This interpretation belies Congressional intent and is at odds with the modern methods of pollution control which are being developed by industry in cooperation with the EPA.

The exceptions permitting tax exempt financing of pollution control and solid waste disposal facilities were enacted in 1968 to continue a tax incentive for installing them. Such equipment is frequently placed in service because public policy demands that the environment be protected even though this may require investment that either is unprofitable for a producer or involves a high degree of financial risk. These provisions have been administered by the Internal Revenue Service since its enactment. The Service's failure to recognize these facts is philosophically unfair and statutorily improper.

Gross Savings Test

Assuming the facility meets the so-called "realized pollution test", the position of the Internal Revenue Service is that the allowable amount of financing for a pollution control facility is its cost reduced by the value of any recovered useful by-product, or the value of any form of "gross" economic benefit to the manufacturer.

Proposed Reg §1.103-8(g)(3) guarantees a reduction in allowable financing even where off-setting costs of operation associated with a pollution control devise equal or exceed the alleged benefits. This formula is inconsistent with EPA guidelines, contrary to standard accounting methods, and legally arbitrary.

Hazardous Waste

As stated earlier, facilities which treat hazardous wastes fail to meet the realized pollution test and accordingly do not qualify as an air or waste pollution control facility under Section 103(b)(4)(F). Even if such devises are acquired pursuant to the Solid Waste Disposal Act, the Treasury regulations deny tax exempt financing under Section 103(b)(4)(E).

In the case of the exemption for solid waste disposal facilities, the term "solid waste" has been administratively defined to mean solid waste within the meaning of the Solid Waste Disposal Act as it existed in 1968, despite the fact that the Act has been amended to modernize the government's response to the problem of solid waste disposal.

Solid waste disposal facilities under Section 103 reflect changing environmental policy. Thus, for example, the bill should include hazardous waste within the definition of solid waste.

Conclusion

The Council of Pollution Control Financing Agencies, as well as many taxpayers, and the EPA have advised the Treasury and Internal Revenue Service that its regulations are legally arbitrary and inconsistent with the Nation's environmental and energy goals. Since these comments have not been repudiated *i.e.*, they have been totally ignored, Congress must amend Sections 103(b)(4)(E) & (F) to guarantee that environmental judgments can be made by those entities capable of ascertaining most intelligent environmental policy without prejudicing governmental units or companies tax rights.

Exhibits

Attached, for the record, is a copy of the detailed submissions to the Treasury as Exhibit B and Exhibit C is a memorandum more fully explaining the problems discussed herein concerning hazardous waste.

EXHIBIT A

COUNCIL OF POLLUTION CONTROL FINANCING AGENCIES

The Council is a national non-profit organization of state and local public agencies which issue pollution control revenue bonds and provide economic assistance to industry for financing pollution abatement facilities. It was formed in 1978, with the following objectives:

- To encourage and facilitate capital financing for environmental improvement and energy conservation.
- To support and further the interests of local and state agencies in assisting industry in achieving environmental quality goals.
- To aid and assist in the development of financial and economic incentives for environmental improvement.
- To support research and provide information about the needs, purposes and benefits of pollution control financing.
- To promote better coordination of federal, state and local policies and regulations for the compatibility of environmental improvement, efficient energy use and economic growth.

The Council provides technical assistance for its members' services for their communities. Among these are meetings and publications, sponsoring consultation among members, and program evaluation and recommendations. Council functions are designed to inform and educate the business, governmental and financial communities about the issues, developments and opportunities for more economical and equitable means of financing environmental improvement.

The Council's members are comprised solely of state and local units of government and their officials, and its Associates include banking, law, engineering and industrial firms.

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UNITED STATES ENVIRONMENTAL PROTECTION AGENCY
WASHINGTON, D.C. 20460

EXHIBIT C

SEP 5 1979

OFFICE OF
PLANNING AND MANAGEMENT

MEMORANDUM

SUBJECT: Proposed Regulations for Section 103(b)(4)(E) and (F) of the Internal Revenue Code

FROM: William Drayton
Assistant Administrator
Planning and Management BILL DRAYTON

TO: Jerome Kurtz
Commissioner
Internal Revenue Service

The Environmental Protection Agency is very interested in the interpretation given to Sections 103(b)(4)(E) and (F) of the Internal Revenue Code (Industrial Development Bonds). So long as Congress mandates subsidies, we would like to ensure that the interpretation of these statutes (1) conforms with Congression intent and (2) does not increase pollution control costs by discriminating against some low-cost means of compliance.

Many of the restrictions imposed by the proposed regulations could be eliminated by substituting a definition of pollution control equipment that relates to the Clean Air Act and the Feder Water Pollution Control Act. A positive definition linked to the statutes may eliminate the need for some of the restrictions IRS has proposed.

With these principles in mind, we offer the following commen on the proposed regulations. EPA's Office of General Counsel an my staff would be happy to work with you in your attempts to reso the problems we have raised and to develop regulations that will effectively implement these sections of the Internal Revenue Code

PROPOSED §1.103-8(g)(ii) - NO FURTHER REDUCTION IN SIZE...

> Property is not described in the preceding sentence unless it...cannot be further reduced in size without losing one of such characteristics.

We have several concerns about this provision. It appears to prohibit Section 103 financing for facilities built to anticipate either capacity expansion or stricter regulations. Both of these restrictions seem unnecessary and unwise. There is no reason to expect firms to invest in unnecessary pollution control equipment even if funded under Section 103. If they do invest in a facility which does not satisfy your proposed Section 1.103 - 8(g) (ii) language, it is because to do otherwise would result in a facility that was either uneconomical or technically inadequate. (Firms might also conceivably do more than is required because they have a real interest in cleaning up the environment; but it seems unreasonable to penalize them for this.) Thus, it would appear that if the provision is effective in limiting the size of facilities, it can only result in unnecessary waste.

From a tax-revenue perspective, this provision may also be bad policy. If the first pollution control facility financed under Section 103 becomes obsolete, the owner may claim a one-time loss on the remaining depreciable value, less any salvage value. In present value terms, this process results in a greater tax-revenue loss than would a full depreciation period. Furthermore, the owner will have to install new equipment, which may then be financed under Section 103, resulting in an additional tax-revenue loss, as resources are diverted from productive capital investment (which is not permitted Section 103 financing) to pollution control investment (which is permitted Section 103 financing).

In short, this appears to be a provision which will provide few if any benefits in restricting the use of Section 103 financing, and creates potential economic and budgeting costs. Since there seems to be no legislative history supporting such a restriction, and the provision is likely to have a net negative impact, we strongly recommend deleting it.

PROPOSED §1.103-8(g)(2)(ii) and (iv) - POLLUTION PREVENTION AND PROCESS CHANGES

> Property is not described in the preceding sentence unless it is a unit which is discrete...
>
> Property is not described in this subdivision to the extent that such property avoids the creation of pollutants...
>
> Property is not a pollution control facility to the extent that such property treats or processes a material in such a manner as to prevent the discharge or release of pollutants when such material is subsequently used.

> A facility that removes ele·ents or compounds from fuel which would be release·l as pollutants when such fuels are burned is no· a pollution control facility whether or not such facility is used in connection with a plant or property where such fuels are burned...

EPA is extremely concerned about the implications of these itations on the financing of pollution prevention equipment /or process changes. Although utilizing process changes and venting pollution may be cheaper before taxes, the proposed ulations may provide an incentive to utilize less efficient, -of-pipe strategies.

Furthermore, the legislative history associated with :tion 103(c)(4)(F) clearly does not disallow the tax-free fi- :cing of pollution prevention activities. The Conference mittee Report states that this provision "applies in respect obligations issued to provide air or water pollution control :ilities, such as, for example, those described in subparagraphs)(i) and (C)(i) of section 48(h)(12) of the Code." Neither of :e provisions would appear to disqualify investment that is ed solely for pollution control, but controls the problem fore it becomes a pollutant.

In fact, Congress and EPA clearly consider process changes be not only acceptable, but sometimes necessary or preferable r the purpose of controlling pollution. Section 111 of the ean Air Act, for instance, explicitly refers to process changes d provides for special extended deadlines in cases where the urce is adopting innovative technologies. Further, some firms y be required to institute a process change in order to comply th EPA regulations. This is true both for air and water pollu- on regulations.

For these reasons, while recognizing the problems involved n dealing with these process changes which serve both to re- uce pollution and increase profits, we believe that some pro- ision should be made to allow pollution reducing process hange to receive the benefit of Section 103 financing.

In particular, facilities such as those which remove im- urities from coal in order to allow it to be burned without xceeding emission standards, clearly ought to be allowed Section 103 financing. Thus we would recommend the elimination of the last two restrictions.

For process changes where there is a true "joint product" oblem, (i.e., pollution control and increased production or re- sed costs), we recommend the adoption of the following provisions:

Property is described in this subsection when such property avoids the creation of pollutants; however the following limitations apply to this section:

(a) To the extent that the process change replaces an existing process by making existing equipment obsolete, the following formula shall be used to determine the "cost" of the process change for purposes of this section:

$$\text{Cost} = (N - S - R) + \left[\frac{(N - S - R)}{Ce} \times (Cn - Ce) \right] \quad 1/\ 2/$$

where:

Cn = Capacity of the new process
Ce = Capacity of the existing process
N = Cost of installing the new process x Ce/Cn (i.e. holding capacity constant)
S = Salvage value of any obsolete equipment
R = Cost of original equipment, at today's prices

1/ Note that this formula easily reduces to:

$$\text{Cost} = (N-S-R) \times (Cn/Ce)$$

2/ This formula assumes that the existing equipment has been fully depreciated. However, when the existing equipment has not yet been fully depreciated, the variable "B" should be added to the equation, as follows:

$$\text{Cost} = (N+B-S-R) \times (Cn/Ce)$$

where: B = Remaining book value of existing equipment now obsolete, at today's prices, minus any tax benefits from unrealized depreciation.

(b) To the extent that a process change produces an economic benefit, such benefit should be subtracted from the cost of the process change (as defined in section (a) above) as provided for in §1.103-8(g)(3) to determine the eligible financing portion of the process change. For purposes of this subsection, any increased revenue due to expansion of capacity should not be treated as an economic benefit.

The formula in subsection (a) permits Section 103 financing for only the increment spent to abate pollution. The first half of the formula [N-S-R] accounts for the additional expenditure required for pollution abatement, holding existing capacity constant. The second half of the equation $[\frac{(N-S-R)}{N} \times (Cn-Ce)]$ accounts for any additional pollution control expenditures used for new capacity expansion.

Subsection (b) accounts for any economic benefit that may result from the process change. Since the formula used in subsection (a) calculates cost on the basis of the existing capacity, a capacity expansion is not treated as an economic benefit for purposes of subsection (b).

The suggested language would prohibit a firm from using Section 103 financing for pollution prevention or process change except for that portion of the investment that is for pollution abatement.

PROPOSED §1.103-8(g)(2)(iii)(A) - PREVENT A MAJOR ACCIDENT

> Property is not used for the control of pollution to the extent that it . . . is designed to prevent the release of pollutants in a major accident.

The term "major accident" is undefined and raises unanswered questions as to Section 103 eligibility. We suggest that this term be more clearly defined or illustrated with a few examples. Pollution control equipment that helps to eliminate polluting effluents may also help prevent a major discharge of hazardous materials, thus preventing a major accident. In this instance, it would be unreasonable to disallow Section 103 financing.

PROPOSED §1.103-8(g)(2)(iii)(B) - EMPLOYEE SAFETY

> Property is not used for the control of pollution to the extent that it . . . prevents the release of materials or heat which would endanger the employees of the trade or business in which such property is used (as determined for example by Federal, State or local employee occupational health or safety standards).

Although we agree in principle that employee safety equipment should not be financed with tax free municipal bonds, one clarification is suggested, given the statutory authority. Some substances that are detrimental to the health and safety of the workers inside the plant are also regulated by EPA as a threat to the public health and safety. Thus, we suggest that in cases where the pollutant is regulated by EPA, State or local environmental agencies (whether or not it is detrimental to the workers inside the plant), Section 103 financing should be permitted.

PROPOSED §1.103-8(g)(2)(iii)(C) - CONTROL OF A NUISANCE

> Property is not used for the control of pollution to the extent that it...is used to control materials or heat that traditionally have been controlled because their release would constitute a nuisance.

This provision raises more questions than it answers. No consistent definition of a public "nuisance" in the legal sense exists. Moreover, courts have found that pollution, as normally defined in the Clean Air Act and Federal Water Pollution Control Act is a "nuisance." (See, for example, Renken v. Harvey Aluminum, 226 F. Supp. 169 (D. Ore. 1963) and Boomer v. Atlantic Cement Co., 26 NY 2d 219 N.E. 2d 870, 309 N.Y.S. 2d 312 (1970).)

It appears to be more reasonable to limit Section 103 financing to those pollutants regulated by the Federal or State governments, as was clearly the legislative intent, than to attempt to develop a new and arbitrary distinction between pollutants and nuisances. We therefore recommend this provision be deleted.

PROPOSED §1.103-8(g)(2)(iii)(D) - HAZARDOUS MATERIALS

> Property is not used for the control of pollution to the extent that it...controls the release of hazardous materials or heat that would cause an immediate risk of substantial damage or injury to property or persons.

Although we understand the original impetus behind this provision, we are concerned that it precludes the use of Section 103 financing to control hazardous and toxic chemical substances which are becoming an increasingly serious public health problem. These substances have created some of the worst pollution problems the Nation faces, both from a public health and an economic standpoint.

Several possible alternatives exist that would preserve your intent and offer Section 103 financing for the control of hazardous and toxic pollutants. You may want to exclude from this restriction any pollution control mandated by the Clean Air Act and Federal Water Pollution Control Act. By referring to the control and not the pollutant, you may be able to exclude nuclear containment vessels, yet permit Section 103 financing for any future controls on nuclear power plants specifically required by EPA. This would also permit Section 103 financing for the control of hazardous and toxic pollutants.

Another possibility is to specifically exclude Section 103 financing for controls mandated by the Nuclear Regulatory Commission.

PROPOSED §1.103-8(g)(iii)(E) - CUSTOMARY PRACTICE

> Property is not used for the control of pollution to the extent that it...controls materials or heat in essentially the same manner as the user of such property has previously controlled such material or heat as a customary practice for reasons other than compliance with pollution control requirements. If such user previously has not generated such material or heat at the location where such material or heat is controlled, such customary practice shall be determined by reference to the use of similar property by similarly situated users.

This restriction has no basis in the legislative history. The Conference Committee cited Section 48(h)(12) of the Tax Code as a standard for defining air and water pollution control equipment. This section requires only that a facility be certified by a State or Federal Agency as being in conformity with pollution ontrol requirements, and that the facility's primary purpose be pollution control. For purposes of section 48(h), whether a particular industry previously installed a facility as a customary practice was irrelevant.

There are also some serious public policy issues involved in the provision. The first problem is that this provision penalizes companies that had traditionally spent more because they had taken more socially responsible actions in attempting to reduce pollution. Firms that had acted in a less socially responsible manner are rewarded. Another problem is that determining the amount of traditional control, and carrying out the studies and analyses required to implement this section, is very expensive. It would appear as if the additional cost and delay that this provision imposes on the applicant far exceed revenue savings to the government. Therefore, we strongly prefer that this section be eliminated.

If, however, you believe that it is necessary for there to be some such provision, then we would strongly recommend an approach which would not depend on such a baseline being estimated for each company independently. Instead, we would recommend that the IRS establish fixed baselines either for all business investment or on an industry-by-industry basis. Although we would prefer eliminating the baseline altogether, we believe that this alternative approach would also alleviate some of the administrative burdens imposed under the proposed regulation.

§1.103-8(f)(2)(iii) - DEFINITION OF SOLID WASTE DISPOSAL FACILITY

Since IRS has publicly stated that they are reconsidering the regulatory definition of a solid waste disposal facility for purposes of Section 103, we would like to comment on this provision in advance of its proposal. Our comments on this provision are necessarily of a general nature, as we do not have access to proposed or draft language.

From an efficiency and equity standpoint, the current regulations appear adequate. Defining solid waste is difficult, and the "no value" concept seems reasonable. Furthermore, subsection C does not prohibit Section 103 financing for recycling facilities in general. Thus, the current regulations provide no incentive or disincentive for either solid waste disposal or recycling. Given the statutory authority which applies generally to solid waste disposal facilities, such a neutral policy is reasonable.

Research is currently underway to develop techniques to recycle wastes into energy sources. Government policy has consistently approved of these developments. We would strongly oppose, therefore, any provision that results in a disincentive to recycle instead of dispose of a waste. Thus, in accordance with Government policy and to avoid inefficiencies in the market system, any restriction that IRS proposes should apply to both disposal and recycling.

At the very least, any newly proposed regulatory change should permit financing of disposal and recycling facilities for traditional governmental wastes, such as garbage and sewage. Many municipalities are experimenting with private sector disposal and recycling arrangements. We would strongly oppose any move to restrict this practice.

Senator NELSON. Next we will hear from Mr. Gants, vice president of National Constructors Association.

STATEMENT OF RONALD M. GANTS, VICE PRESIDENT, NATIONAL CONSTRUCTORS ASSOCIATION

Mr. GANTS. Thank you, Mr. Chairman.

My name is Robert Gants, and I am vice president of the National Constructors Association, and also executive vice president of the U.S. and Overseas Tax Fairness Committee. I have a membership list here, which I would like to submit for the record.

Senator CHAFEE. The National Constructors Association?

Mr. GANTS. Yes, sir.

Senator CHAFEE. With what are they involved overseas?

Mr. GANTS. They are large, heavy industrial construction firms. They design and build process facilities such as powerplants, steel mills, et cetera. They are for the most part engaged in both domestic and international work.

Senator CHAFEE. How many members?

Mr. GANTS. The Constructors Association has 55 members. The Tax Fairness Committee has 60 members. The Tax Fairness Committee comprises also manufacturing concerns and individuals, all of whom are engaged in international work.

Senator CHAFEE. The big contractors, such as Bechtel, Brown, and Root, and people like that?

Mr. GANT. That is correct, Senator.

Senator CHAFEE. Any from Wisconsin?

Mr. GANT. As a matter of fact, Senator, we have several supply organizations that supply goods, equipment, and material that is used in our projects from Wisconsin, everything from orange juice manufacturers, can manufacturers, to travel homes, and things like that.

Senator NELSON. Senator Chafee, that was the most penetrating question asked all day. [Laughter.]

Mr. GANT. Senators, my sole purpose here is to talk about the need in any tax legislation that emanates from the Congress this year to consider and to try to remedy the situation with which we are faced in the international marketplace that has resulted in a tremendous deficit in the balance of trade in this country, losses of jobs both here and abroad, and a loss of marketshare worldwide. I am talking about sections 911 and 913 of the Income Tax Code.

This is a trade issue as well as a tax issue, and it is of great concern to American business both here at home, and American business trying to compete in the competitive international marketplace. Being competitive is what I am talking about.

In order to be competitive you have got to be there. You have to have on-the-scene knowledge, a knowledge of the marketplace. You have to have contacts, and you have to have credibility where you are trying to sell American goods and products. As I say, that depends on whether you are there. You have to be there.

You cannot maintain your place in the international marketplace by reducing your presence abroad. Yet, this is exactly what this nation has done over the past 10 years. We have dropped from 23 percent of the world market share to less than 14 percent in a decade.

The stark fact is that the United States is the only nation that taxes solely on the basis of citizenship. Among the industrialized nations in the world competing in the international marketplace, we are the only nation that effectively taxes its citizens working abroad. Because of that added tax premium it costs substantially more to employ Americans overseas than it does to employ people from other industrialized nations. Let me give you some brief examples here.

One engineering and construction company reported on March 27, 1980, that it now only employs 103 Americans overseas, down from 2,200 in 1977. Sheik Ashemimry of Saudi Arabia was recently reported as saying, and I want to read this for the record:

> It is unfortunate for both the United States and Saudi Arabia that a trend is developing to cut down on the materials, technology, and expertise being exported from the United States to Saudi Arabia.
>
> Many bright, highly educated American technical experts have left Saudi Arabia because of America's foreign tax laws. We can attract experts from England, France, Germany, Korea, Japan, and so on, for much less money because their countries do not tax their citizens working abroad. They encourage them to work abroad. They know that their citizens will return, and spend the bulk of their money in their motherland. Since the U.S. foreign taxes, no longer encourage the American citizen to work abroad, America is suffering the additional loss of having a people to people contact which is the basis of most friendships between countries.

Senator Chafee. Mr. Gants, some people suggest that this may be kind of a good thing, to reduce the Americans, and you hire the natives. Thus, we are bringing along these third world nationals. Is that the way it works out?

Mr. GANTS. That is exacly what is happening, and it is not a good thing. For instance, if you have a French procurement agent procuring the goods and equipment for the job, he tends to specify goods and equipment with which he is familiar. They tend to come from his motherland.

Senator CHAFEE. I meant that the employees that you replace the Americans with, do they come from that country, like Saudi Arabia where they are working, or do they come from some other third nation like Great Britain, or West Germany?

Mr. GANTS. They tend to come from third countries like West Germany, Great Britain, and Canada.

In short, what is happening is that Americans are being replaced on these jobs overseas, and that is cutting down on American jobs, and it is increasing unemployment back here in the United States. In addition, those goods and equipment that would have been manufactured for those jobs back here in the United States are not being ordered from the United States, increasing unemployment further.

We have been challenged on this. We have been asked to prove that there is some linkage between Americans working abroad and U.S. exports. So we asked Chase Econometrics, the subsidiary of the Chase Manhattan Bank, to make a study for us to find out: No. 1, if there is any linkage between Americans abroad and exports; No. 2, if there is an impact on business and unemployment; and No. 3, is there any impact on tax receipts to the U.S. Treasury.

I have the report here, and I will submit that for the record.[1]

Sure enough, Chase found a 10 percent drop in Americans overseas equates, at a minimum, to a 5 percent drop in U.S. exports. It reduces Federal, personal, and corporate income taxes by $6 billion. It increases domestic unemployment by 80,000. It reduces State, local, and corporate profit taxes in the first year by $700,000, and it reduces local personal tax by at least $100 million.

So what I am saying, Senators, is—this is not a tax cut proposal we are advocating. We are advocating a tax gain proposal. Reduce taxes on Americans working abroad, so that they can compete in the international marketplace, and maintain our fair share. We will return money to the U.S. Treasury far in excess of the so-called tax cut.

Senator NELSON. We will have additional questions, which will be submitted in writing, to which I hope you will respond.

Mr. GANTS. We will be happy to.

Senator NELSON. Thank you very much.

[The prepared statement of Mr. Gants follows:]

[1]The report was made a part of the official committee file.

U.S. & OVERSEAS TAX FAIRNESS COMMITTEE, INC.
STATEMENT FOR THE RECORD
THE UNITED STATES SENATE
SENATE FINANCE COMMITTEE

July 31, 1980

SUBJECT: U.S. TAXATION OF AMERICANS WORKING OVERSEAS: A MAJOR BARRIER TO U.S. EXPORTS

OUTLINE

I. U.S. taxation of Americans Overseas operates as "tariff" on the export of U.S. goods and services.

A. The solution is to put Americans overseas on the same tax footing as citizens of the competing industrial nations.

1. No other industrial nation taxes foreign earned income.

2. The other industrial nations are therefore more competitive overseas.

B. U.S. presence in overseas markets is vital to exports.

1. If we want people overseas to buy our goods and services, we've got to have a significant presence in the marketplace, and we've got to be competitive.

2. We can't maintain our share of exports by reducing our presence.

C. U.S. tax policies are forcing Americans to abandon overseas markets and return home as our case histories and data prove.

II. We commissioned Chase Econometrics to perform an independent study assessing the value of an American presence overseas.

   A. The Chase study determined:

      1. The linkage between the presence of Americans overseas and U.S. export performance.

      2. The impact of the downward trends in the employment of Americans overseas on U.S. exports and on U.S. business revenues.

      3. The impact on U.S. tax receipts.

      4. The overall benefit to our economy.

   B. The testimony presents the Chase findings with corroborating data from other studies. In summary:

      1. U.S. export loss is about 5% for 1980 because of current tax practices.

      2. Tax revenue loss is about $6 billion.

      3. Job loss is easily 80,000 in first year, much more later--perhaps one million (according to corroborating study by Georgetown Center for Strategic and International Studies.)

III. Action is needed in 1980

   A. Americans must have an incentive to go overseas.

   B. The incentive--though it involves elimination of taxes on foreign earned income--will not cost government real tax revenues; on the contrary, the government will gain upwards of $6 billion in revenues.

U.S. & OVERSEAS TAX FAIRNESS COMMITTEE, INC.
STATEMENT FOR THE RECORD
THE UNITED STATES SENATE
SENATE FINANCE COMMITTEE

July 31, 1980

SUBJECT: U.S. TAXATION OF AMERICANS WORKING OVERSEAS: A MAJOR BARRIER TO U.S. EXPORTS

Mr. Chairman and Members of the Committee:

The purpose of this statement is to present a review of the case—as supported by recent studies, case histories and trade flow trends—for new tax laws designed to put Americans at work overseas on the same tax footing as the citizens from the other industrial countries with which we must be competitive in worldwide markets.

Few trade issues—and this is a trade issue first and foremost—are of as much concern to American businesses and American citizens attempting to compete in overseas markets than problems created by the U.S. insistance on taxing foreign earned income.

Two years ago, in material we presented to the Senate Finance Committee, we observed that the continued U.S. taxation of foreign earned income was, for all practical purposes, operating as "huge tariffs" imposed by our own government "on the export of certain goods and services that originate in our own country." We went on to observe of the "tariff" that, "It's pricing us out of competition. It's helping the industrial nations with which we must compete increase their share of the international market at our expense."

The basic problem remains the same today. Despite passage of remedial legislation in 1978--legislation we all hoped would work--the tax burden on overseas Americans continues to remove them from competition. In fact, in some cases, the 1978 legislation is proving even more onerous than the disastrous 1976 changes.

The only workable solution, as all of the following material demonstrates, is to put American citizens working overseas on the same tax footing as citizens from all of the other nations competing in international markets.

To do less is to deny Americans at home jobs that flow from exports created by the presence of Americans in overseas markets. In the final analysis, the data simply document, in no uncertain terms, what anyone with experience in foreign markets knows as a matter of experience and just plain business sense: If you want people to buy your goods and services, you've got to have a significant presence in the marketplace, and you've got to be competitive.

Trade is a highly social process and depends on our on-the-scene knowledge of the marketplace, our contacts and visibility and our credibility. In today's international economy--a system our nation substantially created--we can't maintain our place in the market by reducing our presence. On the contrary, we should be doing everything we can do to increase it--and by a very considerable percentage. Yet, after all of the data and studies and case histories are assessed, it will be obvious that we've been reducing our presence in recent years--and have dropped from over 23% of worldwide market share to less than 14% in a decade largely as a consequence.

- Discriminatory Taxation of Americans

The U.S. is the only nation that taxes solely on the basis of citizenship. Among the industrial nations only the U.S. taxes the incomes earned by its own citizens at work in foreign countries.

Because of the added tax premium on Americans overseas, it costs substantially more to employ Americans overseas than it does to employ citizens of other nations. Our data and case histories show the resulting cost of one American in low tax countries can be as much as twice the cost of equally qualified citizens from other nations.

Tax Fairness Committee
July 21, 1980
Page Three

In effect U.S. tax policies discriminate against the employment of Americans in overseas markets.

Here are some examples of the results of the discriminatory tax practices:

- One engineering and construction company reported on March 27, 1980 that it now employs 103 Americans overseas, down from 2200 in 1977.

- Teleconsult reports that, on a small job in Jordan, "We have had to replace all but 2 of the 14 American engineers with foreign engineers."

- Berger International reports that on a project in Nigeria it has been forced to cut its staff of 35 Americans in 1977 to 2 in 1980. The firm further reports that, before 1976, 40% of its staffing overseas was American and that by late 1977 the percentage had been cut to 17%.

- Others report similar experiences:

  - "Our manpower commitments are increasingly being met by supplying personnel from our affiliates in U.K., Italy, France, and Spain. In a major contract in Saudi Arabia, 95 percent of the 300 expatriate supervisors, including those at top level, are supplied by our U.K. affiliate. This work force mix has obvious ramifications as far as purchasing policies are concerned."

  - "This is to advise that we currently have 3 key positions on a highway construction management project in Kuwait which we have been unable to fill with Americans because of the potential tax liabilities. Over the past several months we have filled 6 key positions with Englishmen and Europeans because of our inability to recruit American staff."

Tax Fairness Committee
July 21, 1980
Page Four

- Aramco notes in a survey completed in February 1980 that, "In 1970, 50 percent of Aramco's expatriate (non-Saudi) workforce of 1,725 employees was American." In contrast, because of U.S. tax practices, Aramco's report continues, "Americans are now only 23 percent of the 16,500 employee expatriate workforce and number some 3,800 rather than the 8,200 as would have been the case if U.S. expatriates had remained at the 50 percent level.

- The Associated General Contractors noted a recent trend for construction contracts on U.S. military, U.S. taxpayer- funded projects abroad to be awarded foreign construction firms because "our government after materially increasing our prices [through taxes on foreign earned income]" finds that we are no longer price competitive!

- Abdullah Dabbagh, a Saudi diplomat, said two months ago in New York that, "Americans are still being taxed out of competition in overseas markets." He notes that in 1976, 65% of employees in U.S. firms operating in Saudi Arabia were Americans. The figure is now down to 35%.

- A study by Jennifer D. Milre, M.A. of the U.S. tax impacts on the presence of Americans in England, points to a 20% decline since 1975 despite the fact that England is a high tax country where the impact of U.S. taxes would not be as great.

On the basis of data we've recently compiled and which we're currently evaluating it appears that, as compared to four years ago, we'll shortly have about half the number of Americans overseas largely because the cost of maintaining U.S. workers overseas has risen prohibitively because of U.S. tax practices.

Tax Fairness Committee
July 21, 1980
Page Five

• <u>No Clear Evidence</u>

As recently as February 1980, in a covering letter for a U.S. government report entitled <u>Equitable Tax Treatment of United States Citizens Living Abroad</u>, the observation was made that, "The various studies undertaken on the tax of Americans living abroad do not yet provide clear evidence of the competitive disadvantage and its impact." The report went on to question the merits of an American presence overseas observing at one point that:

> "Employment of Americans abroad may or may not generate goodwill. It would be inaccurate to generalize. In some environments, the presence of Americans abroad has favorable impact; in other environments the impacts may be negative."

Finally, the report goes on to assert that, "Most U.S. export activities take place in the United States," the point apparently being that foreigners who want what we have to offer will come to us; we need not go among them to push our wares.

Given that kind of thinking, which leaves a great deal to be desired just on the face of it, we set about to document the value of "an American presence overseas."

Specifically, we asked Chase Econometrics to undertake an independent study of the impacts of current U.S. tax practices on the capacity of Americans to compete overseas. We asked Chase then to determine the extent to which Americans employed overseas were being replaced by non-Americans. The task for Chase was then to determine:

- The linkage, if any, between the presence of Americans overseas and export performance.
- The impact, if any, of the downward trends in the employment of Americans overseas on U.S. exports and on U.S. business revenues.
- The impact, if any, on U.S. tax receipts.
- The overall benefit to our economy.

Tax Fairness Committee
July 21, 1980
Page Six

What follows are the findings to date of the Case study as augmented by case histories, examples and data collected by our own staff and by our member firms.

- Linkage

Chase, in its preliminary finding, concludes that:

> "The increased cost of employing U.S. workers overseas and the reduction in the number of U.S. workers overseas reduces the competitiveness of U.S. goods and services abroad and results in a substantial drop in exports."

Additionally, with substantial data to back it up, Chase notes that:

> "The return of American workers from overseas will increase the domestic labor force but will not increase the number of domestic jobs. Therefore, domestic unemployment increases."

Perhaps most significantly, Chase concludes, after thorough examination of prior studies on the subject, and evaluations using its own well established macroeconomic model of the domestic economy, that there is a direct, causal linkage between the presence of Americans in overseas markets and the sale of U.S. goods and services.

Although there are a number of variables, depending upon market sector and various market biases on a country-by-country basis, Chase concludes that it is generally the case that a 10% drop in Americans overseas <u>leads to a 5% drop in U.S. exports</u>. Chase concludes that that is a conservative general ratio.

The 5% trade loss estimate is not, as has been suggested, based on a single source. It is based on many sources and indicators. They include findings and data from the General Accounting Office, the Treasury and Commerce Departments, 156 respondents from the overseas American Chambers of Commerce at last count, McGraw-Hill and others. They include original data generated by the Chase surveys. <u>All</u> point to 5% as a <u>reasonable</u> -- and probably conservative -- estimate. In fact, the Chase survey findings, to date, indicate in their own right that the 5% figure is understated. It is what it is represented to be -- a cautious and reasoned estimate.

On the basis of the data collected from the overseas American Chambers of Commerce (AmChams) as just one example, Chase notes that the 5% estimate is well within the safe range. In a progress report to the Tax Fairness Committee, Chase says:

> "AmCham respondents estimated that reduction in the number of U.S. workers in their firms would, on average, reduce exports by about the same percentage (i.e., an elasticity of about 1.0). As in other areas, there is a wide dispersion in responses; but the average is quite credible. While it is somewhat higher than the 0.5 elasticity computed by Treasury (OTA study #33), it is not greatly different. If we apply the lower elasticity of 0.5 to the 10 percent existing decline in employment, the implied reduction in exports is 5 percent. If we were to take the higher elasticity and expected 1980 decline in employment, we would obtain an estimated reduction in exports of 10 percent or higher.

It should be noted that Chase does not say that exports will decrease in absolute terms by 5%. Chase says that because of current U.S. taxes on Americans overseas the level or trajectory of exports will be about 5% less than it would otherwise have been. The distinction is considerable. If the momentum of exports, for other reasons, increases in absolute terms, then the 5% loss or reduction in potential volume becomes correspondingly greater. Obviously, 5% of a larger number is . . . a larger number.

The estimate was therefore used with complete confidence in the highly regarded Chase model of the domestic economy for purposes of assessing both business and tax revenue impacts. The Chase model has 10 years of application behind it. And it is of course widely used by U.S. businesses and many agencies of government.

Significantly, no one has really challenged Chase on the more substantive points of the study. They are the points on which its value really rises or falls. Those points are that there is a direct causal link between the presence of Americans overseas and U.S. exports and that current U.S. tax policies are choking off that presence. The supporting data are extensive. It follows the basic points that the result is a very real loss in business and attributable tax revenues. The question is, "How much?" Chase says about 5% with ample evidence to support it.

Independent of other data that point to the same general conclusion, Chase finds that current tax policies have forced U.S. engineering and construction firms to reduce overseas employment of Americans by about 56% and the aggregate employment of Americans overseas by U.S. firms by 9% to 11%. The trend is accelerating.

If, however, you choke off part or all of the exports attributable to a direct American presence overseas by writing tax laws that force Americans to return home, you deny yourself the business and the jobs and all of the revenues--corporate and tax--that would flow with it.

• Jobs Abroad, Jobs At Home

The general finding of Chase as corroborated is no surprise to us, though the supporting data, combined with the testing of the data in the Chase model of the domestic economy, add substantial support to our basic thesis. The findings and all of the case histories and corroborating evidence cannot be dismissed as insufficient.

Treasury's counter is that it has no data of its own to support that finding. Attempting to dismiss the voluminous Chase data as merely "anecdotal--even though all compiled data are inherently based on anecdote or specific instances--Treasury urges that no remedial action be taken now. Treasury essentially wants everyone to wait until it can catch up with Chase. That hardly constitutes a reasoned challenge to the overwhelming weight of the Chase findings. If Treasury proposes to rely on returns filed by Americans working overseas to verify the Chase findings, its data will not be complete until 1982 tax returns are filed and evaluated. Given the full weight of the Chase study and the unrelenting trade deficits of the last four years, it is questionable that our economy should be required to tolerate two more years of inaction while we "wait and see."

Even if Chase were to concede <u>for the sake of discussion</u> that it has overestimated the impact by 500%, the business and attributable tax revenue losses still far exceed all revenues Treasury may hope to collect by keeping current tax practices in place. That holds true even if the Treasury Department's own demonstrably highly inflated static tax cost estimates are used. But of course such a concession by Chase is not warranted by the facts.

That Americans at work overseas create new markets for U.S. goods and services and generate new jobs for our domestic economy are reflected, further, in a large number of case histories, a sampling of which we present below:

- A member of the U.S. & Overseas Tax Fairness Committee, (TFC) which represents 60 large firms attempting to do business overseas, performed an analysis of a loss of 25 contracts in one year with a total value of $1.3 billion and found that:
  - The losses cost 598 potential U.S. engineering and construction supervisors jobs overseas;
  - The losses cost conservatively 1800 jobs in the U.S. for engineering support;
  - The losses cost $637,594,000.00 worth of goods and services that were to have been purchased in the U.S. or about 13,000 jobs associated with those lost export sales by conservative estimate.

- Other engineering and construction firms report that, though judged technically best qualified on the short lists, they've been disqualified on the basis of costs attributable to U.S. tax policies. For 1978, a sampling of major losses to U.S. firms included documented contract losses of $4.157 billion for one, $4.076 billion for another, and $1.4 billion for a third.

- Berger International reports that it is in trouble in Nigeria (which has a $5 billion surplus position with the U.S.) on a sewage infrastructure project for Abuja, a new city for 3 million people with 5 new satellites of 100,000 to 200,000 people because of its inability to staff with Americans--and faces diversion of equipment sales from the U.S. to the U.K. valued at $36 million for the first phase (or approximately 5% of the total amount).

- Tippetts-Abbett-McCarthy-Stratton (TAMS) notes that its "only product is professional services" and that "75% of our revenues are generated from overseas contracts." TAMS says that "30% of our professional staff is stationed overseas and 60% of our home office man-power concerns projects overseas."

- Loss In International Market Share

We're finding that, since 1976 when Congress reversed long-standing tax exemptions on foreign earned income, our worst fears and projections have proved modest. For example, in that time:

- The U.S. engineering and construction industry share of the Middle East market has dropped from over 10% to less than 1.5%.

- Worldwide, we've dropped from first place in contract awards among the competing industrial nations in 1976 to seventh place as of the quarter ending in March 1980 for a 4.9% share of worldwide construction in 1979 as compared with 16% in 1976.

- Tax Cost That Is Not A Tax Cost

The Chase study estimates a loss of at least 5% in exports in 1980 as a result of current tax practices and notes that:

> "The drop in U.S. income due to a 5 percent ~~drop in~~ real exports will raise domestic unemployment [by 80,000] and reduce federal receipts from personal and corporate income taxes by more than $6 billion, many times the value of increased taxes on overseas workers."

Clearly, reductions in the numbers of Americans at work overseas mean fewer Americans overseas to pay taxes. Fewer American taxpayers overseas means a smaller tax base overseas. If current trends continue based on available case samplings and corresponding conclusions reached by Chase, the number of Americans working overseas, as compared with early 1976, will soon be cut by half. Likely, seventy-five percent or more of potential new positions that would normally be staffed by Americans will go to non- Americans.

The fact is that the Treasury estimates of the "tax costs" or "revenue loss" of substantially removing taxes on foreign earned income are completely static and assume no change in taxpayer behavior. That assumption, as has been shown, runs counter to the facts.

The fact is that there is no actual tax cost if there is no actual tax source. You can't tax people who aren't there.

Using our own data and the data being developed for us by Chase, we find that the maximum real world tax cost to the Treasury, assuming complete elimination of U.S. taxes on foreign earned income, would not exceed $215 million as compared to figures currently being floated by Treasury that range from $495 to over $700 million.

In contrast, as has already been noted, a complete reversal of current tax practices which would effectively eliminate U.S. taxes on most Americans overseas would over a twelve month period result in an increase of at least 5% in U.S. exports or more than $6 billion in real net tax revenues. More sales and more jobs mean more tax revenues. Lost sales mean no tax revenues.

It should be noted that if the U.S. were to recapture the market share it has lost since 1969 its trade flow accounts would once again be in surplus on the export side. As matters now stand, due to the taxation of Americans overseas, we face an additional loss of over $16 billion in trade in 1980, and likely more than that each year following.

It is also noted by Chase that if Americans are not overseas generating new jobs, then they're back home absorbing existing jobs at a time when there aren't enough jobs in the domestic economy to go around. They're swelling the welfare rolls--and therefore tax costs--not the tax rolls. Chase estimates that the added welfare costs may be at least $200 million.

The proposal to put Americans working overseas on the same tax footing as citizens from all of the other competing industrial nations at work in foreign countries--what we call competitive tax equity--does not involve a real tax or revenue cost. On the contrary, it will produce a very large net tax revenue gain--and it will do so very rapidly.

The assertion is sometimes made that the Chase study is invalid because it is too early to judge the export effects of current tax practices and that there were, in any case, no effects from the Tax Reform Act of 1976 because it never took force.

That assertion is wrong.

In 1976 Congress made a basic change in the tax treatment of Americans working overseas. It eliminated the traditional $20,000 exclusion off-the-top and replaced it with a $15,000 exclusion off-the-bottom (which resulted in an actual maximum tax benefit of less than $3005).

The fact is that by 1976, the $20,000 exclusion off-the-top was already woefully inadequate. Its effect had virtually been nullified by rampant inflation overseas. In that light, the effect of the 1976 action cannot be overstated. The action had a deep psychological effect. And because it was seen as a major shift in traditional export policies, it caused considerable changes in corporate overseas marketing strategies and commitments.

Tax Fairness Committee
July 21, 1980
Page Twelve

Despite the fact that implementation of the law was twice delayed, the fact cannot be ignored that it was the law: All business and personal decisions had to be made on the assumption that the 1976 action would sooner or later take force. It had, as Chase verifies, profound effect.

At least as profound was the impact of two Tax Court Rulings in 1976. Those rulings, for the first time as a matter of actual tax practice, made all employer "keep whole" contributions to the employee taxable as income to the employee. The practice took force from the date of the rulings in 1976. The rulings remained fully in force until the provisions of I.R.C. Section 913 provided some relief late in 1978. Even then, relief was clouded in an eighteen-month effort on the part of The Treasury Department to write highly restrictive regulations that would virtually wipe out the effects of Secton 913. For the interim period every American overseas had to proceed in his or her personal planning on the basis of the court rulings as did any U.S. company hiring Americans for overseas assignments.

The impacts of the 1976 and 1978 actions were immediate, real and sustained. They set in motion momentum which continues--the forced return of Americans from overseas markets.

Chase was asked to document the effects, which it has done and which it is continuing to do even more fully. What Chase is reporting -- and what the data irrefutably show--is what has been happening since 1976 and even more specifically since 1978. And it is showing what is happening right now. There's nothing hypothetical about it.

Chase reports that:

> "While the GAO study addressed the expected impact of the 1976 law, our survey of AmCham and NCA firms concentrated on the actual impact of the changes which have occurred, especially since the 1978 law. Treasury estimated that the impact of the 1978 law is much lower than 1976 law, yet our survey results indicate that firms have actually incurred incremental costs due to the 1978 law that are very similar to the incremental costs which they anticipated from the 1976 law."

Quite simply, Chase shows that the result is that the rate of employment of Americans overseas is in a very steep decline, more so in some sectors--especially in manpower intensive service industries--than in others.

- Action This Year

The question is, Where do we go from here?

The answer is not easy, we know. The causes of the imbalances in the trade accounts are many and complex. No one seriously suggests that there is a single cause. Our government has created many export disincentives at a time when it should be creating incentives. We must reverse course.

We suggest that of all the trade disincentives currently in operation, none can be reversed as readily or produce more immediate positive results than the current U.S. practice of taxing the incomes earned by Americans abroad.

Action this year--within the next few months--can effectively slow the momentum toward further trade flow deficits and get the flow headed in the other direction. If we do not get action in the next few months, we'll likely be meeting at about this time next year--many more billions of dollars in the hole and with a needless toll in additional U.S. unemployment, as the Chase and other studies show.

We'd like to make the point that this country's trade policies must also take into account the many non-trade benefits of an American presence overseas-benefits that are, or should be, obvious. It takes little imagination to realize the potential damage to our future influence in the Middle East that stems from the fact that, due almost entirely to U.S. tax policies, the percentage of Americans on the faculty at the University of Petroleum and Minerals in Dhahran, Saudi Arabia, has dropped from 89% in the early 1970's to less than 15% today. That's where many of the future leaders in the Middle East are now in training. Think what that shift will cost our nation--its vital interests, influence and security--in the years ahead. It is symptomatic of a process that is in full flood around the world.

Tax Fairness Committee
July 21, 1980
Page Fourteen

It must be stopped.

Our current tax practices wholly ignore the value to the U.S., in the international marketplace, of American dedication, drive, energy and resourcefulness--things we take for granted here at home and that are built into our culture and work ethic. But anyone with experience knows that they give us a substantial advantage in overseas markets--an enormous appeal--if we can afford to keep Americans in the international marketplace. And that, of course, goes to the issue.

Americans must have incentives to work overseas. They must at least be on the same tax footing as the citizens from the competing industrial nations. And we're showing you today that the incentives we need will cost the Government nothing. It will net the government billions of dollars in added real tax revenues.

We thank you for your interest and hope with your help we'll start to move back toward our proper share of overseas markets this year.

Senator NELSON. We will take the two members of the last panel first because one of them has a travel problem. So I would proceed now and call upon Mr. Max Karl, chairman of the board, Mortgage Guaranty Insurance Co.; and Mr. W. C. Smith, president, Franklin Towne Realty, Inc.

I have a statement that I will not read at this time, but I would ask that it be printed in the appropriate place in the record.

[The prepared statement of Senator Nelson follows:]

STATEMENT OF SENATOR GAYLORD NELSON
BEFORE THE FINANCE COMMITTEE
JULY 31, 1980

TODAY THE FINANCE COMMITTEE CONCLUDES 7 DAYS OF HEARINGS ON PROPOSALS FOR INDIVIDUAL AND BUSINESS TAX REDUCTIONS

IT IS IMPORTANT THAT ANY TAX CUT MUST BE TARGETED TO HELP THE ECONOMY AND IMPROVE PRODUCTIVITY WITHOUT IN ANY WAY REFUELING ANOTHER INFLATIONARY EXPLOSION.

YESTERDAY, I INTRODUCED THE SMALL BUSINESS INVESTMENT ACT OF 1980. IT REPRESENTS A TAX REDUCTION PROGRAM WHICH CONGRESS AND THE NATION CAN AFFORD.

THE PROGRAM IS NON-INFLATIONARY, INEXPENSIVE AND TARGETED AT INCREASING PRODUCTIVITY IN THE MOST IMPORTANT SEGMENT OF OUR ECONOMY - THE SMALL BUSINESS COMMUNITY. SMALL BUSINESSES WHICH ACCOUNT FOR A SIGNIFICANT PERCENTAGE OF OUR GROSS NATIONAL PRODUCT AND PROVIDE MORE THAN HALF OF THE JOBS AND TECHNOLOGICAL ADVANCEMENTS IN THE PRIVATE SECTOR ARE IN DESPERATE NEED OF INVESTMENT CAPITAL NOT ONLY TO EXPAND AND GROW BUT MERELY TO SURVIVE.

THIS PROPOSAL WILL PROVIDE SIGNIFICANT RELIEF TO NOT ONLY SMALL BUSINESSES BUT ALL BUSINESS IN MEETING THEIR CAPITAL FORMATION REQUIREMENTS.

THE STUDY OF THE PROBLEMS RELATED TO CAPITAL FORMATION BEGAN SOME FIVE YEARS AGO UNDER THE AUSPICES OF THE SENATE SELECT COMMITTEE ON SMALL BUSINESS. THE COMMITTEE INITIATED A SERIES OF HEARINGS BEGINNING IN 1975. SIGNIFICANT LEGISLATIVE PROPOSALS WERE DEVELOPED BASED ON INFORMATION GATHERED AT THOSE HEARINGS. MANY OF THESE PROPOSALS HAVE ALREADY BEEN ENACTED INTO LAW. AMONG THEM, A SUBSTANTIAL REFORM OF THE FEDERAL ESTATE AND GIFT TAX LAWS AFFECTING THE INHERITANCE OF FARMS AND SMALL BUSINESSES; AN INCREASE IN THE AMOUNT OF USED MACHINERY AND EQUIPMENT ELIGIBLE FOR THE 10 PERCENT INVESTMENT TAX CREDIT FROM $50,000 TO $100,000; AN INCREASE IN THE CORPORATE SURTAX EXEMPTION FROM $25,000 TO $100,000; AND ENACTMENT OF THE MOST EXTENSIVE GRADUATED TAX RATE STRUCTURE SINCE THE INCEPTION OF THE FEDERAL CORPORATE TAX IN 1909.

THESE CHANGES HAVE HAD A SIGNIFICANT IMPACT ON EASING THE CAPITAL FORMATION PROBLEMS OF SMALL BUSINESS. BUT MUCH MORE NEEDS TO BE DONE IF OUR NATION'S INNOVATIVE AND INDEPENDENT BUSINESS COMMUNITY IS TO PROSPER AND PROVIDE MORE JOBS AND INCREASED PRODUCTIVITY. INDEED, IN THE PRESENT ECONOMIC CLIMATE, MUCH MORE NEEDS TO BE DONE TO INSURE THE VERY SURVIVAL OF THESE BUSINESSES.

EARLIER THIS YEAR, THE FIRST WHITE HOUSE CONFERENCE ON SMALL BUSINESS WAS HELD. THIS CONFERENCE FOCUSED NOT ONLY ON THE CAPITAL FORMATION REQUIREMENTS OF SMALL BUSINESS, BUT ON SUCH DIVERSE PROBLEMS AS REGULATORY REFORM, PATENT POLICY, INFLATION, INNOVATION AND THE DEVELOPMENT OF A SMALL BUSINESS EXPORT POLICY. THE DELEGATES TO THE CONFERENCE CAME FROM EVERY STATE IN THE NATION, AND THEY PRODUCED A SERIES OF LEGISLATIVE RECOMMENDATIONS WHICH REPRESENT AN ATTEMPT TO INJECT NEW CAPITAL INTO THE NATION'S CASH-STARVED SMALL BUSINESSES.

AS CHAIRMAN OF THE SENATE SMALL BUSINESS TASK FORCE, I HAVE JOINED WITH MEMBERS OF THIS COMMITTEE IN INTRODUCING AND ENDORSING MANY OF THE WHITE HOUSE CONFERENCE RECOMMENDATIONS IN THE CAPITAL FORMATION AREA. MANY OF THESE PROPOSALS ARE CURRENTLY PENDING BEFORE THE FINANCE COMMITTEE AND HAVE BEEN THE SUBJECT OF HEARINGS BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT.

THIS MEASURE REPRESENTS A RESPONSIBLE APPROACH TO A PRODUCTIVITY RELATED TAX CUT. IT CONSISTS OF A SERIES OF PROPOSALS WHICH EMBODY THE WHITE HOUSE CONFERENCE RECOMMENDATIONS FOR INCREASING CAPITAL FORMATION FOR SMALL BUSINESS. THEY ARE PROPERLY STRUCTURED, CAREFULLY PHASED-IN, AND WILL NOT COST MUCH MONEY. INDEED, THE FY 1981 REVENUE LOSS WILL BE APPROXIMATELY $75 MILLION. IN THE LONG RUN THE PROPOSALS MAY ACTUALLY INCREASE FEDERAL REVENUES AS A RESULT OF THE NEW JOBS AND ENHANCED PRODUCTIVITY THEY WILL CREATE.

TODAY'S PANEL OF EXPERT WITNESSES SHOULD PROVIDE THE NECESSARY INFORMATION FOR THE DEVELOPMENT AND IMPROVEMENT OF THIS PROGRAM. I LOOK FORWARD TO REVIEWING THEIR TESTIMONY.

OUR NEXT PANEL OF WITNESSES CONSISTS OF MR. MAX KARL AND MR. W.C. SMITH.

MR. MAX KARL IS CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER OF MGIC INVESTMENT CORPORATION. MR. KARL'S COMPANY IS PRIMARILY ENGAGED IN THE BUSINESS OF PROVIDING MORTGAGE INSURANCE FOR RESIDENTIAL HOUSING LOANS. HE HAS FIRST HAND KNOWLEDGE OF THE MANY ECONOMIC DIFFICULTIES OF THE HOME BUILDING INDUSTRY AND HE IS IN A UNIQUE POSITION TO UNDERSTAND THE CONCERNS OF THE NATION'S POTENTIAL HOME BUYERS.

MR. W.C. SMITH IS A PITTSBURGH BUILDER, DEVELOPER AND REALTOR WHO HAS LONG BEEN ACTIVE IN MAKING MORE HOUSING AVAILABLE AT A LOWER COST TO OUR NATION'S YOUNG HOMEBUYERS.

-3-

THIS PAST APRIL I INTRODUCED THE HOME MORTGAGE ASSISTANCE ACT OF 1980, S. 2560. THIS MEASURE WOULD PROVIDE AN EXCLUSION FROM GROSS INCOME FOR INTEREST AND DIVIDENDS EARNED ON SAVINGS DEPOSITS WHICH ARE USED BY THE DEPOSIT INSTITUTION FOR RESIDENTIAL MORTGAGE LENDING PURPOSES.

MR. KARL AND MR. SMITH WILL BE ADDRESSING THEIR REMARKS TO THIS PROPOSAL. THEY WILL BE FOLLOWED BY A PANEL OF WITNESSES REPRESENTING THE SMALL BUSINESS COMMUNITY WHO WILL BE TESTIFYING ON THE CAPITAL FORMATION PROBLEMS FACED BY SMALL BUSINESSES.

Senator NELSON. I will ask you to identify yourself for the reporter, and proceed.

STATEMENT OF MAX KARL, CHAIRMAN OF THE BOARD, MORTGAGE GUARANTY INSURANCE CORP.

Mr. KARL. Mr. Chairman, and members of the committee, my name is Max H. Karl. I am a native of Milwaukee, Wis., and I am chairman of MGIC Investment Corp. of that city.

Twenty-three years ago I founded Mortgage Guaranty Insurance Corp., the principal subsidiary of MGIC Investment Corp. and the Nation's first and largest private mortgage insurer of this modern era.

I realize that this committee is working to find the best ways to reduce the overall burden of individual and business taxation in ways that will provide jobs, encourage capital formation, improve productivity, minimize inflationary pressures, and generally stabilize our volatile economy.

I genuinely believe that the single most important and direct path toward those objectives lies in addressing the problems in the housing sector of the economy, since it is problems in that sector that have both triggered and borne the brunt of our last two painful recessions.

I have been a long-time student of thrift and home ownership in the United States and throughout the world. What I see today distresses me greatly. The Nation and the world face a debilitating capital shortage. A decade of rapid growth in many nations and accelerating inflation has reduced savings flows greviously. Nowhere is this more evident than in the United States.

After averaging over 6 percent of disposable income during most of the post World War II period, personal saving have declined dramatically in the last 5 years, from 7.5 percent to 3.5 percent. The U.S. record compares poorly with that of other Western nations, many of which have provided tax incentives for savings. The latest data show a 9 percent savings rate in Canada, 17 percent in France, 14 percent in Germany, 25 percent in Japan, and 17 percent in the United Kingdom.

The decline in personal savings rate holds dire consequences for virtually every aspect and segment of our economy, but no sectors are hit harder than housing and the financial intermediaries that provide residential mortgage finance.

An increase in the levels of savings and investment are critical to controlling the inflationary forces which grip this nation, pollute the national currency and wealth, and endanger our competitiveness in world markets. S. 2560, the bill introduced by you, Senator Nelson, recognizes the fact this fact and provides incentives for thrift, which in my judgment will work to permanently increase the rate of personal savings.

S. 2560, the Home Mortgage Assistance Act, would channel these new savings funds toward the housing industry. This is important both in the short run and the long run. Housing today is in desperate straits. Housing starts recently dipped below the million unit annual rate and now stand at roughly half the annual rate needed to meet the housing needs of the 1980's.

Unemployment in residential construction and related trades stood at 16.5 percent in June. Even with mortgage interest rates falling back to the 12-percent level, we find few buyers.

Senator NELSON. Mr. Karl, I am going to have to go and answer that rollcall. So you will have to wait 5 minutes. I apologize.

[Recess.]

Senator NELSON. You may go ahead, sir. This is one of those very bad days.

Mr. KARL. I pointed out that unemployment in residential construction and related trades had reached 16.5 percent last June. Even with mortgage interest rates falling back to the 12-percent level, we find relatively few buyers.

Potential homeowners are understandably reluctant to take on the big monthly payments associated with these interest rates. Unprecedented numbers of loan applicants are finding they cannot qualify for a mortgage loan at current interest rates.

The twin problems of mortgage money availability and affordability are long term in nature and need to be addressed with long-term solutions. We need to face these problems now before they are further aggravated by demographic forces. The greatest concentration of first time homebuyers today is between the ages of 25 and 34. Americans in that age bracket will grow from 36 million this year to over 41 million in 1990.

The effect of higher interest rates on monthly mortgage payments and the annual income requirement for homeownership is dramatic. Purchase of the average home, $69,400 as of March 1980, at a 12-percent interest rate would require an income of $30,864 to carry a $643 monthly payment, but at 8 percent the monthly payment would be $458 and would take an annual income of only $21,984 for the same house.

Senator NELSON. There is a reduction from $31,000 to $21,000. Is that what you are saying?

Mr. KARL. That is right. The median household income in the United States is presently $21,350. So we have to make it possible for the median income buyer to purchase a home. The higher interest rate excludes 15 million households from homeownership.

Prominent housing economists agree that the Nation needs 2.2 million new housing units per year throughout the decade of the 1980's to meet housing demand. To the extent that the housing finance infrastructure is unable to support that level of construction, scarcity will prevail in both ownership and rental units.

Any shortfall of supply can cause inordinate housing price increases, as was the case in the late 1970's. Since S. 2560 would raise new funds and stabilize housing output, it clearly has the potential to keep demand and supply in better balance and hold down price rises.

Some critics may view this plan as inflationary. In reality the opposite is true. While it is granted that new housing can have some inflationary impact in the year of construction, it should be noted that it has a dampening effect for many years afterward. Building equity in a home is anti-inflationary as it diverts funds from the spending system.

The extremely low level of personal savings today is both a cause and a result of inflation. To the extent that the plan proposed here is successful in increasing the rate of personal savings, it would draw funds away from personal consumption, and have a decidedly deflationary impact.

The first question that most people ask almost instinctively is: What will this plan cost the Treasury? Authoritative estimates will, of course, have to come from the Office of Tax Analysis. If we instantaneously converted the entire home mortgage system in America and funded it with tax free savings, the revenue loss would be very significant. No one, however, is advocating such a precipitous move.

You, Senator Nelson, you would be the first to agree with me that we have to develop and mold a program that addresses the problems of mortgage money availability and affordability, and bring some desperately needed stability to the housing market. We want to do this without any stress on the Treasury.

In pursuance of these objectives we may well need to place limitations on the concept embodied in S. 2560. State and municipal housing finance agencies have clearly demonstrated the viability and effectiveness of utilizing tax exempt instruments to assist modest income homebuyers. I have done considerable analysis on ways of making those mechanisms work in the private sector.

Details of this work are contained in a separate document that is part of my statement for the record. To illustrate briefly, if we work with 3- or 5-year certificates of deposit with an administratively controlled tax exempt rate, the flow of funds into this type of account can be held within acceptable boundaries, as well as altered to complement broader economic and monetary policies.

Parameters would also be established for the families applying for preferred rate loans under this program, probably based on household income. If we assume that the program is controlled in these ways and accounts for 20 percent of mortgage originations, I estimate that the cost to the Treasury would start out in the first year at $330 million, rising to $970 million by the third year.

A tax-exempt savings program administered at such a level could support affordable mortgages for an additional 600,000 homes. The numbers are very rough, but the point they make is an extremely important one. The total cost to the Treasury can be very modest if the program is within reasonable limits, the impact on housing can be significant.

The principal benefits offered to the economy by the proposed plan are an increased level of savings and added stability in the housing sector. During recent recessions, housing has been highly volatile. The valleys have been 50 percent below the peaks, and the related unemployment has been massive, 25 percent, as a matter of fact, in 1975.

Even a slight moderation of the cycles can bring enormous revenues to the Treasury. The National Association of Home Builders estimates that 1.4 million jobs will be lost this year in residential construction and related trade when compared to the normal employment of 1978. Such housing unemployment adds 1.3 percentage points to the national total.

A recent study published by the Congressional Budget Office concludes that a 1-percentage point increase in unemployment will create a Treasury revenue loss of $20 to $22 billion, plus increased unemployment benefits of $5 to $7 billion. A 1.3 point increase translates into a deficit increase of more than $35 billion, a figure which dwarfs by far the potential cost of the tax incentive program.

Faced with problems so deep and far reaching as the availability and affordability of mortgage funds in the 1980's, some may seek a quick fix. More fundamental approaches are advised. Senator Nelson, your proposal links savings incentives to the challenge of providing affordable mortgage funds to homebuyers.

Adoption of the fundamental concept embodied in S. 2560 could have a significant stabilizing effect on housing cycles, employment, and prices. And it would efficiently accomplish its ends in the private sector, substantially reducing the need for Government subsidies in housing, and reversing the trend toward socialization of housing finance.

Summing up, Mr. Chairman, the need for fresh approaches to stimulate more savings in this Nation is an imperative in the 1980's. It is also critical that a fair share of such funds be channeled into housing. Without this effort, the dream of a home of one's own will be simply that—a dream for growing numbers of Americans.

The adoption of the principles in S. 2560 could help turn that dream into a reality for growing numbers of families and do it without new Government programs or agencies.

Senator Nelson, you are to be commended for your initiatives in this critical area.

Senator NELSON. Thank you very much, Mr. Karl.

I have to go vote, and Senator Bradley did not get back yet. If you need to leave to meet your schedule, you go ahead. We may have some questions to submit to you, which you can answer in writing, or if you have the time, you may wait.

[Recess.]

Senator CHAFEE. Mr. Smith, it is a pleasure to see you here again, and I have an idea what you will be testifying to, and look forward to hearing you.

STATEMENT OF W. C. SMITH, PRESIDENT, FRANKLIN TOWNE REALTY, INC.

Mr. SMITH. My name is W. C. Smith, and I am a homebuilder, developer, and realtor from Pittsburgh, Pa. I appreciate the opportunity to appear today and express my opinion and offer proposals for future tax cuts.

Tax free treatment of savings deposits used for residential mortgage purposes, as proposed in S. 2560, and H.R. 6907, introduced by Mr. Archer on the Ways and Means Committee, would achieve the following results.

One, I suggest, an increase in revenue of $44 billion, a reduction of expenditures related to unemployment of $14 billion, and a positive budget impact of $48 to $50 billion.

Two, it would restore employment to more than 1 million persons in the housing and related industries and create new additional employment of approximately 1 million.

Three, it would produce today a residential mortgage rate of 5.5 to 6 percent. You might be interested in the mechanics of how this would occur, along with the other benefits.

The first thing is that the cost of the mortgage is directly attributable to the cost of money. Tax free treatment used for residential mortgages would produce a cost of money today of approximately 4 percent: The normal markup on money is 1.5 to 2 percent. This would produce today a residential mortgage rate of approximately 4.5 to 5 percent.

The reason that occurs is because of the tax free treatment. If you were to look for a benchmark, you will find that housing authority construction notes which are issued by HUD had a cost last month of about 3.8 to 4 percent. That was because they are tax free, and they are short term.

In this instance, a deposit in S. & L., a bank, a commercial savings bank, would produce the same result because it would be insured by the Federal Government, that is, the FDIC up to $100,000, and it would be short term, and should produce the same effect, a cost of money approximating 4 percent.

What impact does this have on housing affordability? The first thing is, on an average price home, or a $50,000 mortgage, it would reduce the cost to the average person by $200 a month. To say the least, this is deflationary. You are not going to have cost price pressures for more wages in the employment area, when you can reduce the actual cost of producing housing. The same goes as far as the CPI index is concerned.

Obviously, all the time, someone says: What is the cost to the Treasury? The cost to the Treasury, as calculated by the people on the Joint Tax Committee, for all savings used for residential mortgage purposes is $13.5 billion.

The Bentsen bill has already been passed, and it has a value of $1.5 or $1.6, and this gets it down to about $12 billion. Under the House passed mortgage revenue bond bill, there would be about $2 billion in lost revenue. But this actually displaces funds that otherwise would have come from savings to help housing.

So you are at a number that is around $10 billion. This is without any benefits. When you realize that 1 percent unemployment represents $22 billion in lost revenue, and $7 billion in expenditures for unemployment, that is $29 billion, and we have over 1 million people unemployed in the housing industry today.

We have a shortfall annually of almost 1 million units for the 1980's, and that represents a duplicate. So if this bill were passed, your positive budget impact would be an increase in revenue by $44 billion by putting people back to work, and meeting the housing needs. It would reduce direct expenditures attributable to unemployment by $14 billion. So now you are at $58 billion-plus. If you deduct the direct revenue loss of $10 billion, you still have a positive budget impact of $48 billion.

Now, we always think about revenue loss, and nobody ever thinks of the reciprocal. If you look at the study of the Congressional Budget Office, and convert that unemployment and employment into those numbers, and revenues and expenditures, you will see that that works.

In addition to that, now you are going to desocialize, or defederalize the housing industry. The programs that you have that require direct expenditures to subsidize 7.5 percent interest rates, and people who can no longer afford housing, can be eliminated. They will actually atrophy because the private sector now, for the first time, will be able to produce rental housing, and single-family housing without direct Federal subsidies.

Until we do that, and unless we do it, the only alternative is growing Federal subsidy. I would suggest to you, gentlemen, that this type of a tax cut, which enables the private sector to function, creates employment, has a positive budget impact, is one that should seriously be considered at this time.

Thank you.

Senator BRADLEY. Thank you, Mr. Smith, for your testimony.

I would just like to ask you one question. If we did this, and cut out all the Federal assisted housing, interest rates, subsidies, and so forth, is it your belief that the market would allocate housing to all levels of income?

Mr. SMITH. Yes, it would, because you will that in the recent proposals there is a suggestion by Mr. Landrow that you take the limit off income for rental housing. The reason you don't have rental housing today is because you cannot make a profit producing it. You can't make a profit producing it because the interest rate is too high.

This is the same reason you have to give a person of a $21,000 median income a subsidy, it is because the interest rate that he has to pay on his monthly payment is too high. If you reduce that, you reduce his cost of buying a house by $200 a month. Once you do that, you don't need the direct subsidy.

What happens, over the years we have had to build up a substitute program of direct subsidies because the interest rates have been so high. Once you do it effectively by giving a tax break to the depositor, the consumer gets the benefit in the lower cost housing, and the Government reduces its direct expenditures for housing.

Senator BRADLEY. Tell me, how do you think this would affect residential housing in urban areas where the housing is obviously deteriorating and has to be replaced in some form?

Mr. SMITH. It will be a great impact because the first that will happen, again you have lower cost rehabilitation, you have people who will be able to afford the housing within the city. The natural trend of housing within the city is because of problems of the cost of transportation, but now you have it at a point where without the

Government subsidy and administrative programs, you can do it more rapidly.

I believe that some of the States have contended, if they have revenue bonds, they can move their programs through faster. This would be cheaper than revenue bonds by 1 percentage point, and you don't have to get the approval of all the Federal agencies and local agencies. You could go ahead.

I could go ahead with rehabilitation of low income housing and make a profit at it, and introduce it to the consumer at a one percentage point interest lower than any of the existing programs.

Senator BRADLEY. Thank you very much.

Senator CHAFEE. Mr. Smith, two questions.

One, we had very substantial Federal subsidies for housing when the interest rates were low. An interest rate of 5 or 6 percent looks low now, whereas once upon a time it was not terribly low, let us say, 7 years ago. Yet, the Federal Government was already into the subsidies.

Mr. SMITH. Sir, the greatest production of housing in the United States occurred after World War II when interest rates were 4.5 to 5.5 percent. It was only approximately 10 to 12 years ago when interest rates started going up because of actions of the Federal Reserve Board that it became necessary to create the type of direct subsidies that we have.

They continued to grow in intensity and amount each year. We had subsidy programs before, but generally back after World War II the only programs you had were those which actually helped the indigents with public authority housing. Since that time, because of the increase in the cost of money and interest rates, we have had to build other programs.

I would suggest that if you can return to a private sector solution at this 6 percent rate, most of the direct subsidy programs will cease to exist.

Mr. KARL. Senator Chafee, might I add that there is a hard core of homebuyers that can never afford even reasonable interest rates. They could not afford a 4 or 5 percent interest rate, and they have had to be subsidized in the past through Government programs.

I am convinced that the level affordability would increase substantially once we had this tax incentive program because the difference in 8 percent, and 12 percent means that 80 percent of the potential homebuyers would qualify as against the 20 percent that qualify today.

Senator CHAFEE. We have had revenue bonds in many States. In my State 70 percent of the houses are built from mortgage revenue bonds, and at the same time there is a continued rise of section 8 and other forms of Government subsidized housing.

Mr. SMITH. The reason that is, Senator, is because that type of housing is such that people are at that stage able to make a higher profit on that type of subsidy. The mortgage revenue bonds still have an inefficiency depending of about 1.0 to 1.5 percent.

If you have a mortgage revenue bond payable in 1984, the first term, at 6 percent, there is a inefficiency factor of about 1 percent. You could actually be down at 5 percent for that same type of money if you did it directly.

Senator CHAFEE. The point we make is that people can borrow money now under those bonds at relatively low rates of interest. I think that the problem in the housing market is not entirely directly related to mortgage rates, I think there are a lot of other problems.

Let me ask you another question. In your proposal, Mr. Smith, you also allow the deductibility of the mortgage interest that the mortgagee pays?

Mr. SMITH. Yes, Senator, and the reason is this. It is obvious that even with that deductibility today, we have been unable to meet the housing needs of the country. What has happened is that that deductibility is already factored into the cost of housing. If you take it away, you are going to have to replace it with something else.

The cost of housing has gotten to the point today, at today's rates, only 14 percent of the people can buy a house even with that deductibility. So we have to maintain whatever that factor is plus introduce whatever new factors are necessary to make it affordable. If you take it away, you have to compensate in some other fashion.

Senator NELSON. Thank you very much, gentlemen, for taking the time.

Senator DURENBERGER. May I ask a question or two.

I apologize to both of you for not hearing your full statements, but let me suggest to you that maybe the problem is not affordability, but cost. I think we ought to make a distinction between that. It is not the cost of money. It is the cost of housing.

I think the answer to Bill Bradley's question here is, it is not just lowering interest rates and making housing more attractive, it is somehow getting control over the inflationary part of the cost of housing.

If people can move in and out of housing as easily as they have in the last 10 years in this country, every 2 or 3 years taking the inflationary gain and using that as the downpayment on another home, we are creating a problem that does not get solved by some form of tax incentives for investment or by a larger capital pool from which to draw mortgage money.

I am wondering if either of you has an opinion on how tax policy in this country ought to be changed beyond what you have suggested to somehow get control of that huge inflationary factor.

One of the things that has been suggested by Senator Chafee's question is the deductibility of interest, and I have heard at least one comment on that.

Mr. SMITH. The one major problem that we have is this. The tax policy of the United States right now, along with regulatory policy, is creating synthetic shortages of housing, and aggravating inflation. I am an investor in real estate, and many of us are. We would not get the return on the real estate that we invest in if there were an adequate supply.

The tax policies are creating the shortfall. They are creating a situation in which each year we have a million shortfall, and because of the recession we have 2.5 million shortfall. The only way you are going to solve the inflation in housing is by production of housing.

The other thing related to that is this, you might be surprised that in the last 5 weeks we have had increases in our price of lumber, 10 percent. This is just within 5 weeks. The reason for much of that is not merely because the plants have shut down, but because Federal regulations have so restricted the cutting of lumber that the Federal regulations have created the synthetic shortgage of the commodities that we purchase.

To solve the problems of housing, and the cost of housing, we have to do two things. We have to be able to supply the quantities which go into housing by reducing Federal regulation, and let the suppliers of those commodities produce them. Then we have to produce an adequate housing base so that there is not a shortage.

So it is the shortage that creates inflation. What is occurring in producing that housing, you have to have customers that can afford it, and affordability becomes the key there. If you have people who can afford to purchase a product, the product will be reduced. You will increase your total housing supply each year, and ultimately you will balance the supply of housing required by the demographics each year.

Until you produce an adequate supply of housing, you are inevitably being condemned to inflation in housing.

Senator DURENBERGER. Thank you.

Mr. KARL. I just wanted to add that housing is a labor intensive process. It is inevitable that labor costs are going to inch up. I don't know how you can stop that.

The other thing I want to mention is the Minnesota plan which has been advocated, and that is on the mortgage side, where you try to get a tax exempt mortgage instrument. One thing that it does not do that the 2560 does, and that is to stimulate savings. We are talking about a plan here that starts with the stimulation of savings to increase this horrible personal savings rate that we are at. To me 2560 combines both. It creates cheaper housing. It increases the savings rate in this country.

Senator DURENBERGER. Thank you very much.

Senator NELSON. Thank you very much, gentlemen.

[The prepared statement of Mr. Karl follows:]

SUMMARY OF PRINCIPAL POINTS
FROM STATEMENT OF MAX H. KARL, CHAIRMAN
SENATE FINANCE COMMITTEE
S.2560, THE HOME MORTGAGE ASSISTANCE ACT

- The steep decline in the rate of personal saving from 7.5% in the 4th quarter of 1974 to 3.5% at the end of 1979 is damaging our whole economy and particularly the housing sector.
- The low personal saving rate is a major factor contributing to the current severe housing slump. Housing starts are at an annual rate of 1.1 million compared to the 2.2 million "normal" annual rate for the 1980's.
- Millions of potential homeowners, particularly first time buyers, are unable to qualify for mortgages due to high interest rates.
- The twin problems of the availability and affordability of mortgage money will persist through the 1980's.
- The concepts underlying S.2560 would work to permanently increase personal saving and channel the funds into housing.
- The plan would be anti-inflationary because it would draw funds away from consumption and into savings.
- Housing downturns can be extremely costly to the Treasury. The Congressional Budget Office says that one percentage point of unemployment increases the deficit by $25-29 billion. If the housing recession results in 1.3 million jobs lost, as projected, the Treasury will lose about $35 billion, far more than the cost of S.2560.
- The concepts of S.2560 can be shaped and structured in ways that will limit the scope of the program and hold Treasury losses under $1 billion annually.

STATEMENT OF MAX H. KARL, CHAIRMAN
MGIC INVESTMENT CORPORATION
SENATE FINANCE COMMITTEE
S.2560, THE HOME MORTGAGE ASSISTANCE ACT

Mr. Chairman, Members of the Committee - my name is Max H. Karl. I am a native of Milwaukee, Wisconsin, and am Chairman of MGIC Investment Corporation of that city. Twenty-three years ago I founded Mortgage Guaranty Insurance Corporation, the principal subsidiary of MGIC Investment Corporation and the nation's first and largest private mortgage insurer of this modern era.

I realize that this committee is working to find the best ways to reduce the overall burden of individual and business taxation in ways that will provide jobs, encourage capital formation, improve productivity, minimize inflationary pressures, and generally stabilize our volatile economy. I genuinely believe that the single most important and direct path toward those objectives lies in addressing the problems in the housing sector of our economy, since it is problems in that sector that have both triggered and borne the brunt of our last two painful recessions.

I have been a long-time student of thrift and home ownership in the United States and throughout the world. What I see today distresses me greatly. The nation and the world face a debilitating capital shortage. A decade of rapid growth in many nations and accelerating inflation has reduced saving flows greviously. Nowhere is this more evident than in the United States. After averaging over 6% of disposable income during most of the post World War II period, personal saving has declined dramatically in the last five years, from 7.5% to 3.5%. The U.S. record compares poorly with that of other western nations, many of which have provided tax incentives for savings. The latest data show a 9% savings rate in Canada, 17% in France, 14% in Germany, 25% in Japan, and 17% in the United Kingdom.

The decline in the personal saving rate holds dire consequences for virtually every aspect and segment of our economy, but no sectors are hit harder than housing and the financial intermediaries that provide residential mortgage finance.

An increase in the levels of savings and investment are critical to controlling the inflationary forces which grip this nation, pollute the national currency and wealth, and endanger our competitiveness in world markets. S.2560, the bill introduced by Senator Gaylord Nelson, recognizes this fact and provides incentives for thrift which, in my judgment, will work to permanently increase the rate of personal saving.

S.2560, The Home Mortgage Assistance Act, would channel these new savings funds towards the housing industry. This is important both in the short run and the long run. Housing today is in desperate straits. Housing starts recently dipped below the 1,000,000 unit annual rate and now stand at roughly half the 2.2 million unit annual rate needed to meet the housing needs of the 1980's. Unemployment in residential construction and related trades stood at 16.5% in June. Even with mortgage interest rates falling back to the 12% level, we find few buyers. Potential homeowners are understandably reluctant to take on the big monthly payments associated with these interest rates. Unprecedented numbers of loan applicants are finding they cannot qualify for a mortgage loan at current interest rates.

The twin problems of mortgage money availability and affordability are long term in nature and need to be addressed with long-term solutions. We need to face these problems now before they are further aggravated by demographic forces. The greatest concentration of first time homebuyers today is between the ages of 25 and 34. Americans in that age bracket will grow from 36 million this year to over 41 million in 1990.

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The effect of higher interest rates on monthly mortgage payments and the annual income requirements for home ownership is dramatic. Purchase of the average home, $69,400 as of March 1980, at a 12% interest rate would require an income of $30,864 to carry a $643 monthly payment, but at 8% the monthly payment would be $458 and would take an annual income of only $21,984 for the same house. Median household income in the U.S. is presently $21,350 according to the Conference Board. The higher interest rate excludes 15 million households from home ownership.

Prominent housing economists agree that the nation needs 2.2 million new housing units per year throughout the decade of the 1980's to meet housing demand. To the extent that the housing finance infrastructure is unable to support that level of construction, scarcity will prevail in both ownership and rental units. Any shortfall of supply can cause inordinate housing price increases, as was the case in the late 1970's. Since S.2560 would raise new funds and stabilize housing output, it clearly has the potential to keep demand and supply in better balance and hold down price rises.

Some critics may view this plan as inflationary. In reality the opposite is true. While it is granted that new housing can have some inflationary impact in the year of construction, it should be noted that it has a dampening effect for many years afterward. Building equity in a home is anti-inflationary, as it diverts funds from the spending system.

The extremely low level of personal savings today is both a cause and a result of inflation. To the extent that the plan proposed here is successful in increasing the rate of personal saving, it will draw funds away from personal consumption and have a decidedly deflationary impact.

The first question that most people ask almost instinctively is: "What will this plan cost the Treasury?" Authoritative estimates will, of course, have to come from the Office of Tax Analysis. If we instantaneously converted the entire home mortgage system in America and funded it with tax free savings, the revenue loss would be very significant. No one, however, is advocating such a precipitous move. I think Senator Nelson would be among the first to agree with me that we need to develop and mold a program that addresses the problems of mortgage money availability and affordability, and brings some desperately needed stability to the housing market, all without undue stress on the Treasury. In pursuit of those objectives, we may well need to place limitations on the concept embodied in S.2560. State and municipal housing finance agencies have clearly demonstrated the viability and effectiveness of utilizing tax exempt instruments to assist modest income homebuyers. I have done considerable analysis on ways of making those mechanisms work in the private sector. Details of this work are contained in a separate document that is part of my statement for the record. To illustrate briefly, if we work with a three or five year certificate of deposit with an administratively controlled tax exempt rate, the flow of funds into this type of account can be held within acceptable boundaries, as well as altered to complement broader economic and monetary policies. Parameters would also be established for the families applying for preferred rate loans under this program, probably based on household income. If we assume that the program is controlled in these ways and accounts for 20% of mortgage originations, I estimate that the cost to the Treasury would start out in the first year at $330 million, rising to $970 million by the third year. A tax exempt savings program administered at such a level could support affordable mortgages for an additional 600,000 homes. The numbers are very rough, but the point they make is an extremely important one: The total cost to the Treasury can be very modest if the program is kept within sensible boundaries, and the impact on housing can be significant.

The principal benefits offered to the economy by the proposed plan are an increased level of savings and added stability in the housing sector. During recent recessions, housing has been highly volatile. The valleys have been 50% below the peaks, and the related unemployment has been massive (25% in 1975). Even a slight moderation of the cycles can bring enormous revenues to the Treasury. The National Association of Home Builders estimates that 1.4 million jobs will be lost this year in residential construction and related trades, when compared to the normal employment of 1978. Such housing unemployment adds 1.3 percentage points to the national total. A recent study published by the Congressional Budget Office concludes that a one percentage point increase in unemployment will create a Treasury revenue loss of $20-$22 billion plus increased unemployment costs of $5-$7 billion. A 1.3 point increase translates into a deficit increase of more than $35 billion, a figure which dwarfs the potential costs of the tax incentive program.

Faced with problems so deep and far-reaching as the availability and affordability of mortgage funds in the 1980's, some may seek a "quick fix". More fundamental approaches are advised. Senator Nelson's proposal links savings incentives to the challenge of providing affordable mortgage funds to homebuyers. Adoption of the fundamental concept embodied in S.2560 could have a significant stabilizing effect on housing cycles, employment and prices. And it would efficiently accomplish its ends in the private sector, substantially reducing the need for government subsidies in housing, and reversing the trend toward socialization of housing finance.

Summing up, Mr. Chairman, the need for fresh approaches to stimulate more savings in ~~this nation~~ is an imperative in the 1980's. It is also critical that a fair share of such funds be channeled into housing. Without this effort the dream of a home of one's own will be simply that - a dream for growing numbers of Americans. The adoption of the principles in S.2560 could help turn that dream into a reality for growing numbers of families and do it without new government programs or agencies. Senator Nelson is to be commended for his initiatives in this critical area.

Exhibit A

U.S. PERSONAL SAVING RATE

	4th Quarter Personal Saving Rate
1974	7.5%
1975	6.7%
1976	5.2%
1977	5.1%
1978	4.7%
1979	3.5%

Source: Federal Reserve Bulletin

EXHIBIT B

EFFECT OF VARIOUS INTEREST RATES ON MONTHLY
PAYMENT AND ANNUAL INCOME REQUIREMENTS FOR
HOME MORTGAGE LOANS

	8% Interest		10% Interest		12% Interest		14% Interest	
House Price	Monthly Payment	Needed Annual Salary	Monthly Payment	Needed Annual Salary	Monthly Payment	Needed Annual Salary	Monthly Payment	Needed Annual Salary
$45,000	$297	$14,256	$356	$17,088	$417	$20,016	$480	$23,040
55,000	363	17,424	435	20,880	509	24,432	587	28,176
65,000	429	20,592	514	24,672	602	28,896	693	33,264
75,000	495	23,760	593	28,464	695	33,360	800	38,400
85,000	562	26,976	672	32,256	787	37,776	907	43,536
Avg. Existing House $69,400 (March 1980)	$458	$21,984	$548	$26,304	$643	$30,864	$740	$35,520
Avg. New House: $72,400 (March 1980)	478	22,944	572	27,456	670	32,160	772	37,056

Assumptions: 10% Downpayment
25% Gross Monthly Income to Housing (P&I Only)
30 Year Mortgage Term

Existing Price Per NAR; New Price Per NAHB

1978

A Plan For Tax Exempt Housing Savings Certificates (HSC)

Summary

Purposes

- To stimulate greater consumer savings and reduce inflationary consumption
- To increase production of needed housing at affordable terms for average American families
- To strengthen financial institutions' abilities to provide affordable mortgage funds for home buyers

Elements

1. **Maturity** - Maturities of three years and five years would be offered

2. **Amount of Certificates** - For each taxpayer, the maximum amount of such certificate could not exceed $100,000 (FSLIC/FDIC insured maximum) There would be no legally prescribed minimum amount

3. **Interest Rate** - Rates would be fixed for the term of the certificate, but initial offering rates would vary monthly Rates would be set at three-fourth's of the yields for Treasury Bills and Notes of like maturities, but could be varied to fall within 6 to .9 of Treasury yields

4. **Offering Institutions** - Certificates would be sold at financial institutions having federal insurance on deposits, or which are otherwise insured in accordance with the requirements of State law

5. **Use of Proceeds** - All deposits in such certificates would be subject to the following guidelines

   a. Residential mortgages would be originated or purchased at yields not greater than 2% over the average cost of such certificates in any quarter A 1% origination fee would also be allowed Renegotiated rate, graduated payment and fixed rate mortgages would be eligible investments

   b. Such mortgages could only be made on single-family, owner-occupied primary residences

   c. Ceilings would be imposed for borrower income, mortgage amount, and/or sales price

   d. An initial transaction period would allow a one year interval before mortgage originations or purchases would be required

   e. Lenders' short term investment of certificate funds would be required to be in U S Treasury obligations

A Plan To Encourage Personal Savings, Stabilize Housing and Combat Inflation

The average American family today cannot afford the average American home. That is the stark reality being faced today by millions of young Americans The post-war baby boom of the 1950's and early 1960's produced a generation of young people who are now reaching the normal age for household formation and home buying Demographers project 8 5 million household formations for the period 1980-1984, up significantly from a decade earlier

To comprehend the plight of the potential first-time home buyer, consider these facts purchase of a home with a 10% down payment (typical for a first-time home buyer) on a 30 year mortgage of $60,000 at 13% interest would require a monthly payment of $831 including normal taxes and insurance Based on traditional underwriting guidelines, the people buying that average home would need to have gross household income in excess of $39,000 With median household earnings today slightly under $20,000, the average family is clearly priced out of the market

The inability of mortgage lenders to qualify potential home buyers is a problem with complex roots The basic inflationary psychology of our country is one of the major causes Equally fundamental and intertwined is our declining rate of personal saving According to Stanford University economics Professor Michael Boskin

> "There is no greater problem facing the U S economy today than our extremely low rate of saving and closely related low rate of investment"

After averaging over 6% of disposable income during most of the post World War II period, personal saving has declined dramatically in recent years

	Personal Saving Rate
4th Quarter 1974	7 5%
4th Quarter 1975	6 7%
4th Quarter 1976	5 2%
4th Quarter 1977	5 1%
4th Quarter 1978	4 7%
4th Quarter 1979	3 5%

The U S record contrasts with that of other western nations, many of which have provided tax incentives for savings The latest data show a 9% savings rate in Canada, 17% in France, 14% in Germany, 25% in Japan, and 17% in the U K

The decline in the personal saving rate holds dire consequences for virtually every aspect and segment of our economy, but no sectors are hit harder than housing and the financial intermediaries that provide residential mortgage finance Approximately 60% of U S home purchases are financed by savings and loan associations and mutual savings banks For those institutions the problems inherent in the lower personal saving rate have been multiplied by the concomitant changes in the structure and cost of savings accounts Competition for individual savings funds increased sharply beginning in the late 1970's

The increased competition for scarce savings dollars raised rates and sent the cost of residential mortgage funds to unprecedented levels The forces behind today's high interest rates are not all cyclical Much of the change has been institutionalized, i e , the creation of money market funds, the establishment of six month and thirty month money market certificates and the phase out of Regulation Q The changes described are long-term and far-reaching, and they will not go away with the current economic cycle The affordability of homeownership has become a major and growing social issue

Faced with a problem so deep and far-reaching, some may seek a "quick fix". More fundamental approaches are advised. Congress has recently taken an important first step in the direction which appears to hold the greatest potential for stimulating savings and stabilizing housing More than 70 bills were introduced in the 96th Congress offering income tax exemptions for savers. The legislation passed, as part of the Windfall Profits Tax Bill, exempts the first $200 of interest and/or dividends from an individual return, or $400 from a joint return. More needs to be done. An appropriate second step would be to link incentives to saving to the challenges of providing affordable home ownership to first time homebuyers

The Proposal

The proposal calls for creation of Housing Savings Certificates (HSC) to be offered at any financial institution having federal insurance on deposits or which are otherwise insured in accordance with the requirements of the law of the State in which the institution is located and offering residential mortgage loans Interest earned on these certificates would be exempt from federal income taxation For each taxpayer the maximum amount of HSC holdings could not exceed $100M, the FSLIC/FDIC insured maximum There would be no legally prescribed minimum certificate amount

Two maturities would be offered, three years and five years, corresponding to the possible "roll-over" period for renegotiable rate mortgages. Thus, the historical thrift institution problem of financing longer-term assets (mortgages) with short-term liabilities (savings) could be substantially alleviated

Interest rates would be fixed for the term of the certificate, but initial offering rates would change monthly Rates would be set at approximately three-fourth's of the yield levels for Treasury obligations of the same maturity, but could be modified from time to time by the federal Depository Institutions Deregulation Committee to fall within the range of .6 to .9 of Treasury yields

All deposits in HSC accounts would be earmarked for investment in mortgages on single family, owner-occupied primary residences Mortgages originated or purchased with these funds would be at yields not greater than 2% above the average cost of HSCs in any quarter An additional origination fee of 1% would be allowed in order to cover up-front expenses.

The preferred mortgage funds available under the HSC program would be available to households with income not greater than 125% of the median household income as estimated by the Department of Commerce

Cost To The Treasury

It is assumed that the HSC program might attract $50 billion of savings in the first year, of which 50% would be new savings and the other 50% would be transferred from other savings plans On that basis the annual rate of revenue loss for the Treasury would be $700 million That figure would rise for at least the second and third years, reaching perhaps $1 billion in the third year

Offsets To The Cost

The principal benefits offered to the economy by the HSC plan are an increased level of savings and added stability in the housing sector. During recent recessions, housing has been among the most volatile sectors. The valleys can be 50% below the peaks and the related unemployment can be massive (25% in 1975). Even a slight moderation of the cycles can bring enormous savings to the Treasury. The National Association of Home Builders estimates that 1.4 million jobs will be lost this year in single family construction, when compared to normal employment of 1978. If accurate, housing unemployment translates into 1.6 percentage points of increased unemployment A study published by the Congressional Budget Office in February, 1980 concludes that a one percentage point increase in unemployment will create a Treasury revenue loss of at least $20 billion and increased unemployment costs of at least $5 billion Together, these factors suggest that one percentage point of unemployment translates into $25 billion in total deficits and a 1.6 point increase translates into a deficit increase of $40 billion The moderation of housing cycles, therefore, offers a potential to pay back the Treasury a great deal more than the cost of the HSC program. There are also other offsets to make the plan even more attractive from the standpoint of the Treasury:

1. Because the HSC money will go into lower rate loans, the amount of itemized interest deductions will be diminished If $50 billion of mortgages were originated at rates averaging 3% under normal market rates, the Treasury would save an additional $500 million in tax revenues.

2. The lower mortgage rates afforded under the program will tend to reduce the housing component of the CPI and therefore limit COLA adjustments

3. The HSC program in many areas of the country would fill in for and replace the tax exempt mortgage financing being done by state and municipal agencies To the degree that this occurred there is not an incremental drain on Treasury revenues The same is true of any funds that might be attracted away from other forms of tax exempt municipal financing

4. Increased activity in housing related industries, such as appliances and furniture, will also produce tax revenues to offset initial losses

Non-Inflationary Impact On Housing

Prominent housing economists agree that the nation needs 2.2 million new housing units per year throughout the decade of the 1980's to meet housing demand .To the extent that the housing finance infra-structure is unable to support that level of construction, scarcity will prevail in both ownership and rental units. Any imbalance of demand and supply will cause inordinate housing price increases, as was the case in the late 1970's Since the HSC plan would support and stabilize housing output, it clearly has the potential to keep demand and supply in better balance and hold down price rises

While it is granted that new housing does have some inflationary impact in the year of construction, it should be noted that it has a dampening effect after completion Once completed, sold and mortgaged, home expenses limit discretionary income Housing-related expenses normally can draw off 40% of household income, thus reducing the funds otherwise available to create inflationary pressures in the consumer economy. Building equity in a home is anti-inflationary, as it diverts funds from the spending stream

The extremely low level of personal savings today is both a cause and a result of inflation To the extent that the plan proposed here in successful in increasing the rate of personal savings, it will draw funds away from personal consumption and have a decidedly deflationary impact When financial intermediaries funnel those savings back into housing, there will be some offsetting inflationary pressures. The alternative, as noted above, is to permit a housing shortgage to conspire with a shortgage of lendable mortgage funds The result can only be very strong rises in the housing expense component of the consumer price index Therefore, the plan to channel affordable funds into housing should not be considered inflationary when compared with the alternative of scarce housing and scarce mortgage funds

Summary

The HSC plan would create tax exempt housing savings certificates of three and five year maturities to be offered through mortgage originating financial institutions having federal insurance on their deposits The plan could substantially increase the rate of personal saving and focus stable incremental funds on the most volatile sector of our economy, single family housing. The HSC plan is not a short-term "quick-fix" for a cyclical problem. Rather it is a permanent means of creating a stable and affordable source of funds to finance the housing needs of American families. The plan retains the basic structure that has worked for over a century and made Americans among the best housed people in the world: Personal thrift supporting home mortgages. Both the American economy and the average American family need this plan

Senator NELSON. Next we will hear from a panel consisting of Mr. William Barth, senior partner and director of Small Business Practices, Arthur Anderson & Co. on behalf of the Small Business Legislative Council; Mr. Arthur D. Little, president, National Association of Small Business Investment Cos.; Mr. James D. McKevitt, National Federation of Independent Business; Normal R. Sherlock, executive vice president, American Bus Association; Bruce H. Hahn, National Tooling & Machining Association; Philip Ranno, president, National Association of Metal Finishers; Sidney Lieberstein, vice president, Machinery Dealers National Association, and Mr. J. Stephen Putnam, president of F. L. Putnam & Co., on behalf of the National Association of Securities Dealers.

Mr. Barth, if you would begin.

STATEMENT OF WILLIAM BARTH, SENIOR PARTNER AND DIRECTOR OF SMALL BUSINESS PRACTICES, ARTHUR ANDERSEN & CO., ON BEHALF OF SMALL BUSINESS LEGISLATIVE COUNCIL

Mr. BARTH. Thank you, Mr. Chairman.

My name is William Barth. I am director of the small business practices of Arthur Andersen & Co. Today I am appearing on behalf of the Small Business Legislative Council—SBLC—an organization of 81 national trade and professional associations whose membership consists largely of small businesses. The SBLC membership and their affiliates represent over 4.5 million small business firms throughout the Nation.

Accompanying me is Jerome Gulan, SBLC's legislative director and vice president of the National Small Business Association.

Over the years a written record of statements made in support of small business could easily fill a smalltown library. Literally thousands of articulate, knowledgeable, and responsible individuals have espoused the cause of small business. However, the record of accomplishment is remarkably short.

In some instances no one bothered to follow up on an idea. In other instances small business was simply pushed aside so that the Congress could deal with priorities that seemed more important at that time. This year we are told that history will not repeat itself. I sincerely hope that this year will be different.

Now to illustrate my concern about the difference between thought and action, let me briefly present five examples.

First, it is presumed that the current tax structure should encourage the development and growth of small business. To that end a graduated corporate tax structure was created. It begins today at 17 percent, and then goes to 20, 30, 40, and finally to 46. The thought is that these reduced rates allow small- and medium-size companies to plow back a greater portion of earnings into their businesses.

One might think, from looking at the graduated tax rates that the small businesses, therefore, pay out a smaller percentage of their income in taxes than do businesses in, say, the $100 million range. In fact, the opposite is quite true.

Many small businesses pay effective rates that are higher than their larger competitors. The reasons for this are many, but among others the nature of operations of many large companies provides above average benefits of certain credits and other incentives, and small businesses sometimes find that the process of claiming a deduction is so burdensome that they simply forego the opportunity.

The SBLC endorses the recommendation of the White House Conference that calls for replacing the corporate tax rate schedule with more graduated rates covering the first $500,000 of income.

Second, since 1971, all businesses have been granted the option of taking faster writeoff of depreciation under the ADR system. However, because of its complexity, the ADR system is used by less than one-half of 1 percent of the small businesses in the Nation.

The SBLC endorses the second priority of the White House Conference that calls for the adoption of a simplified and accelerated capital cost recovery system that would give small businesses more equitable depreciation deductions.

There are alternative capital cost recovery methods that are now under consideration that in varying degrees result in a higher percentage of benefits accruing to large companies. The SBLC is deeply concerned that such method as might be chosen will not be so costly as to preclude small business from receiving equitable benefits from programs most important to it.

The White House Conference identified lack of available capital as the foremost concern of the delegates. In this respect, two options are currently under review:

First, a deferral of taxes for rollovers of investments affecting small business. Under the present law, the owner of a small business who wishes to sell his company has the option of selling for cash and immediately paying a tax, or exchanging ownership of his small business for stock in a larger company. This swap of stock for stock does not trigger an immediate capital gains tax. The result is that an increasing number of small businesses are being bought out by larger businesses. The SBLC believes that taxes should be deferred upon the sale of a closely held company.

Second, SBLC favors the deferral of taxes attributable to the sale of any investment assets provided the funds are timely invested in a qualifying small business. A new proposal now before Congress calls for the creation of a new financial instrument called, a small business participating debenture.

I commend you, Mr. Chairman, for your leadership in bringing forth Senate bill 2981, and I must also recognize the efforts of Senator Weicker during a long period of incubation.

SBPD legislation represents a breakthrough in business financing concepts. There are yet ways to be devised using this concept to help businesses.

Senator NELSON. You are going to have to stop at this point, otherwise we will never make it through the panel. I don't like to do this, but you can see our problem.

Let me say, on the corporate tax side, I was involved in that, we started the hearings back in 1974 or 1975, and regardless of the fact that you no doubt can demonstrate that very large corporations with various kinds of writeoffs are showing an effective rate lower than many small businesses, the fact is that the amendment that was adopted in 1976, and the further amendment in 1978 increasing the progressivity to $100,000, does save the small corporation with a taxable income of $100,000 a total of $14,700 a year, which is a very, very dramatic reduction in taxes over what that corporation paid in 1975.

On the ADR question, I certainly agree with you. We had a big fight in the Finance Committee that only about, as I recall it, somewhere around five-tenths or five-tenths of 1 percent of the corporations in America use ADR. It is for very large corporations. It is very complicated.

In committee I was defeated on the proposition that we have a 3-year straightline depreciation on the first $25,000 of capital investment which was targeted to small businesses. However, we offered that as a substitute on the floor, and defeated the position of the Finance Committee.

The reason the Finance Committee's position was defeated, which would not have occurred 3 years, or 4 years earlier, is that small business groups around this country were finally getting organized enough to be effective so that their voice was heard. That is a very encouraging sign. We would never have won that a few years earlier.

I would say, on the White House Conference, we had hearings and drafted bills, introduced probably two-thirds or three-quarters of all the major provisions recommended by the White House Conference prior to the White House Conference, and we have introduced others since then.

The point I want to make is, I don't think that it is a discouraging scene in terms of small business in this country because it has only been in the last 3 or 4 years that small business groups all over this country have become organized enough to have an effective voice so that their interests and concerns are heard and are being considered.

I think that you will see an increase in that impact very rapidly in the next 2, 3, 4 years. My guess is that within a 2-year period of the 15 top recommendations of the White House Conference—at least 12 of them will be adopted. I don't think that there is any doubt about it.

We have a number of them pending right now and we may get some of them adopted this year—whether it is capital gains rollover, expansion of subchapter S, an expansion in the graduated corporate tax, an increase in the heritance tax exemption, which I think is very important for maintenance of farms and small business in the families.

I just want to say to you, from my perspective, looking at where we were half a dozen years ago, I think the small business groups around this country have done a tremendous job. Since they represent people, and lots of people, you can be sure that you have a sustaining force in the representative kind of government that will be heard once its voice is expressed on the issues.

So I just wanted to say, don't be discouraged about the way we are moving. I have been on this committee for the last 16 years, and more legislation has moved in the last 4 than it did in the previous 12.

Mr. Barth. You are correct. I would also applaud you on behalf of SCLC for Senate bill 2998, which you introduced yesterday, that parallels a good many of our priority items.

[The prepared statement of Mr. Barth follows:]

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Small Business Legislative Council*

STATEMENT OF

WILLIAM D. BARTH

ON BEHALF OF

THE SMALL BUSINESS LEGISLATIVE COUNCIL

BEFORE THE

SENATE COMMITTEE ON FINANCE

HOLDING HEARINGS ON

PROPOSED TAX CUTS

JULY 31, 1980

"It is the declared policy of the Congress that the Government should aid, counsel, assist, and protect, insofar as is possible, the interests of small business concerns in order to preserve free competitive enterprise...."

(P.L. 85-536, as amended, Section 2(a), Small Business Act.)

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Small Business Legislative Council*

SUMMARY

The Small Business Legislative Council (SBLC), whose 81 member associations and their affiliates represent more than 4 million small business enterprises, urges that tax reduction proposals being considered provide equity for small business, increase productive capacity, and, to whatever extent possible, assist in lessening current inflation.

To this end, the SBLC specifically endorses the following provisions:

1. Broadening of the current graduated tax rate structure and raising the limit to $500,000.
2. Depreciation acceleration and simplification proposals which will provide equity to small business.
3. Capital formation proposals providing for:
   a. Tax deferral for rollovers of investments affecting small business.
   b. Tax deferral on sale of assets provided the funds are re-invested in qualifying small business.
   c. Creation of new financial instruments such as Small Business Participating Debentures.

*Of the National Small Business Association

4. Investment tax credits:

   a. Elimination of the limit on used equipment.

   b. Replacing the current targeted jobs tax credit with a general jobs tax credit.

5. Estate tax treatment revisions for family-owned firms in order to avoid job losses, plant abandonment or business mergers caused by excessive tax liabilities.

In addition to the specific points listed above, the SBLC supports, generally, the package of tax bills relating to Capital Formation Incentives for Small Business now pending before the Subcommittee on Taxation and Debt Management Generally.

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STATEMENT OF WILLIAM D. BARTH
ON BEHALF OF THE SMALL BUSINESS LEGISLATIVE COUNCIL
BEFORE THE SENATE FINANCE COMMITTEE
HOLDING HEARINGS ON PROPOSED TAX CUTS
JULY 31, 1980

Mr. Chairman and Members of the Committee:

My name is William D. Barth. I am Director of Small Business Practice of Arthur Andersen & Co. Today I am appearing on behalf of the Small Business Legislative Council (SBLC), an organization of 81 national trade and professional associations whose membership consists largely of small businesses. The SBLC membership and their affiliates represent over four and one-half million small business firms nationwide. Accompanying me is Herbert Liebenson, SBLC's Executive Director and President of the National Small Business Association.

Although I am speaking on behalf of the Small Business Legislative Council, my training and past 32 years of experience is in the accounting and auditing profession. Accountants are trained to give a cold, objective look at the facts of a situation. That training and experience were applied in preparation for my comments this afternoon.

I began by looking at the record of statements made in support of American small business. I assure you this was not an easy task. Over the years a written record of these statements could easily fill a small town library. Literally thousands upon thousands of articulate, knowledgeable and responsible individuals have espoused the cause of small business. Their ideas were sound, their proposals all within the realm of possibility and the support for their suggestions seemed overwhelming.

Then I began looking at what actually came of those ideas and proposals. If one believes that small business is one of the most important elements of our economic system -- and I hold that belief -- then a comparison of thoughts and actions is discouraging.

I found the record of accomplishments to be remarkably short. In most cases sound ideas -- that would have helped our nation's small businesses -- have simply been discarded even though they would not have impacted the U.S. Treasury or structure of our economy. These ideas were discarded for a variety of reasons. In some instances, no one bothered to follow-up on an idea. In other instances, small business was simply pushed aside so that Congress could deal with priorities that seemed more important at the time. In still other instances, Congress was presented with a number of porposals that seemed to conflict with one another and, instead of resolving the dispute, it simply waited until the proposals died a natural death due to inattention.

This year we are told that history will not repeat itself. This year we are told that from the thoughts that are voiced here and in other forums, there will be action. Although experience leads me to think otherwise, I sincerely hope that this year will be different and that something will be accomplished.

To illustrate my concern about the difference between thought and action, let me briefly present five examples that quickly came to the surface during my preparations for today.

1. The first impact that government has upon business, large or small, is through taxation. It is presumed that the current tax structure should encourage the development and growth of small business. To that end a graduated corporate tax rate was created. It begins at 17 percent for the first $25,000 of corporate income, 20 percent for the next $25,000 of income, 30 percent for the following $25,000 and then goes to 40 percent for incomes of from $75,000 to $100,000. Beyond that the tax rate is 46 percent.

The thought is that these reduced rates allow small and medium-sized companies to plow back a greater portion of earnings into their businesses. This then would allow the small businesses to expand, improve their operations and become more competitive. Small and medium-sized businesses -- which make up 97 percent of

American enterprises -- should thus retain more profits and fuel their own growth.

And, one might think from looking at the graduated tax rate that small businesses pay out a smaller percentage of their income in taxes than do businesses in the, say, $100 million range.

In fact, the opposite is often true. Many small businesses pay effective rates that are higher than their larger competitors. The reasons for this are many: large companies have the in-house expertise to identify and claim their rightful tax deductions, the nature of operations of many large companies provide above average benefits of certain credits and other incentives, and small businesses sometimes find that the process of claiming a tax deduction is so burdensome that they simply forego the opportunity.

Please do not infer from my comments that I am in any way opposed to the tax structure available to large busineses. I am not arguing against anything; I am arguing for small business.

The Small Business Legislative Council endorses the recommendation of the White House Conference on Small Business that calls for replacing the corporate tax rate schedule with more graduated rates covering the first $500,000 of income, not the first $100,000. I will confess that there are many that can find ample reason to argue against this revision of the corporate rate schedule. (ATTACHMENT A)

But, as a practical matter, this is the best solution that has come along to date. It is relatively easy to implement and, just as important, it is relatively easy for small businesses to understand and apply.

More complicated solutions, I fear, will collapse under their own weight, and the result will again be much verbal support for small business and no action. I urge you not to let that happen again.

2. Since 1971 all businesses have been granted the option of taking faster write-offs of depreciable assets under an Accelerated Depreciation Range system.

This system is sometimes known by the shorthand term "ADR." However, because of its complexity the ADR system is used by less than one-half of one percent of the small businesses in the nation.

The Small Business Legisaltive Council endorses the second priority of the White House Conference that calls for the adoption of a simplified and accelerated capital cost recovery system that would give small businesses more equitable depreciation deductions. (ATTACHMENT B)

There are alternative capital cost recovery methods now under consideration that in varying degrees provide for substantially higher depreciation deductions however they would result in a higher percentage of benefits accruing to large companies.

The Small Business Legislative Council is deeply concerned that such method -- as might be chosen -- will provide equity to small companies. Simply stated, small business is concerned that no single modification of existing tax rules produces such significantly higher deductions for any segment of the business community as to pre-empt those several programs of high priority to small companies.

Even the Treasury has acknowledged that the present ADR system is burdensome to calculate for both the taxpayer and the Internal Revenue Service.

3. The White House Conference on Small Business identified lack of available capital as the foremost concern of the delegates. Again, this is an area where numerous proposals have been presented to bring new funds to small businesses. To date, few if any have been approved. Two options, however, are under current consideration:

A. A deferral of taxes for rollovers of investments affecting small business. Under the present law, the owner of a small business who is retiring, or for some other reason wishes to sell his company, has the option of selling for cash and immediately paying a capital gains tax or, as is common, exchanging ownership of his small business for stock in a large company. This swap of stock-for-stock does not trigger an immediate capital gains tax. Small business owners, being astute, often execute a swap rather than sell for cash. The result is that an increasing number of small businesses are being bought out by larger businesses.

The Small Business Legislative Council is among the advocates who argue that taxes should be deferred upon the sale of a closely-held small business.

Secondly, the SBLC favors the deferral of taxes attributable to the sale of any investment asset provided the funds are timely invested in a qualifying small business. The acute and increasing capital shortage experienced by small business necessitates that some plan be adopted to provide encouragement to investors to put new funds into the small business sector. This is a simple, straight-forward proposal.

B. A new proposal, now before Congress, calls for the creation of a new financial instrument called a Small Business Participating Debenture. This would encourage investments in small enterprises on terms attractive to an investor and acceptable to the borrower. For a pre-established period, the holder of a Small Business Participating Debenture would share in the profits of a business much as a traditional stockholder and would receive favorable tax treatment on the receipt of his share of the earnings. The uniqueness of the small business capital formation problem calls for a unique new investment.

The Small Business Legislative Council endorses the Small Business Participating Debenture as a solution that is easily within reach. (ATTACHMENT C)

4. A fourth example of the difference between thought and action -- as they impact small business -- relates to allowances for investment tax credits. Prior to 1979 there were two sources of credits -- investments in productive assets and investments in people. Both were designed to stimulate and encourage business growth and development.

Though the tax credits for investments in productive assets have been significant to many small companies, the aggregate impact upon large companies has been of far greater importance. The reason is simple. Large businesses are typically capital and asset intensive. In contrast, small businesses are labor intensive.

Not surprising then is the recent statistic that 94 percent of all investment tax credits go to companies with assets of more than $1 million.

In contrast to the tax credit arising from the investment in assets, the credit for investment in people (known as the jobs credit) was severly limited as of January 1, 1979. Today we have a "targeted jobs credit" which is of very minor consequence.

Again, small business was the loser, as small business provides jobs. It is important to note that small business not only provides 55 percent of the private sector jobs in our economy, but also has provided 87 percent of the new jobs in the private sector in the past decade.

According to current estimates, the cost of one unemployed person -- in terms of lost revenues and actual social benefits paid -- exceeds $21,000. Simply stated, for every one million unemployed people in the nation, the cost to the taxpayers exceeds $21 billion annually.

We believe that implementation of a meaningful jobs credit would constitute fiscal responsibility on the part of government and we so urge you to act in that area. (ATTACHMENT D and ATTACHMENT E)

5. The fifth example is in the area of estate tax laws. It is often said that the purpose of estate taxes is to discourage the long-term (say more than 100 years) ownership of assets by a succession of heirs of an individual. Presumably, such taxes would alleviate the abuses that the fourders of our nation saw under the old English land title system. Perhaps the concept was valid when estate tax laws were enacted.

Today, however, we need a reexamination of that concept as it applies to small business. A we know, large businesses are owned by a large number of shareholders and the existence of these businesses goes on generation after generation.

The opposite is true of small businesses. Often they are merged or dissolved upon the death of the owner and the result is a loss of jobs, abandoned plants, and devastating economic effects upon the entire community.

The Small Business Legislative Council encourages you to ease the burden imposed upon the heirs who are faced with the problem of survival upon the death of the owner of a small business.

In summary, small business has, over the years, experienced a disheartening and demoralizing series of events in which its expectations were raised and then abruptly dashed to the ground. This has led many small business leaders to believe that nothing can or will be done on their behalf. In a very real sense, they are victims of "the system."

In the past we have heard the comment that small business was not able to articulate its viewpoint, that it was "unable to get its act together" and that, because of this, nothing came out of the hundreds of creative ideas that would have helped our nation's small businesses survive and prosper.

We believe, as do you, that this time something can be done for small business. We believe that this can be the year for both thought and action. We believe that our political system is effective and responsive to the ends and the needs of all its constituents, including small business.

Thank you for the opportunity to appear before the Committee. We urge your consideration of the ideas presented.

ATTACHMENT A

GRADUATED BUSINESS TAX SYSTEM

The graduated corporate income tax originally advanced by SBLC was enacted in 1978. It provides for a tax on the first $100,000 of taxable income according to the following schedule:

$0 -	$ 25,000	--	17%
$25,001 -	50,000	--	20%
$50,000 -	75,000	--	30%
$75,000 -	100,000	--	40%
Over -	100,000	--	46%

This was an historic step. Given the difficulty small businesses face in raising capital for investment (compared to the ready access to the capital markets enjoyed by the largest corporations), these lower tax rates will make it easier for small companies to re-invest more of their earnings into expansion and improvement.

Small business still faces many tax law obstacles. Estate and gift taxes are particularly burdensome; businesses shouldn't be forced into the arms of corporate takeover or driven out of business entirely due to excessively heavy taxes at the time of transfer of assets within an estate or family business. Among the most afflicted groups of small business falling into this category are farms -- truly small, family owned businesses.

Depreciation simplification is also backed by the small business community. The current ADR (Asset Depreciation Range) system is far too complex to be effectively utilized by most small businesses. The need for a simplified, straight-line depreciation system has long been recognized by the small business community, and was supported in the 95th Congress. The need persists, and small business must continue to back the needed changes.

RESOLVED

The Small Business Legislative Council continues to urge expansion and further simplification of the graduated business tax system, including investment tax credits, capital gains taxes, estate and gift taxes, and depreciation allowances. The SBLC, recognizing the gains made in the 95th Congress in the adoption of the graduated business tax system, continues to urge further reduction of the minimum rate of corporate taxation to 12 percent, as well as a widening of the brackets to which the graduated rates apply. At a minimum the present $100,000 cut-off point should be increased as a first step to $250,000.

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July 31, 1980

The position paper -- Graduated Business Tax System -- is supported, as of this date, by 57 members of the Small Business Legislative Council:

American Assn. of Nurserymen
Washington, DC

American Textile Machinery Assn.
Washington, DC

Amusement & Music Operators Assn.
Chicago, IL

Assn. of Diesel Specialists
Kansas City, MO

Assn. of Indep. Corrugated Converters
Washington, DC

Assn. of Physical Fitness Centers
Bethesda, MD

Automotive Warehouse Distribs. Assn.
Kansas City, MO

Bldg. Service Contractors Assn. Intl.
Vienna, VA

Business Advertising Council
Cincinnati, OH

Christian Booksellers Assn.
Colorado Springs, CO

Direct Selling Assn.
Washington, DC

Eastern Manufs. & Importers Exhibit
New York, NY

Electronic Reps. Assn.
Chicago, IL

Furniture Rental Assn. of America
Washington, DC

Independent Bakers Assn.
Washington, DC

Indep. Business Assn. of Michgian
Kalamazoo, MI

Indep. Business Assn. of Washington
Bellevue, WA

Indep. Sewing Machine Dealers of America
Hilliard, OH

Inst. of Certified Business Counselors
Lafayette, CA

Intl. Franchise Assn.
Washington, DC

Local and Short Haul Carriers Natl Conf.
Washington, DC

*Of the National Small Business Association

Machinery Dealers Natl. Assn.
Silver Spring, MD

Manufacturers Agents Natl. Assn.
Irvine, CA

Marking Device Assn.
Evanston, IL

Menswear Retailers of America
Washington, DC

MN Assn. of Commerce & Industry Small
Business Council, St. Paul, MN

Natl. Assn. for Child Devel. & Ed.
Washington, DC

Natl. Assn. of Brick Distributors
McLean, VA

Natl. Assn. of Floor Covering Distribs
Chicago, IL

Natl. Assn. of Plastic Fabricators
Washington, DC

Natl. Assn. of Retail Druggists
Washington, DC

Natl. Burglar & Fire Alarm Assn.
Washington, DC

Natl. Candy Wholesalers Assn.
Washington, DC

Natl. Coffee Service Assn.
Chicago, IL

Natl. Concrete Masonry Assn.
Herndon, VA

Natl. Electrical Contractors Assn.
Bethesda, MD

Natl. Family Business Council
West Bloomfield, MI

Natl. Home Furnishings Assn.
Washington, DC

Natl. Home Improvement Council
New York, NY

Natl. Independent Dairies Assn.
Washington, DC

Natl. Insulation Contractors Assn.
Washington, DC

Natl. Meat Assn.
Washington, DC

Natl. Office Machine Dealers Assn.
Des Plaines, IL

Natl. Office Products Assn.
Alexandria, VA

Natl. Paper Box Assn.
Haddonfield, NJ

Natl. Paper Trade Assn.
New York, NY

Natl. Parking Assn.
Washington, DC

Natl. Patent Council
Arlington, VA

Natl. Pest Control Assn.
Vienna, VA

Natl. Precast Concrete Assn.
Indianapolis, IN

Natl. Small Business Assn.
Washington, DC

Natl. Society of Public Accountants
Washington, D.C.

Natl. Tire Dealers & Retreaders Assn.
Washington, DC

Natl. Tooling and Mach. Assn.
Washington, DC

Natl. Wine Distrib. Assn.
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Power & Comm. Contractors Assn.
Washington, DC

Sheet Metal & Air Cond. Contrs.
Natl. Assn., Vienna, VA

ATTACHMENT B

CAPITAL INVESTMENT RECOVERY

Small business has seen its role in the U.S. economy dwindle for decades. Much of the reason for its decline lies in its inability to get the capital to be able to compete with large business in this country. The corporate giants, meanwhile, have access to the capital they need at the lowest available rates. They continue to increase their share of the Gross National Product at the expense of small business.

This competitive country must redirect its economic structure to return to the principles of private enterprise upon which it was founded. At the rate we are going there will soon be no small business in America. The American dream of starting one's own business and making it a success will be nothing more than a dream. No one man or woman will be able to come close to competing with the major corporations.

The U.S. Congress can help restore the American dream by passing legislation facilitating the recovery of capital. But it must be of genuine help for the small business and not a tool for big business to continue to take over and freeze out small business as it has been doing for years. The corporate giants, with their easy access to capital at the lowest rates, would use any legislation to accelerate expansion to the disadvantage of small business if there is not a ceiling on the benefits. The small retailer would get little joy from his newly won benefits if he found a major corporate chain was using them to open a store next door. This would happen without a ceiling. The small manufacturer would find the same thing. Whatever he was able to invest in new productive equipment would be more than matched by the well-heeled giant that had been running him out of business anyway. In some industries, major corporations who presently subcontract would find it a greater advantage to manufacture themselves should legislation without a ceiling be passed.

Any tax bill accelerating depreciation should provide a 10% investment tax credit for all equipment, machinery, and furnishings. It would allow them to be depreciated over four years. This type of capital investment could be depreciated as much as four or five times faster than presently allowed. These breaks would be targeted to small business by limiting to $1 million the amount of total investment in equipment, machinery and furnishings upon which accelerated depreciation would be allowed.

Buildings and fixtures would also be depreciated much faster. These types of investments could be written off in 10 years. This type of investment could be depreciated as much as six times faster than under present rules. This break would also be targeted to small business by limiting to $1 million per year the amount of investment in buildings and fixtures upon which accelerated depreciation would be allowed.

Over 97-1/2% of all U.S. companies would be able to use this legislation to full advantage. Most of the remaining 2-1/2% of companies, which account for 79% of the investment in this country, could use it up to the ceiling amounts. Thus this bill both would help small business and significantly reduce the revenue loss that would occur if there were no ceilings on benefits.

RESOLVED

Increased capital investment by small business is essential if this basic American institution is to survive and prosper. SBLC endorses legislation that will encourage increased capital investment by small businesses. The combined effect of more rapid depreciation and increased investment tax credit will assure small business a greater return on its investment in such capital, thereby making small business more profitable, and better able to compete in all markets.

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Small Business Legislative Council*

July 31, 1980

The position paper -- Capital Investment Recovery -- is supported, as of this date, by 51 members of the Small Business Legislative Council:

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American Assn. of Nurserymen
Washington, DC

American Textile Machinery Assn.
Washington, DC

Amusement & Music Operators Assn.
Chicago, IL

Assn. of Indep. Corrugated Converters
Washington, DC

Assn. of Physical Fitness Centers
Bethesda, MD

Automotive Warehouse Distribs. Assn.
Kansas City, MO

Building Service Contractors Assn.
Intl., McLean, VA

Business Advertising Council
Cincinnati, OH

Christian Booksellers Assn.
Colorado Springs, CO

Direct Selling Association
Washington, DC

Eastern Manufs. & Importers Exhibit
New York, NY

Electronic Reps. Assn.
Chicago, IL

Indep. Business Assn. of Michgian
Kalamazoo, MI

Indep. Business Assn. of Washington
Bellevue, WA

Indep. Sewing Machine Dealers of America
Hilliard, OH

Inst. of Certified Business Counselors
Lafayette, CA

Intl. Franchise Assn.
Washington, DC

Local and Short Haul Carriers Natl Conf.
Washington, DC

Machinery Dealers Natl. Assn.
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Menswear Retailers of America
Washington, DC

Natl. Assn. of Brick Distributors
McLean, VA

Natl. Assn. of Floor Covering Distribs.
Chicago, IL

Natl. Assn. of Plastic Fabricators
Washington, DC

Natl. Assn. of Plastics Distribs.
Jaffrey, NH

Natl. Assn. of Retail Druggists
Washington, DC

Natl. Beer Wholesalers Assn. of Am.
Falls Church, VA

Natl. Burglar & Fire Alarm Assn.
Washington, DC

Natl. Candy Wholesalers Assn.
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Natl. Coffee Service Assn.
Chicago, IL

Natl. Concrete Masonry Assn.
Herndon, VA

Natl. Electrical Contractors Assn.
Bethesda, MD

Natl. Family Business Council
West Bloomfield, MI

Natl. Home Furnishings Assn.
Washington, DC

Natl. Home Improvement Council
New York, NY

Natl. Independent Dairies Assn.
Washington, DC

Natl. Office Machine Dealers Assn.
Des Plaines, IL

Natl. Office Products Assn.
Alexandria, VA

Natl. Parking Assn.
Washington, DC

Natl. Patent Council
Arlington, VA

Natl. Pest Control Assn.
Vienna, VA

Natl. Precast-Concrete Assn.
Indianapolis, IN

Natl. Small Business Assn.
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Natl. Society of Public Accountants
Washington, D.C.

Natl. Tire Dealers & Retreaders Assn.
Washington, DC

Natl. Tooling and Machining Assn.
Washington, DC

Natl. Tour Brokers Assn.
Lexington, KY

Natl. Wine Distrib. Assn.
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Power & Comm. Contractors Assn.
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Natl. Assn., Vienna, VA

ATTACHMENT C

SMALL BUSINESS PARTICIPATING DEBENTURE

The lack of available debt or equity capital has been identified as a universal concern of small businesses. Historically, commercial banks have supplied the most significant amounts of outside capital to the small business community and it is expected that this trend will continue in the future. However, it has often been said that this source of capital is not adequate for the long-term needs of smaller firms.

Additionally, there are other roadblocks for a firm seeking capital. For example, direct investments by employees or others in small independent businesses are difficult to attract as the rewards associated with these investments are rarely equal to the related risks. The small business owner is hesitant to sell an equity interest in the business because of the desire to maintain independence and the competitive advantage of confidentiality. Moreover, an equity interest in a small business is often difficult to liquidate for the intermediate-term investor.

A partial solution is a new, hybrid security for use by small businesses who need capital but in amounts less than those generally provided by venture capital companies. The new hybrid security is called a Small Business Participating Debenture (SBPD). It would combine certain debt characteristics (such as an interest rate and a maturity date) with existing equity characteristics (such as a share in the net profits of the issuing enterprise). The significant characteristics of the SBPD concept are its tax consequences. The total interest paid by the SBPD issuer would be treated as an interest expense and deductible by the company. This would include the interest due through the stated rate and any "premium" interest payments made that represent a share of net income.

The tax benefits and incentives to the investor in SBPD's include taxing "premium" interest earned as if it were a long-term capital gain. In the event that the investor does not recover his full investment, SBPD legislation would allow him an ordinary loss deduction.

In summary:

Advantages to Small Business Borrowers	Advantages to SBPD Investors
Entire cost of borrowing is tax deductible.	Receives tax credits as incentive for making investment.
Avoids giving up equity.	Portion of interest (share of profits) is taxable as a capital gain.
No necessity for additional bureaucratic controls.	Losses on SBPD investments would be offset by ordinary income.
Potentially, the total of borrowing could be reduced as a result of tax benefits of the investors.	

The administration of the SBPDs would be relatively inexpensive as no government involvement is required nor is there any risk of loss to the government. Unlike several pieces of legislation aimed at small business, this one has only a nominal cost to the Treasury; accordingly, this solution is a practical one.

This new hybrid security has been discussed extensively and has received widespread support. In July 1980, Senators Lowell P. Weicker (R.Conn.), Gaylord Nelson (D.Wisc.) and others introduced a bill before the U.S. Senate (S. 2981) to amend the Internal Revenue Code to create SBPDs.

RESOLVED

The Small Business Legislative Council supports the concept of the Small Business Participating Debenture and urges passage of S. 2981 or similar legislation by Congress as quickly as possible.

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July 31, 1980

The position paper -- Small Business Participating Debenture -- is supported, as of this date, by 48 members of the Small Business Legislative Council.

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American Assn. of Nurserymen
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American Metal Stamping Assn.
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American Textile Machinery Assn.
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Amusement & Music Operators Assn.
Chicago, IL

Assn. of Indep. Corrugated Converters
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Assn. of Physical Fitness Centers
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Business Advertising Council
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Christian Booksellers Assn.
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Direct Selling Association
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Eastern Manufs. & Importers Exhibit
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Electronic Representatives Assn.
Chicago, IL

Furniture Rental Assn. of America
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Indep. Business Assn. of Michigan
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Indep. Sewing Machine Dealers of America
Hilliard, OH

Inst. of Certified Business Counselors
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International Franchise Association
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Local and Short Haul Carriers Natl. Conf.
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Machinery Dealers Natl. Assn.
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Manufacturers Agents Natl. Assn.
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Natl. Assn. of Floor Covering Distribs.
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Natl. Assn. of Retail Druggists
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Natl. Burglar & Fire Alarm Assn.
Washington, DC

Natl. Candy Wholesalers Assn.
Washington, DC

Natl. Coffee Service Association
Chicago, IL

Natl. Electrical Contractors Assn.
Bethesda, MD

Natl. Family Business Council
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Natl. Home Furnishings Assn.
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Natl. Home Improvement Council
New York, NY

Natl. Indep. Dairies Association
Washington, DC

Natl. Office Products Association
Alexandria, VA

National Paper Box Association
Haddonfield, NJ

Natl. Patent Council
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Natl. Pest Control Assn.
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Natl. Precast Concrete Assn.
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Natl. Small Business Assn.
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Natl. Society of Public Accountants
Washington, DC

Natl. Tire Dealers & Retreaders Assn.
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Natl. Tooling and Machining Assn.
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Natl. Wine Distributors Assn.
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ATTACHMENT D

JOB CREATION

The 95th Congress refused to extend or expand a job creation tax credit which allowed a business to take a tax credit of 50 percent of the cost of hiring up to two new employees with a maximum credit of $20,000. Instead, Congress created a new targeted jobs credit and extended and expanded the Work Incentive (WIN) program.

Under the new targeted credit, a tax credit of 50 percent of the first $6,000 of wages per employee in a trade or business for the first year of employment, and 25 percent of such wages for the second year of employment, would be provided for hiring members of seven specific groups that have unemployment rates above the national average. The ordinary tax deduction for wages would be reduced by the amount of the credit. Wages eligible for the credit would be limited to 30 percent of the total FUTA wages paid by an employer.

The current WIN tax credit for hiring welfare recipients would be increased so that rates for hiring a business employee are the same as for the targeted jobs credit. The rate for hiring a non-business employee would be 35 percent of the first $6,000 of wages for the first year of employment.

As signed, H.R. 50, the Humphrey-Hawkins bill was a far cry from the massive federal jobs and economic planning bill introduced by the late Senator Humphrey and Rep. Hawkins during the mid-1970s recession. But it retained the central goal of reduction of the unemployment rate to 4 percent by 1983. In addition, the final version tied a new national goal, a reduction of the inflation rate to 3 percent by 1983 and zero percent by 1988, to its unemployment goal.

RESOLVED

In the elimination of current high unemployment, the small business sector should be the employer of the first resort, with the incentive being provided by a job creation tax credit without regard to the status of the individual.

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Small Business Legislative Council*

July 31, 1980

The position paper -- Job Creation -- is supported, as of this date, by 61 members of the Small Business Legislative Council and other associations.

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American Pulpwood Assn.
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American Textile Machinery Assn.
Washington, DC

Assn. of Diesel Specialists
Kansas City, MO

Assn. of Indep. Corrugated Converters
Washington, DC

Assn. of Physical Fitness Centers
Bethesda, MD

Automotive Engine Rebuilders Assn.
Glenview, IL

Automotive Warehouse Distribs. Assn.
Kansas City, MO

Bldg. Service Contractors Assn. Intl.
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Christian Booksellers Association
Colorado Springs, CO

Direct Selling Association
Washington, DC

Furniture Rental Assn. of America
Washington, DC

Independent Bakers Assn.
Washington, DC

Indep. Business Assn. of Michigan
Kalamazoo, MI

Indep. Business Assn. of Washington
Bellevue, WA

Indep. Sewing Machine Dealers of America
Hilliard, OH

International Franchise Association
Washington, DC

Inst. of Certified Business Counselors
Lafayette, CA

Local and Short Haul Carriers Natl. Conf.
Washington, DC

Manufacturers Agents Natl. Assn.
Irvine, CA

Marking Device Association
Evanston, IL

Menswear Retailers of America
Washington, DC

*Of the National Small Business Association

MN Assn. of Commerce & Industry Small
Business Council, St. Paul, MN

Natl. Appliance Service Assn.
Kansas City, MO

Natl. Assn. for Child Devel. & Educ.
Washington, DC

Natl. Assn. of Brick Distributors
McLean, VA

Natl. Assn. of Plastics Distribs.
Jaffrey, NH

Natl. Assn. of Retail Druggists
Washington, DC

Natl. Burglar & Fire Alarm Assn.
Washington, DC

Natl. Candy Wholesalers Assn.
Washington, D.C.

Natl. Campground Owners Assn.
Wheaton, MD

Natl. Coffee Service Assn.
Chicago, IL

Natl. Concrete Masonry Assn.
Herndon, VA

Natl. Electrical Contractors Assn.
Bethesda, MD

Natl. Family Business Council
West Bloomfield, MI

Natl. Glass Dealers Assn.
Washington, DC

Natl. Home Improvement Council
New York, NY

Natl. Indep. Dairies Assn.
Washington, DC

Natl. Insulation Contractors Assn.
Washington, DC

Natl. Office Machine Dealers Assn.
Des Plaines, IL

Natl. Office Products Assn.
Alexandria, VA

Natl. Paper Box Association
Haddonfield, NJ

Natl. Paper Trade Association
New York, NY

Natl. Parking Association
Washington, DC

Natl. Patent Council
Arlington, VA

National Peach Council
Martinsburg, WV

Natl. Pest Control Association
Vienna, VA

Natl. Precast Concrete Association
Indianapolis, IN

Natl. Small Business Association
Washington, DC

Natl. Society of Public Accountants
Washington, DC

Natl. Tire Dealers & Retreaders Assn.
Washington, DC

Natl. Tooling & Machining Assn.
Washington, DC

Natl. Truck Equipment Association
Oak Park, MI

Natl. Utility Contractors Assn.
Washington, DC

Natl. Woodwork Manufacturers Assn.
Chicago, IL

Oregon Feed, Seed and Suppliers Assn.
Portland, OR

Printing Industries of America
Arlington, VA

Retail Bakers of America
Washington, D.C.

Sheet Metal & Air Cond. Contrs. Natl.
Assn., Vienna, VA

ATTACHMENT E

INVESTMENT TAX CREDIT

The decline in our productivity is caused by several conditions. For the first time in twenty years, the Joint Economic Committee Annual Report of 1979 unanimously concluded that an increase in productivity is vital to the improvement of our economic standard of living and to the reduction of inflation. A partial cause of this situation is the antiquated production facilities of many American manufacturers. Another partial cause is the utilization of inefficient equipment; and yet another partial cause is the overall age of our country's industrial machinery. The most recent U.S. survey of machine tools shows only 11% of the industrial machinery in use today is less than five years old: 76% is at least ten years old. Equipment renewal and upgrading are necessary in both large and small manufacturing companies. Increasing productivity through equipment renewal is best achieved for small business through the purchase of affordable used machinery and equipment.

Under present law there is a $100,000 limitation on the amount of used equipment eligible for investment tax credit, but there is no limitation on the investment credit available for new equipment. This discriminatory tax treatment impacts directly and primarily on small business which is already hindered by its inability to externally or internally generate capital necessary to buy new equipment.

In order to increase productivity and competition, the discriminatory ceiling on the amount of used property eligible for a tax credit must be eliminated; and, the carryover provisions available for new property must also be available for similarly situated used property. Traditionally, small businesses purchase used capital equipment; large businesses basically purchase newly manufactured capital equipment. The cost of obtaining capital for production equipment is high for everyone, especially those who cannot borrow at the prime rate. Firms purchasing used capital equipment do not have a chance to offset some of their costs through this tax credit. Confining the investment credit to only equipment with the latest technology helps primarily the largest enterprises and basically ignores the numerically greater small business segment of our economy which needs this tax credit the most. Because the small business sector offers the greatest potential for increasing employment, there is normally a direct relationship between increased installation of used machinery and increased employment.

RESOLVED

Small Business Legislative Council urges and supports changes in the IRS Code to allow a full investment tax credit for used machinery and equipment. This full investment tax credit will allow small businesses to receive the same tax incentive provided to big businesses and would allow small businesses to compete, to maintain their current market share, and to hopefully expand output and productivity.

ATTACHMENT E

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Washington, D.C. 20006
Telephone
(202) 296-7400

Small Business Legislative Council*

July 31, 1980

The position paper -- Investment Tax Credit -- is supported, as of this date, by 51 members of the Small Business Legislative Council:

American Assn. of MESBICs
Washington, DC

American Assn. of Nurserymen
Washington, DC

American Metal Stamping Assn.
Richmond Heights, OH

Assn. of Diesel Specialists
Kansas City, MO

Assn. of Indep. Corrugated Converters
Washington, DC

Assn. of Physical Fitness Centers
Bethesda, MD

Automotive Warehouse Distribs. Assn.
Kansas City, MO

Bldg. Service Contractors Assn. Intl.
Vienna, VA

Business Advertising Council
Cincinnati, OH

Christian Booksellers Assn.
Colorado Springs, CO

Direct Selling Association
Washington, D.C.

Eastern Manufs. & Importers Exhibit
New York, NY

Electronic Reps. Assn.
Chicago, IL

Independent Bakers Assn.
Washington, DC

Indep. Business Assn. of Michigan
Kalamazoo, MI

Indep. Sewing Machine Dealers of America
Hilliard, OH

Intl. Franchise Assn.
Washington, DC

Local and Short Haul Carriers Natl Conf.
Washington, DC

Machinery Dealers Natl. Assn.
Silver Spring, MD

Manufacturers Agents Natl.
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Narrow Fabrics Institute
New Rochelle, NY

Natl. Assn. of Catalog Showroom Merchs.
New York, NY

Natl. Assn. of Floor Covering Distribs.
Chicago, IL

Natl. Assn. of Plastic Fabricators
Washington, DC

Natl. Assn. of Plastics Distribs.
Jaffrey, NH

Natl. Assn. of Retail Druggists
Washington, DC

Natl. Candy Wholesalers Assn.
Washington, DC

Natl. Coffee Service Assn.
Chicago, IL

Natl. Electrical Contractors Assn.
Bethesda, MD

Natl. Family Business Council
West Bloomfield, MI

Natl. Home Improvement Council
New York, NY

Natl. Independent Dairies Assn.
Washington, DC

Natl. Insulation Contractors Assn.
Washington, DC

Natl. Meat Assn.
Washington, DC

Natl. Office Machine Dealers Assn.
Des Plaines, IL

Natl. Paper Box Assn.
Haddonfield, NJ

Natl. Paper Trade Assn.
New York, NY

Natl. Parking Assn.
Washington, DC

Natl. Patent Council
Arlington, VA

Natl. Pest Control Assn.
Vienna, VA

Natl. Small Business Assn.
Washington, DC

Natl. Society of Public Accountants
Washington, DC

Natl. Tire Dealers & Retreaders Assn.
Washington, DC

Natl. Tooling and Machining Assn.
Washington, DC

Natl. Tour Brokers Assn.
Lexington, KY

Power & Comm. Contractors Assn.
Washington, DC

Printing Industries of America
Arlington, VA

Sheet Metal & Air Cond. Contrs.
Natl. Assn., Vienna, VA

STATEMENT OF ARTHUR D. LITTLE, PRESIDENT, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

Mr. LITTLE. My name is Arthur Little. I am chairman of Narragansett Capital Corp. of Providence, R.I., and President of NASBIC—the National Association of Small Business Investment Companies this year.

Senator NELSON. Welcome back to the committee.

Mr. LITTLE. You have already summarized most of my testimony. I will try to be as brief as possible.

Senator NELSON. I remember you testifying the last time, and I think that we agreed on about 95 percent. The other 5 percent was wrong, but that is a whale of a record to have anyway.

Mr. LITTLE. I don't have to tell you, of course, the importance of small business in our economy, and also that the current economic crisis particularly severe on small businesses.

We happen to feel that the Federal policies which have encouraged consumption rather than savings and investment are largely responsible for the inflation rate and unemployment. Perhaps more importantly, from our point of view, they have contributed to the decline of entrepreneurism and innovation. We feel that tax policy should and can be directed toward the revitalization of the business sector.

NASBIC supports all of the capital formation recommendations of the White House Conference, particularly the further graduation of corporate income tax rates, and basically the 10-5-3 depreciation proposal.

In addition, we support a number of measures which will increase the ability of businesses to raise capital, and get credit from external investors and lenders. Most important of these from our point of view is embodied in your S. 653, the capital gains rollover provisions.

There are a number of other recommendations which we would like to make. Senator Cranston has recently introduced Senate 2923, which would lower the effective capital gains rates even further. We think that that is a good step.

Senate 2981, the small business participating debenture, again I really would like to congratulate the work of the people of Arthur Andersen in pioneering this concept, and Senator Weicker in sponsoring it. I think that it is a terrific concept, and one that should be heartily supported.

We also support tax credits for investments in small business, your Senate bill 487, restoration of restricted stock options, and the proposals that you have made on subchapter S corporations.

There are a couple of other items. One in particular that is of interest to us, which is a support for a change in subchapter M of the Tax Code which would enable all SBIC's to qualify for pass-through tax treatment under section 851, providing that they complied with the various diversification requirements.

That really concludes what I have to say on those particular tax measures. There is one very, very important that is happening now, and it is coming forth from the Treasury Department and the Internal Revenue Service, and that is their recent proposal relative to debt and equity, and how those two things would be regarded by our tax authorities.

What they have suggested, frankly, will be an absolute disaster for the small business community. We are working as well as we can with the Treasury people at the moment to get them to understand that point of view. We rather suspect that we will have to come back to this committee and ask for your help in that matter as well. I hope that your committee is fully aware of the danger posed by these new regulations.

Senator NELSON. We are aware of that, and we share your concerns. It is vital to small business, and I suspect that that aspect of the problem has not been very carefully evaluated, and your small business input, I would hope, would cause them to modify it.

Mr. LITTLE. We are working as hard as we can, sir.

[The prepared statement of Mr. Little follows:]

NASBIC
NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

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WASHINGTON, D. C. 20005

July 30, 1980

Summary of Statement of Arthur D. Little, President,

National Association of Small Business Investment Companies

Committee on Finance
United States Senate

1. The importance of small business to our economy is well documented. Not only are 97% of all businesses in the country considered small, but studies have proven these firms to be our leading job creators and industrial innovators.

2. The current economic crisis is especially severe for small firms, which are less able to absorb the impact of inflation. Federal policies which have encouraged consumption rather than savings and investment are largely responsible for our alarming inflation and unemployment, and have contributed to the decline in entrepreneurism and innovation.

3. Tax policy can and should be directed towards the revitalization of the business sector. NASBIC supports all of the capital formation recommendations of the delegates to the White House Conference on Small Business, particularly a further graduation of corporate tax rates and a system of of simplified and accelerated depreciation (such as "10-5-3").

4. In addition, NASBIC supports changes in the tax code which will increase the ability of businesses to raise capital and attract credit from external investors and lenders. The most important of these is the capital gains rollover, as embodied in S. 653, introduced by Senator Nelson. A capital gains rollover would greatly stimulate the flow of venture capital to small firms and would discourage economic concentration by rectifying an existing tax code bias which enables an entrepreneur to defer taxes only by selling out to another corporation in a stock transaction.

5. Additional tax changes to stimulate investment which are supported by NASBIC include a further reduction of individual and corporate gains tax rates (S. 2923, Cranston); the creation of the small business participating debenture (S. 2981, Weicker); tax credits for investment in small ventures (S. 487 Nelson); the restoration of restricted stock options (S. 2239, Packwood); and changes in Subchapter S which would enable SBICs to own stock in Sub S companies and be exempt from the passive income test.

6. Finally, NASBIC supports a change in Subchapter M of the tax code which would enable all SBICs to qualify for pass-through tax treatment under Section 851, provided they comply with the diversification requirements of the Section.

NASBIC

NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

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WASHINGTON, D. C. 20005

STATEMENT OF

ARTHUR D. LITTLE

Before the

COMMITTEE ON FINANCE

UNITED STATES SENATE

July 31, 1980

Good morning Mr. Chairman and Committee Members. I am Arthur D. Little, Chairman of Narragansett Capital Corporation, the nation's largest publicly held small business investment company. I am also serving this year as President of the National Association of Small Business Investment Companies and I am pleased and honored to have the opportunity to present my remarks before this distinguished Committee on behalf of the Association.

Before getting into the substance of my remarks, I would like to comment briefly on SBICs and small business. I will follow with recommendations for specific legislative changes.

SBICs and Small Business

Small business investment companies are privately-organized, privately-capitalized, and privately-managed venture capital firms. They are licensed and regulated by the Small Business Administration pursuant to the Small Business Investment Act of 1958, and serve as sources of long-term debt and equity capital for small and independent companies. SBICs are entitled to borrow funds from the Federal Financing Bank up to a maximum leverage rate of 4-to-1, but all of the company's private capital is subordinated to the government leverage (i.e. all private money in an SBIC is lost before the government funds are reached). In the 21-year history of the program, SBICs have provided over $3 billion to more than 40,000 firms.

The importance of small business to our economy is well documented. Not only are 97% of all business enterprises in the country considered small, but studies have proven these firms to be our leading job creators and industrial innovators. Sixty-six percent of all net new jobs between 1969 and 1976 were created by firms with fewer than 20 employees, and over half of the innovations introduced into industry since World War II originated in small companies.

The current economic crisis affects all business, but it is particularly severe for small firms, which are less able to absorb the impacts of inflation. Many economists believe that federal policies which have encouraged consumption rather than savings and investment are largely responsible for our declining productivity and high rate of inflation. Businesses are finding it impossible to accumulate the capital necessary to invest in new equipment and ideas and as a result research and development has declined, fewer innovations are incorporated into our industrial system, and our productive capacity has slowed.

TAX RECOMMENDATIONS

Tax policy can and should be directed toward the revitalization of the business sector. The Internal Revenue Code must be changed to emphasize capital formation and reinvestment of gain, rather than to reward consumption as it has in the past. Only through substantial tax relief can small business, the most productive segment of our economy, fulfill its potential and help to alleviate the existing economic malaise.

At the White House Conference on Small Business, over 1,600 delegates voted capital formation the biggest problem facing small firms today. "Capital formation" is a broad term, but it comprises three distinct elements: 1) the capacity of a business to generate and retain internal funds; 2) the ability of a business to raise capital and attract credit from external investors and lenders; and 3) business continuity -- the ability of an entrepreneur to pass along a business to his heirs without subjecting them to excessive estate taxes. Without question, the factor which most affects a company's capital formation capabilities is the Internal Revenue Code.

As outside investors, SBICs are immediately affected by tax policies which shape the prevailing investment climate, such as treatment of capital gains. However, the SBIC program can only prosper to the extent that the small business sector does, therefore; we are strong advocates of all proposals that will provide tax relief to independent business owners.

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Let me begin by addressing some of the tax policies which determine the ability of a business to retain internally generated capital. This is an area of crucial importance to small firms because they generally lack the access to long-term debt instruments available to larger companies. The top priority of the delegates to the White House Conference was a change in income tax schedules. They advocated further graduating the corporate tax rates so that the maximum rate would not become effective until a company had earned $500,000. Such a tax reduction is imperative if small businesses are to survive this period of high inflation.

In addition, independent firms desperately need tax relief in the area of depreciation. The current Asset Depreciation Range is too complex to be a viable option for small business people, and NASBIC supports a simple, accelerated system of depreciation such as that contained in the "10-5-3" bills.

Small, growth-oriented companies must receive additional financing from outside sources to capitalize improvements and expansions, especially in their early stages. Equity capital and long-term loans are provided by investors who hope to be rewarded for their risks with capital gains. The importance of venture capital was illustrated by a survey done by the American Electronics Association in 1978 which showed that young, high-technology electronics firms looked to outside investors for approximately 70% of the capital they needed to finance growth. Congress should encourage investment in these innovative high-growth companies by providing tax incentives and removing existing obstacles.

<u>Capital Gains Tax Rollover</u>: NASBIC's top priority at this time is a capital gains rollover -- a deferral of taxes on the gain from an investment which is <u>reinvested</u> within a specified period of time in a qualifying small business or SBIC. Specifically, we support S. 653, introduced by Senator Nelson, which we feel would provide a substantial portion of needed new venture and equity dollars, would have a minor revenue impact, and could be easily and fairly administered. This is essentially the rollover proposal which was endorsed by delegates to the White House Conference. In addition to stimulating the flow of venture capital, such a rollover would work to discourage economic concentration by rectifying an existing tax code bias. Currently, an entrepreneur can defer taxes only by selling out to another corporation in a stock transaction. Were a capital gains rollover to be adopted, a business owner could sell one business and go into another without a major tax impact. Additionally, the capital gains rollover could be utilized by corporate investors as well as individuals. This would be extremely helpful since approximately 50% of the professionally managed venture capital in the country is in corporate form.

The rollover concept exists in different forms and our organization feels that the Nelson bill is most responsive to the needs of small businesses. Another type of rollover is that embodied in S. 1964 introduced by Senator Heinz. S. 1964 would introduce into the Tax Code an "investment account" rollover mechanism. Under the proposal, all funds placed in such account would be allow to earn interest, dividend or capital gain income, all of which for tax purposes would not be recognized until withdrawn from the account. As funds are withdrawn, all ordinary income would be taxed first with any capital gains tax applied, if earned, to the final dollars withdrawn from the account. The investment account approach is an innovative and creative capital formation idea. From the standpoint of small business investment companies, however, it is not very attractive.

Additional Tax Recommendations: The Revenue Act of 1978 reduced the maximum capital tax from 49% to 28%, and the result has been an unprecedented amount of new venture capital flowing into the system. Commitments to venture capital companies increased from $39 million in 1977 to $570 million in 1978 and $319 million in 1979, and actual venture capital disbursements leapt from $400 million to $1 billion. The tax reduction applied only to individuals, however, and further relief is necessary for corporations. Senator Cranston recently introduced S. 2923, which would effectively reduce both individual and corporate tax rates from 28% to 21%. Action by Congress to further reduce the capital gains tax, especially for corporate investors, would be extremely helpful. While NASBIC's top priority is the capital gains rollover, our association would enthusiastically support a further reduction in the capital gains tax rate if corporate investors are included.

There are a number of additional revenue measures currently pending before the Congress which would encourage external investments in business without causing major revenue losses to the Treasury. S. 2981, a bill introduced by Senator Weicker, would create the small business participating debenture, or SBPD. The SBPD is a hybrid security which would have the status of a debt security (a stated redemption date and rate of interest to be determined by the market for the security) but which also would return to the lender a share of the company's profits, if earned, over a fixed period of time, taxable at capital gains rates. The SBPD is a totally new concept in small business financing, and one which could do a great deal to stimulate investment in small firms. It would be especially attractive to companies who do not want to give up equity but wish nonetheless to attract outside investors. It would also be attractive to the investor since it would provide him with the potential for capital gain. Our association strongly urges the Congress to consider the enactment of a small business participating debenture provision.

Several bills introduced in Congress, including S. 487, sponsored by Senator Nelson, would provide investment tax credits for investments in small ventures. Such a provision would certainly help increase the flow of funds to small businesses and our Association favors any provision which will stimulate small business investment. However, we feel that it is better to reward success than to provide incentives at the front end. The capital gains tax rollover or a reduction in the capital gains tax rewards a successful investor because it is only the success story which will result in a capital gain. The investment tax credit, however, can be viewed as a gimmick which may be used to promote poor investments. NASBIC therefore feels that the investment tax credit should be given a lower priority in the small business capital formation area.

The restoration of pre-1964 stock options would be extremely helpful to venture capital companies and other small businesses. Recently the Democratic Task Force on the Economy expressed its support for reinstituting the restricted options, and NASBIC supports S. 2239, introduced by Senator Packwood and cosponsored by Senators Nelson and Cranston, which would accomplish this goal. Since smaller firms can seldom provide the high salaries and fringe benefits of larger corporations, they must have other incentives to offer their management. Restricted stock options allow employees to share in the appreciation of the company for which they work.

I wish to digress from the pending tax legislation for just a moment to mention a proposed IRS regulation which would absolutely devastate the small business community. On March 24, IRS published a proposed Section 1.385 covering the treatment of certain interests in corporations as stock or indebtedness; in taking that action, the Service was following a mandate given it by Congress in the Tax Reform Act of 1969. In essence, the proposed rule would force the reclassification of many business loans into stock. In such a case, the business would lose the deductibility of interest payments for tax purposes.

NASBIC and other organizations have strongly opposed this proposal. IRS held a public hearing on the question on July 23 and indicated some willingness to try to limit the adverse impact of the proposal on small business. Naturally, we hope that it will follow through on that promise, but I did want to make this brief report to the Finance Committee, because small business may be coming to you for legislative relief next year if IRS is unable or unwilling to mitigate the enormous harm its proposal would wreak on smaller firms.

Finally, I would like to briefly mention two areas in which changes could be made in the tax law to strengthen the venture capital industry and thereby increase the amount of long-term debt and equity capital flowing into small businesses. The first is Subchapter S. Under present law, only individuals are permitted to own stock in a corporation organized under Subchapter S of the Internal Revenue Code. We feel that the Sub S rules should be liberalized to enable SBICs to own stock in this type of company, and also that SBICs be exempt from the passive income test of Subchapter S should they choose to elect Sub S status.

Last but not least, we recommend that a change be enacted in Subchapter M of the Code which would enable all SBICs to qualify for pass-through tax treatment under Section 851, provided they comply with the diversification requirements of the Section. The Senate Banking Committee and the House Consumer Protection and Finance Subcommittee are marking up bills this week which would exempt SBICs from the Investment Company Act of 1940 -- an act which was passed to regulate mutual funds before professionally managed venture capital companies came into existence. Should this legislation become law, my company could get out from under the debilitating 1940 Act.

Under present law, however, we would lose our Sub M pass-through if we de-registered from the 1940 Act. The absurd result of that action would be to cause Narragansett Capital to pay over $1 million per year in taxes. We hope that Congress does not consciously want to offer us that difficult choice and we anticipate that legislation will soon be introduced to rectify that tax problem.

CONCLUSION

In summary, our Association strongly supports the five capital formation proposals of the White House Conference on Small Business as well as certain other legislative proposals which would increase the amount of venture capital flowing to small business. We specifically support the Jones-Conable capital cost recovery bill and the Nelson rollover bill and we feel that Congress, in order to provide incentives for corporate venture capitalists to finance more small businesses, would be both wise and prudent to promptly enact a small business rollover provision.

STATEMENT OF JAMES McKEVITT, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. McKEVITT. Thank you, Senator Nelson, and Senator Durenberger. I will just read extracts, and keep this under 5 minutes.

I would like to point out that the combined effect of high inflation and interest rates, slumping sales, and worst earnings levels we have seen since we began collecting this data in 1973 has caused NFIB's index of small business optimism to reach its historic low in April of this year.

Five of the ten index components reached all-time lows. To what extent that has changed over the succeeding 3 months will not be known until early August. Still, the membership has made it clear, particularly in the Midwest, that many are struggling.

We are in the midst of a serious situation. Even though current economic indicators provide relief in the rate of inflation and interest rates, basic structural problems remain in the Nation's economy. These structural problems must be addressed if we are to achieve a steady noninflationary growth for the future.

NFIB's members have consistently voiced their views on overall economic policy. Inflation is their principal problem, and has been for the last 5 years. Regulation and paperwork burden has come in second, and tax relief and simplification has come in third.

By 3 to 1 they favor balancing the Federal budget, if possible, before cutting taxes, and by 4 to 1 for a constitutional amendment limiting Federal spending. They understand that the most important ingredient in our long-range planning is slowing the growth of Federal spending.

When a tax cut occurs is not crucial. That it does occur is more important. The manner in which it occurs is even more important. But that it is done in the context of restricting Federal spending is of greatest importance. It is paramount that we adopt sound fiscal and tax policy designed for long-term economic growth rather than preoccupying ourselves with immediate, less critical objectives.

Inflation has badly damaged cash flow, forcing more and more businesses to borrow for operating purposes. Inflation has created uncertainty, giving those with the best planning departments and forecasting services, certainly not small business, competitive advantages. Inflation has pushed small business into higher tax brackets, caused an overvaluation of inventories, and has increased replacement costs.

Finally, because small businesses operate in a highly competitive environment, they are unable to fully pass on their inflated costs, creating more borrowing, less investment, lower productivity, and less jobs.

Should you decide to enact a tax cut this year, NFIB has these thoughts.

Social security—payroll taxes are more costly for more small businesses than any other kind of tax including the income tax. The largest of these payrolls taxes is, of course FICA.

Over the past several years, we have witnessed substantial increases in both the social security tax rate and wage base. That will continue. Large increases over the next few years are already programed in order to fund legislated benefits. Unfortunately, even those tax increases will be woefully insufficient. It has been estimated that without reform of our social security system, payroll tax rates will need to reach 22 to 24 percent in the next 20 years. That is the comment of Mr. Robinson, former chief actuary for the Social Security Administration.

Little in the way of tax policy could create greater havoc in small business' ability to function as an integral part of the American economy than should such rates be realized. This is especially true for starting small businesses, a traditional avenue for social mobility, innovative ideas, and economic decentralization.

These payroll taxes which serve to fund both annuity and transfer benefit payments place labor intensive small business at a competitive disadvantage which serves to further limit its ability to save and reinvest.

When we speak of capital formation for small business, it is impossible to avoid FICA. FICA, with the help of other payroll taxes, is the single greatest impediment to small business capital formation. Therefore, it should not surprise you that comprehensive reform of social security will be NFIB's highest priority in the 97th Congress.

We recognize that the review and debate necessary to achieve this objective cannot be undertaken until next year. Any short-term action taken this year which effectively reduced options currently available would be considered counterproductive and vigorously opposed. But we are not unmindful of the impact that the January 1 increase will have on small business.

For the reasons cited above, NFIB supports Senator Bradley's and Representative Gephardt's proposal provided that the 2-year sunset is retained. This legislation would not jeopardize the substance of long-term reform and would enhance its possibilities by providing a 2-year respite in which to thoroughly deliberate the issues involved.

On the subject of depreciation, NFIB strongly endorses the need for reform of depreciation policy as embodied in the Capital Cost

Recovery Act as introduced in H.R. 4646 and S. 1435. The concepts of equity and simplicity in tax policy are exemplified in this proposed legislation.

Senator NELSON. You support the 10-5-3?

Mr. MCKEVITT. The position we have taken on that—Senator Bentsen mentioned this the other day, about the concern of some of the real estate investors and the impact the "10" would have—at this time we leave it to the wisdom of the Senate Finance Committee, and the House Ways and Means Committee for their further deliberations.

Senator NELSON. I have listened and read some comments on the "10" part of the 10-5-3, there was a suggestions made, which I don't feel qualified to make an independent judgment on at the moment, that the real estate aspect of it simply be left out, and that they continue to operate under current law.

In any event, apart from that difference, does your organization endorse the "10" aspect?

Mr. MCKEVITT. We still endorse the 10-5-3 proposal, Senator.

Suffice it to say that we do not concur with those who suggest small business will realize only minimal gains from 10-3-5. Nor do we agree with overly simplistic analyses which equate the distribution of corporate assets by firm size to the distribution of 10-3-5 benefits by firm size.

And as we painfully learned in 1978, we do not find it productive to develop an "ideal" small business depreciation scheme only to have it fail.

The plain facts are these: small business cannot and does not currently use ADR because of its complexity. Large firms can and do use ADR. ADR is more advantageous than other methods of depreciation. That means the current depreciation system provides an inherent bias for and a competitive advantage to larger firms. 10-3-5 erases that bias by making accelerated depreciation available to all; not in theory, but in practice. Further small business needs to recover its investment capital more quickly than firms of other sizes, and 10-3-5 provides that as well.

A brief summary of the other matters that we support: The cash method of accounting, to allow firms to use the cash method of accounting in place of the accrual method allowing small firms to retain earnings, and not pay an inventory tax on inflated costs of inventories; corporate rate reductions which have been recommended by the White House Conference on Small Business; rollover of gain on sale of business to allow small business to rollover the gain from the sale of a small business when reinvested within 18 months into another small business; investment tax credit on used property to increase the current ceiling of $100,000 to $200,000 on a firm's ability to obtain the investment tax credit; and finally, the deferred investment account.

Thank you.

Senator NELSON. Thank you, Mr. McKevitt.

[The prepared statement of Mr. McKevitt follows:]

STATEMENT OF JAMES D. "MIKE" MCKEVITT, DIRECTOR OF FEDERAL LEGISLATION, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

I am James D. "Mike" McKevitt, Director of Federal Legislation for the National Federation of Independent Business (NFIB) and I am pleased to appear before you today on behalf of the Federation's 610,000 small business firms to discuss a possible tax cut.

The combined effect of high inflation and interest rates, slumping sales, and the worst earnings levels we have seen since we began collecting these data in 1973, caused the NFIB Index of Small Business optimism to reach its historic low in April. Five of the ten index components reached all-time lows. To what extent that has changed over the succeeding three months won't be known until early August. Still, the membership has made it clear, particularly in the Mid-West, that many are struggling.

We are in the midst of a serious situation. Even though current economic indicators provide relief in the rate of inflation and interest rates, basic structural problems remain in the Nation's economy. These structural problems must be addressed if we are to achieve a steady non-inflationary growth for the future.

The need for a tax cut

NFIB's members have consistently voiced their views on overall economic policy. Inflation is the principal problem—taxes are less of one. By 3 to 1 they favor balancing the Federal budget, if possible, before cutting taxes and by 4 to 1 for a constitutional amendment limiting Federal spending. They understand that the most important ingredient in our long-range planning is slowing the growth of Federal spending.

Three other factors need to be considered in any tax cut decision. First, the structure of the tax cut proposed and whether the cut will encourage capital formation or consumption. Second, the absolute size of the tax cut. The final and least important factor, though the factor given the greatest publicity, is the timing of the cut.

When a tax cut occurs is not crucial. That it does occur is more important. The manner in which it occurs is even more important. But that it is done in the context of restricting Federal spending is of greatest importance. It is paramount that we adopt sound fiscal and tax policy designed for long-term economic growth rather than preoccupying ourselves with immediate, less critical, objectives.

Our views on the desirability of an immediate tax cut sound like an "unqualified maybe", but we are reflecting the skepticism of small business and their desires that sound policy decisions be made whatever the timing.

These views may seem unusual in light of the fact that small business raises capital in only two manners—earnings and debt. Yet they should only serve to underline the severe impact that inflation has had on small business. Inflation has badly damaged cash flow, forcing more and more businesses to borrow for operating purposes. Inflation has created uncertainty, giving those with the best planning departments and forecasting services (certainly not small business) competitive advantages. Inflation has pushed small business into higher tax brackets, caused an overvaluation of inventories, and has increased replacement costs. Finally, because small businesses operate in a highly competitive environment, they are unable to fully pass on their inflated costs, creating more borrowing, less investment, lower productivity, etc.

Priorities in a Tax Cut

Should you decide to enact a tax cut this year, NFIB lists the following four priorities:

Social Security

Payroll taxes are more costly for more small businesses than any other kind of tax including the income tax. The largest of these payroll taxes is, of course, FICA.

Over the past several years, we have witnessed substantial increases in both the Social Security tax rate and wage base. That will continue. Large increases over the next few years are already programmed in order to fund legislated benefits. Unfortunately, even those tax increases will be woefully insufficient. It has been estimated that without reform of our Social Security system, payroll tax rates will need to reach 22 to 24 percent in the next twenty years.

Little in the way of tax policy could create greater havoc in small business' ability to function as an integral part of the American economy than should such rates be realized. This is especially true for starting small businesses, a traditional avenue for social mobility, innovative ideas, and economic decentralization. These payroll taxes which serve to fund both annuity and transfer benefit payments place labor intensive small business at a competitive disadvantage, which serves to further limit its ability to save and reinvest.

On January 1, the FICA tax rate increases 0.52 percent. For a hypothetical corporate business employing 10 people at an average of $15,000 in covered earnings, that 0.52 percent increase amounts to $780. Assuming that same business had net earnings of $25,000 and Congress desired to offset the FICA rate increase through corporate rate reductions, the Congress would need to drop the corporate surtax exemption rate by 18 percent or 3 percentage points.

When we speak of capital formation for small business, it is impossible to avoid FICA. FICA, with the help of other payroll taxes, is the single greatest impediment to small business capital formation. Therefore, it should not surprise you that comprehensive reform of Social Security will be NFIB's highest priority in the 97th Congress.

We recognize that the review and debate necessary to achieve this objective cannot be undertaken until next year. Any short-term action taken this year which effectively reduced or closed options currently available would be considered counter-productive and vigorously opposed. But we are not unmindful of the impact that the January 1 increase will have on small business.

For the reasons cited above, NFIB supports Rep. Gephardt's proposal, H.R. 7046, provided the two year sunset is retained. This legislation would not jeopardize the substance of long-term reform and would enhance its possibilities by providing a two year respite in which to thoroughly deliberate the issues involved. Simultaneously, H.R. 7046 gives small business some relief particularly necessary in attempting to recover from the economic ravages of this spring.

NFIB would emphasize Rep. Gephardt's proposal is not the basis of permanent reform. Therefore, should the Congress fail to act in the next two years, the sunset provision should be allowed to become effective.

Depreciation

NFIB strongly endorses the need for reform of depreciation policy as embodied in the Capital Cost Recovery Act (CCRA), introduced as H.R. 4646 and S. 1435. The concepts of equity and simplicity in tax policy are exemplified in this proposed legislation NFIB was involved in the drafting of this bill, along with groups representing large firms. Our reasoning and rationale for support of this bill are detailed in a paper which we are including as a part of this package (see Appendix A).

Suffice it to say, we do not concur with those who suggest small business will realize only minimal gains from 10-5-3. Nor do we agree with overly simplistic analyses which equate the distribution of corporate assets by firm size to the distribution of 10-5-3 benefits by firm size. And as we painfully learned in 1978, we do not find it productive to develop an "ideal" small business depreciation scheme only to have it fail.

The plain facts are these: small business cannot and does not currently use ADR because of its complexity. Large firms can and do use ADR. ADR is more advantageous than other methods of depreciation. That means the current depreciation system provides an inherent bias for and a competitive advantage to larger firms. 10-5-3 erases that bias by making accelerated depreciation available to all—not in theory, but in practice. Further, small business needs to recover its investment capital more quickly than firms of other sizes. 10-5-3 provides that as well.

Cash accounting (the inventory tax)

IRS regulations, section 1.471-1 states, "In order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income producing factor." Regulation under section 446 states, "In any case which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales unless otherwise authorized." Thus IRS regulations require a small manufacturer, retailer, or wholesaler to use the accrual method of accounting.

The effect of accrual accounting is to make income taxable *before* it is received. Since inventories must be accounted for, the cost of any inventories on hand at the end of the year will increase gross profits and taxable income. The result is to:

1. Increase tax liability,
2. Tie up cash requiring greater levels of inventory financing, and
3. Create complexity in recordkeeping that causes increased expenditures for professional accounting services.

IRS recognizes that accural accounting causes an overvaluation of inventories. So, it permits the LIFO method of inventory identification. That means for accounting purposes, the last items purchased are the first items sold. The LIFO method attempts to match current revenues with current costs to determine net income. During a period of high inflation, such as the present, this matching of revenues and cost reduces net income and tax liabilities. The simpler FIFO (First in First Out) method, however, matches revenues with earlier costs, causing greater net income and tax liability.

An over simplified comparative example which highlights the differential effects follows:

	FIFO	LIFO
Income statement:		
Sales	$10,000	$10,000
Cost of sales	6,000	6,000
Income before taxes	4,000	2,000
Income taxes	2,000	1,000
Net sales	2,000	1,000
Balance sheet accounts:		
Inventory	8,000	6,000
Income taxes	2,000	1,000

By using the LIFO method, this business has deferred $1,000 in tax liability for one year and has given itself an extra $1,000 in tax liability for one year and has given itself an extra $1,000 of internally generated capital to work with.

Unfortunately, there is a problem with LIFO. It is so complex that less than 1 percent of all active corporations (1974) use the method. Thus, a small entrepreneur with full knowledge of the Internal Revenue Code has three options: (1) be out of compliance and not use accrual accounting, (2) use accrual accounting and pay what amounts to an "inventory tax", or (3) use accrual and LIFO, probably spending more on records and accounting fees that the "inventory tax" costs.

The IRS solution to the problem (which the agency has only recently admitted exists) is to simplify LIFO. The idea is to create a series of indices to reflect inflation rates in each industry. But while possibly appealing in theory, it would be of questionable value in practice. If, for example, one index were to be used for an industry, those inventories subject to a very high rate of inflation would still have an "inventory tax" levied on them. If the inventories were subject to inflation, just the opposite would occur. Further, it is conceivable that a "Mom and Pop" variety store could end up using more indices than a division of General Motors.

The small business answer is to allow a method of accounting currently available to small farmers, the Cash Method of Accounting. This method would in effect allow a small business to expense inventories when paid. By allowing a small business to match current costs and revenues in this way, small business will be able to compete on a more equitable basis. They will be able to retain more capital, which will provide the impetus for expansion and growth. And cash accounting is simple.

Let me quote from the committee reports prepared for the Committee on Ways and Means by the staff of the Joint Committee on Internal Revenue Code. "The primary justification of the cash method exception for farmers was the relative simplicity of the cash method of accounting, which, for example, eliminates the need to identify specific costs incurred." The cash method treats income received as taxable income and expenses paid as deductions. This allows the immediate deduction of purchases of inventory, reducing net income and tax liability in the current period.

Under the cash method all items which constitute gross income are to be included for the taxable year in which actually or constructively received. Expenditures are to be deducted for the taxable year in which actually made. This concept conforms to the most basic recordkeeping system. In fact, all individuals file tax returns on a cash basis.

Criticism directed toward suggesting use of the cash method has come from the Department of Treasury and the accounting profession. Both view the cash method proposal as an invitation for abuse because it could distort income by altering the definition of income. Criticism by the accounting profession of the cash method of keeping records is most understandable. The cash method is a violation of Generally Accepted Accounting Principles (GAAP) and not technically sound. But technical purity is not the real world. Further, ample precedent exists for differences between GAAP and tax law. In a recent tax court case of some notoriety, the Supreme Court in Thor Power Tool was quite forward in their statement that tax law does not necessarily always reflect good accounting practice.

The major concern of the Treasury Department and IRS is the potential for abuse, illustrated by some farmers' use of the cash method and the tax shelters that have been uncovered during subsequent examinations. The opinion of Treasury is that to allow a new segment of the population to use the cash method opens wide the potential for additional tax abuse and tax shelter opportunities.

Prior court cases and revenue rulings have laid out four (4) major points, upon which a determination being a valid business or a tax shelter is made. They are:

1. Who is a businessman?
2. Purchase versus deposit,
3. Business purpose, and
4. Distortion of income.

IRS will not allow a deduction on a cash basis for inventory or goods purchased at the end of the year if all four factors show that an abuse situation exists. The basis for this position is Regulation Section 1.461-1(a), which states: "If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible or may be deductible only in part for the taxable year in which made." Armed with this language, IRS has attempted to go after some farmers who take advantage of the cash method and create artificial losses through large end of year purchases. However, code section 447 of the IRC specifically allows farmers to use the cash method, so the loss can be disallowed only if a pattern of abuse is evident. Section 447 of the Internal Revenue Code (IRC) provides the legal basis upon which a farmer may elect to use the cash method. It is due to this code section that many shelter situations are protected if a facts and circumstances pattern reveals an attempt at following the rules as laid out in prior tax court cases.

The difference between a small businessman and tax shelter opportunist using the cash method is a matter of sophistication. For each criterion, as outlined by the courts, upon which a shelter abuse situation turns, would never occur in a small business situation.

(A) *Who is a businessman?*—The vast majority of small business will maintain its independence by not taking in investors through giving out equity. They will borrow as much as they can, but they will not give up equity in their business. This concern can easily be remedied in legislation by providing that the owners be active participants in the enterprise, and that only they are allowed economic participation in the firm.

(B) *Purchase versus deposit.*—Few small firms have the borrowing capacity to indulge in year-end buying sprees, especially on credit. If a purchase of inventory is made, it is for purposes of resale within the next few weeks, not in six months. To prohibit cash accounting by saying that small business will enter into year-end inventory contracts completely disregards the economic reality inherent in small business. It is commonly understood that most small retailers and wholesalers engage in a very rapid turnover of inventories. Legislation could easily take this into account by insisting that no purchase of inventory at year-end be so great that it alters that normal rate of inventory turnover.

(C) *Business purpose.*—For a small retailer with minimal storage facilities, believing that a purchase of inventory has no business purpose is ludicrous.

(D) *Distortion of income.*—In our opinion, there is currently a distortion because cash accounting is not allowed. However, the ability of small business to distort income on purpose by the purchase of unusable year-end inventories is severely limited.

Corporate rates

In 1978, the Congress made a significant step in assisting corporate small business. The Congress expanded the numberr of steps in the corporate surtax exemption and reduced their rates. The steps are in $25,000 increments up to $100,000 with rates ranging from 17 to 46 percent.

The White House Conference on Small Business made an increase in the number of steps and a further reduction in rates its number one priority. The Conference's proposal contains eight steps to $500,000 with rates ranging from 12 to 46 percent. NFIB agrees with that goal.

The proposal contains two important elements for small business. By expanding the number of steps and widening them, you ease the climb up the corporate tax ladder and provide relief for those larger small businesses with net earnings between $100,000 and $500,000 which will pay over $49,000 in corporate tax. Over 45 percent of that is the result of one-third of the business' earnings (the $50,000 over $100,000). By expanding and increasing the brackets that problem is reduced.

Further graduation of the corporate tax structure will provide a needed incentive for expansion for those small firms that are less capital intensive and would not benefit from other types of tax reform that leans toward the capital intensive firm.

Beyond these major recommendations, we would suggest particular investment incentives that would generally impact much smaller portions of the small business population, but would be helpful for those affected.

Rollover

The objective of a small business rollover is to keep capital invested in small business within the small business community rather than witness it flee to other sectors of the economy. The small business rollover operates very much in the same manner as does a similar provision for homeowners. After selling a small business, the individual is allowed a deferral of any capital gain if that money is reinvested in another small business within eighteen months.

Approximately one in ten small entrepreneurs have owned a business prior to the one they now own. A non-mutually exclusive one in ten have found investors the major source of initial finance for their current business. A rollover of the nature we are discussing would encourage any capital gains derived from those businesses to be reinvested in another small business.

Investment tax credit on used property

Currently, the Investment Tax Credit (ITC) can only be applied to the first $100,000 of used property. While the vast majority of small businesses find that ceiling perfectly adequate, larger small businesses, particularly in manufacturing, do not. For them, a ceiling of $200,000 is more reasonable.

A small business has important and legitimate business reasons for employing used equipment. It simply may not be able to afford to purchase the latest available, but would find used equipment more productive than current equipment. Perhaps more important is the lead time often required to purchase new equipment. A small business will often expand in response to orders that need rapid filling. The purchase of immediately available used equipment allows a small business to take on such orders.

Deferred investment account

An unincorporated business frequently operates at a tax disadvantage in relation to its corporate competitors, particularly in attempting to accumulate investment capital. For example, a corporation is allowed by statute to retain earnings within specific limitations at a generally lower tax rate than would occur for a non-corporate entity.

As an incentive to save and invest as well as to achieve greater equity in the tax treatment of corporate and non-corporate businesses, NFIB supports allowing non-corporate businesses to establish a deferral account of up to $25,000 (a maximum of $5,000 per year) for purchases of capital assets. Funds placed in this separate account would be taxed at the lowest corporate rate. Any earnings on the account would be taxed as ordinary income. Should funds from the account be diverted to other purposes, they would be taxed at capital gains rates (remember they have already been taxed once before at corporate rates). Finally, to be eligible the taxpayer would be required to derive at least 50 percent of his net income from his business.

This deferral account is particularly conducive for the smallest businesses, most of whom are noncorporate. Differing from large firms, these businesses don't reinvest every week, month, and year. Their size forces them to set aside money when they can and let it accumulate until a sufficient amount is available to procure a loan to finance the investment. This process often occurs over a period of two or three tax years. The deferral account allows this savings period to be reduced and greater investment to occur.

The suggestions listed are those which NFIB feels would provide the greatest incentive to savings and investment for small business. Others are available, but need further development.

NFIB National Federation of Independent Business

APPENDIX A

CAPITAL COST RECOVERY ACT AND SMALL BUSINESS

The Capital Cost Recovery Act (H.R.4646 and S.1435) represents an ambitious attempt to reverse the current course of capital spending and investment. The need for a new approach in capital cost recovery is substantiated by current trends in productivity and fixed investment as a percentage of gross domestic product. Of equal importance is a widely agreed upon need for a simplified capital cost recovery system that is usable by both big and small business and by corporate and non-corporate taxpayers.

Until now, substantially all debate surrounding the bill has focused on the need for CCR and the role depreciation policy can play in encouraging capital formation and investment. This paper explains why NFIB strongly feels the Capital Cost Recovery Act will help small business substantially and why the proposal will not give large firms competitive advantages because of their current larger dollar investment relative to small business. In addition, the paper demonstrates that CCR provides tax equity and simplicity by allowing small business an accelerated depreciation method that will not require expensive tax advice, a cost which can often drain off the profit of using one of the accelerated methods. Overall policy questions that are involved in the debate are not addressed.

Note: All statistical references are to the Department of Treasury Statistics of Income, for 1975

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Asset Depreciation Range (ADR)

The purpose of depreciation is to provide a reasonable allowance for exhaustion of an asset used in the production of income. Since its inception, however, much of the disagreement between business taxpayers and the IRS has centered around the definition of "reasonable." The legislative history of depreciation shows that various alternative methods of depreciation evolved, all providing different choices for taxpayers and substantial complications as well.

In 1971, economists and tax policy advisors perceived that if a relatively high rate of inflation continued unchecked, the overtaxation of profits would begin to have a detrimental effect on retained earnings and capital investment. Overtaxation of the profits would take place because depreciation deductions, which are based on the historic cost of an asset, not its replacement cost, would be undervalued. Undervaluation of a deduction causes profits to be taxed at a higher effective rate. A new depreciation method was needed to alleviate the impact of inflation, and also to simplify depreciation methods and add a degree of certainty for businesses for the useful lives being employed.

The Asset Depreciation Range (ADR) system of depreciation was introduced in 1971 by the Treasury Department. The major benefits of the new policy were:

1. ADR greatly simplified the administration of depreciation by reducing disagreements between taxpayers and the IRS;
2. ADR allowed shorter asset life for tax purposes; and
3. ADR provided a simpler method of classifying assets.

Unfortunately, the benefits of ADR didn't accrue uniformly to all businesses. Only 3 percent of the total depreciation deductions claimed under ADR were claimed by corporations with less than $10 million in total assets. For partnerships, just two-tenths of one percent of all partnerships elected ADR. This represented only 8.6 percent of the total partnership depreciation deductions claimed.

While no comparative data is available for sole proprietorships, we can assume a similar statistical pattern to that for partnerships would emerge. In contrast, 85.6% of the firms with $250 million or more in assets use ADR. These figures show a strong and direct relationship between the size of a firm and its use of the Asset Depreciation Range (see Tables 1A and 1B). Thus, the benefits of ADR have failed to accrue uniformly across the business community. This is especially true when firm size is the basis for comparison.

Simplicity and Equity

The relationship between the size of a firm and ADR usage is critically important. Tables 1A and 1B illustrate the usage of ADR increases with the size of the firm, not only in terms of absolute depreciation dollars, but also as a percentage of assets. The reasons for this difference range from the costs of setting-up ADR and performing the required annual audits to those involved in interpreting the system's complex rules.

The regulations defining how ADR works consist of 25 definitions that need to be understood before the regulations can be read. A publication that is specially written to explain depreciation methods needs 50 pages to treat ADR, and the useful life tables that accompany it comprise an additional 50 pages.

The ADR method has provided simplicity only to the big firms which already maintain substantial records of their assets and have the use of the necessary tax expertise to interpret the law. Small business doesn't have the use of the necessary tax expertise to interpret the law. Small business doesn't have the resources to take advantage of ADR and is forced to use other, simpler methods; this causes small firms to pay relatively greater taxes and higher effective tax rates. It is particularly for these reasons that we believe that CCR will prove to be so important a tax reform.

By repealing ADR and all other depreciation methods except "facts and circumstances" for excluded firms, CCR reduces the range of available depreciation choices down to the following steps:

1. Determine which of the three classes the assets fall into;
2. Go to a table, and depending on which year it is, pick up the CCR percentage for that year; and
3. Multiply the percentage by the cost of the asset.

For a small, as well as a big, business this procedure is simple and equitable.

Current Depreciation Benefits

To understand the differences in how large and small businesses depreciate their assets, it would be helpful to review several illustrations. Examples one, two and three in the Appendix illustrate three methods of depreciation — straight line, the procedure most used by small business; ADR with a 200% declining balance, the normal method for a very large firm; and the proposed new capital cost recovery system — applied to the type of assets usually purchased by smaller businesses.

If the straight line and ADR methods are compared for cumulative tax effect in each year, a tremendous disparity is apparent. Since small business tends to use straight line and big business tends to use ADR, larger firms are currently recovering their investments far more rapidly than smaller firms. This factor alone gives big business a large competitive advantage and reduces the relative cost of its capital investment.

Prior Analysis of Small Business Impact

Prior attempts at providing an analysis of how small business would fare under CCR concluded that it would do rather poorly. One analysis which has been widely publicized, attempted to review current depreciation deductions distributed by firm size. It showed that in 1975, 75.1% of all corporate depreciation deductions were taken by 1.3% of the corporations filing. It then concluded that small business would be giving big business a bonanza by supporting passage of CCR with little benefit for itself.

This analysis is severely flawed because it makes at least two major untenable assumptions:

> First, it assumes that the business community is made up of only corporations, or that corporate entities are the only significant business form; and
>
> Second, that the current relationship of depreciation deductions to firm size would continue if CCR were enacted.

The United States businesss community is by no means entirely corporate. In fact, taken together proprietorships and partnerships constitute about 60% of the total, placing corporations clearly in the minority.

Over 99% of all partnerships fall in the asset size category of $5 million or less. It is reasonable to assume that the remaining 1% falls in the $5 million to $10 million asset size bracket. The IRS data on sole proprietorships is not broken down by asset size. However, it is broken down by annual gross receipts. Reviewing these figures and the standard relationships between receipts and assets, it can be assumed that all sole proprietorships fall in the under $5 million in assets category.

With the inclusion of partnerships and proprietorships, the results of this prior analysis are altered dramatically. Now, we find 58% of all depreciation dollars expensed by firms with assets greater than $10 million (see Table 2). That means that if we define small business as those firms with less than $10 million in assets, they receive 42% of all depreciation benefits. Thus, even if a static relationship between relative depreciation benefits received by large and small firms is to be maintained after the enactment of CCR, small business would receive at least a 42% share.

A continuing static relationship cannot be assumed, however. As a practical matter, large businesss currently can use ADR and small business cannot. One of the major aims of CCR is to create an equitable depreciation system that all businesses can use. Therefore, even if only 50% of the small firms with depreciable assets take advantage of CCR, the relative position of small business must improve.

The foregoing seems implausible when one considers the current asset distribution between large and small business. However, it is not and there is a good reason why it is not. Comparing depreciation expense as a percentage of depreciable assets for corporations, partnerships and proprietorships on an all industry basis reveals an important relationship between large and small business average depreciation rates (see Table 4 and 5). For "All Industries", the average depreciation rate for firms with less than $5 million in assets is 9.2%, 8.6% for non-farm industries. For businesses with over $250 million in asset size, the average rate of depreciation is 6.2%

Big business investment consists of substantially longer lived assets such as buildings, steel mills and manufacturing plants. The average firm in the over $250 million in assets category uses an effective average depreciable life of 16 years, while small business has an effective average rate of about 13 years. Simply put, the types of assets small business buys are of a much shorter overall useful life. The differential mix in assets causes the apparent contradiction of large firms possessing a relatively greater portion of assets than their relative portion of depreciation benefits. This also illustrates how close the average rates of depreciation between large and small business are and the tremendous advantage ADR does provide.

Advantage Gained Under CCR

Review examples 1, 2 and 3 again. If 10-5-3 were in effect, the after tax benefits would be substantially greater for those who had been using straight line (small businesses)

Note: Tables 4 and 5 compare the average depreciation rates for all industries by asset size category. The rate is arrived at by dividing depreciation deductions by depreciable assets.

rather than ADR (big businesses). Becuase all assets would not be depreciated at the same accelerated rate, the amount of benefit to big business or small business will be determined strictly by the total amount and type of asset purchased. It would be difficult to come up with a simpler or more equitable system.

Add to this the advantage gained by all firms by eliminating IRS review of useful lives and investment tax credits and by reducing present substantial recordkeeping requirements, and CCR shows itself not only as a very necessary but also as a very attractive alternative to current depreciation policy.

Finally, small business will unquestionably be the immediate beneficiary of the enactment of 10-5-3. This is because the sponsors of H.R. 4646 and S.1435 have agreed to eliminate the phase-in period for the first $100,000 in assets. In other words, firms with less than $100,000 in asset purchases a year will not have to deal with the complicated transition rules established by the legislation. Since most small businesses purchase less than $100,000 in depreciable assets a year, they will be completely under CCR in the first year.

Table 1A

Source: 1975 Statistics of Income, Corporation Income Tax Returns

Percentage of Assets Being Depreciated Using the Asset Depreciation Range (ADR) For Corporations, in 1975

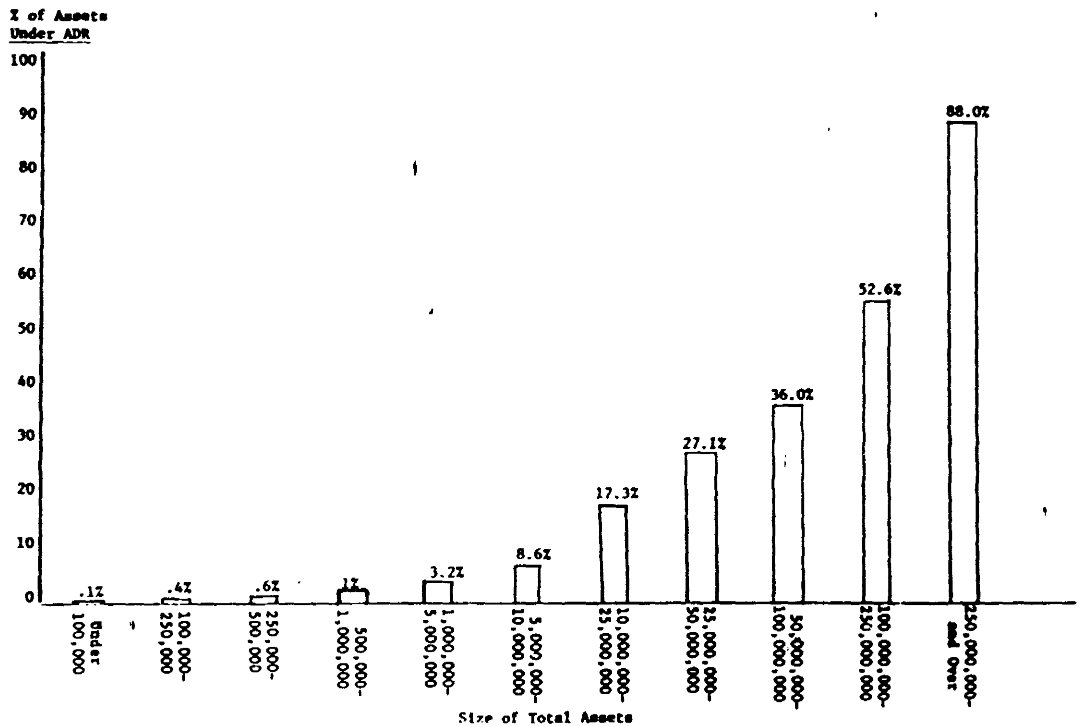


TABLE 1B

Depreciation Deductions for Corporations by Asset Size, 1975

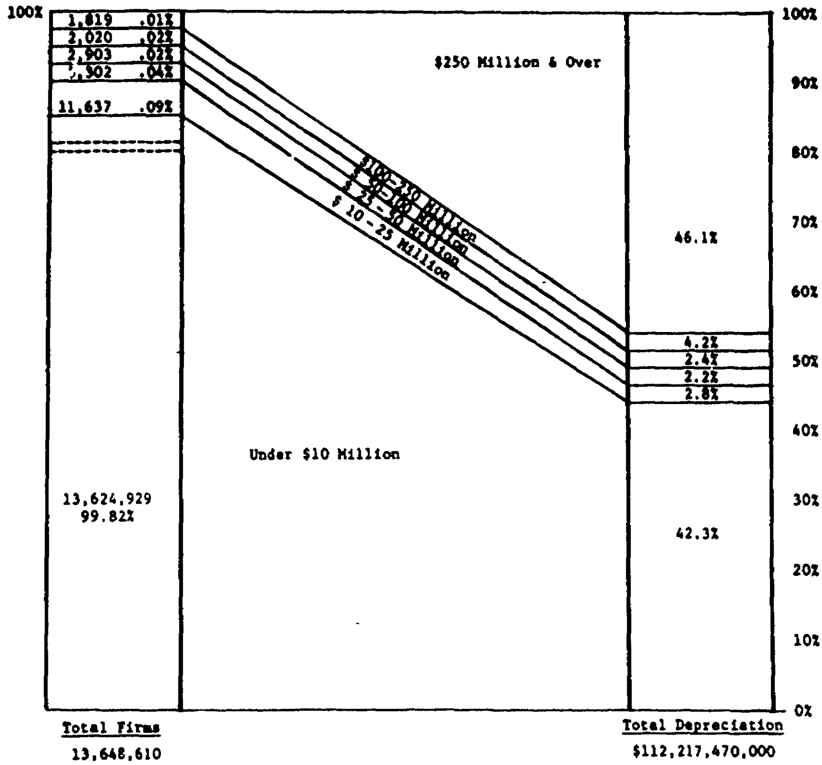
Size of Total Assets	Total Depreciation Deductions (All $'s in thous.)	Depreciation Deductions for those Using ADR (in thousands)	Percentage of ADR Depreciation to Total
Under $100,000	$ 2,845,477	$ 52,345	1.8%
100,000-250,000	2,840,064	12,372	.4
250,000-500,000	2,915,334	20,093	.7
500,000-1,000,000	3,278,586	39,030	1.2
1,000,000-5,000,000	6,997,425	266,641	3.8
5,000,000-10,000,000	2,637,065	263,568	9.9
10,000,000-25,000,000	3,156,351	569,222	18.0
25,000,000-50,000,000	2,478,134	726,573	29.3
50,000,000-100,000,000	2,717,439	1,032,636	38.0
100,000,000-250,000,000	4,701,708	2,493,805	53.0
Greater than 250,000,000	51,728,081	44,265,918	85.6
TOTAL	$86,295,664	49,742,203	57.6%

57.6% of Total Depreciation deduction taken by Corporations were under ADR

Source: 1975 Statistics of Income, Corporation Income Tax Returns, Department of Treasury.

Table 2

Depreciation by Asset Size of Corporation, Partnerships, and Sole Proprietorships, 1975



Source: 1975 Corporation Statistics of Income, Treasury Data

Table 3

Depreciation by Asset Size for All Entities - 1975

Size of Assets	Depreciation for Corporations (in thous.)	Depreciation for Partnerships (in thous.)	Depreciation for Sole Proprietorships	Total	% of ADR Use by Corp.	ADR $*
Under $5,000,000	$18,876,886	$ 7,525,306	$15,813,054	$ 42,206,246	2.1%	$ 886,520
5,000,000-10,000,000	2,637,065	2,583,446	----	5,220,511	9.9%	516,831
10,000,000-25,000,000	3,156,351	----	----	3,165,351	18.0%	569,222
25,000,000-50,000,000	2,478,134	----	----	2,478,134	29.3%	726,573
50,000,000-100,000,000	2,717,439	----	----	2,717,439	38.0%	1,032,636
100,000,000-250,000,000	4,701,708	----	----	4,701,708	53.0%	2,493,805
Greater than 250,000,000	51,728,081	----	----	51,728,081	85.6%	44,265,918
TOTAL	$86,295,664	$10,108,752	$15,813,054	$112,217,470	45.0%	$50,491,505

*Assumes relationship between ADR electors and non-ADR electors for partnerships and sole proprietorships is the same as for corporations.

Source: 1975 Corporate Statistics of Income, Department of Treasury.

Table 4

Average Rate of Depreciation for All Industries

Size of Total Assets	Depreciation Assets for Corp., Part., & Prop. (in thous.)	Depreciation Expense (in thous.)	Average Rate of Depreciation
Under $5,000,000	$455,947,931	$42,206,246	9.2%
5,000,000-10,000,000	83,520,565	5,220,511	6.3%
10,000,000-25,000,000	41,378,176	3,165,351	7.6%
25,000,000-50,000,000	35,130,838	2,478,134	7.1%
50,000,000-100,000,000	37,735,192	2,717,439	7.2%
100,000,000-250,000,000	69,427,297	4,701,708	6.8%
Greater than 250,000,000	841,080,474	51,728,081	6.2

Source: Treasury Statistics

Table 5

Average Rate of Depreciation

All Non-Farm Industries

Size of Total Assets	Depreciab'e Assets For all Firms (in thous.)	Depreciation Expense (in thous.)	Average Rate of Depreciation
Under $5,000,000	$378,871,479	$32,588,378	8.6%
5,000,000-10,000,000	82,712,645	5,150,410	6.2%
10,000,000-25,000,000	40,799,779	3,112,355	7.6%
25,000,000-50,000,000	34,948,941	2,462,751	7.1%
50,000,000-100,000,000	37,546,557	2,705,926	7.2%
100,000,000-250,000,000	68,379,593	4,644,774	6.8%
Greater than 250,000,000	841,080,474	51,728,081	6.2%

Source: Treasury Statistics

EXAMPLE 1

Office Equipment (Class II)
Cost - $100,000
Purchase Date - 7/1
I.R.S Recommended Useful Life - 10 years
ADR Life - 8 years
No Salvage Value

	Year 1	Year 2	Year 3	Year 4	Year 5
A) Straight Line Method					
Cost	$100,000	---	---	---	---
Current Depreciation	5,000	10,000	10,000	10,000	10,000
Tax Effect @ 46%	2,300	4,600	4,600	4,600	4,600
I.T.C.	10,000	---	---	---	---
Cumulative Tax Effect	$ 12,300	$16,900	$21,500	$26,100	$30,700
B) ADR - 200% Declining Balance					
Cost	$100,000	---	---	---	---
Current Depreciation	12,500	21,875	16,406	12,305	9,229
Tax Effect @ 46%	5,750	10,063	7,547	5,660	4,245
I.T.C.	10,000	---	---	---	---
Cumulative Tax Effect	$ 15,750	$25,813	$33,360	$39,020	$43,265
C) 10-5-3					
Cost	$100,000	---	---	---	---
Current Depreciation	20,000	32,000	24,000	16,000	8,000
Tax Effect @ 46%	9,200	14,720	11,040	7,360	3,680
I.T.C.	10,000	---	---	---	---
Cumulative Tax Effect	$ 19,200	$33,920	$44,960	$52,320	$56,000

EXAMPLE 2

Trucks (Class II)
Cost - $100,000
Purchase Date - 7/1
I.R.S Recommended Useful Life - 5 years
ADR Life - 5 years
No Salvage Value

	Year 1	Year 2	Year 3	Year 4	Year 5
A) Straight Line Method					
Cost	$100,000	---	---	---	---
Current Depreciation	10,000	20,000	20,000	20,000	20,000
Tax Effect @ 46%	4,600	9,200	9,200	9,200	9,200
I.T.C.	6,667	---	---	---	---
Cumulative Tax Effect	$ 11,267	$20,467	$29,667	$38,867	$48,067
B) ADR - 200% Declining Balance					
Cost	$100,000	---	---	---	---
Current Depreciation	20,000	32,000	19,200	11,520	6,912
Tax Effect @ 46%	9,200	14,720	8,832	5,299	3,180
I.T.C.	6,667	---	---	---	---
Cumulative Tax Effect	$ 15,867	$30,587	$39,419	$44,718	$47,898
C) 10-5-3					
Cost	$100,000	---	---	---	---
Current Depreciation	20,000	32,000	24,000	16,000	8,000
Tax Effect @ 46%	9,200	14,720	11,040	7,360	3,680
I.T.C.	10,000	---	---	---	---
Cumulative Tax Effect	$ 19,200	$33,920	$44,960	$52,320	$56,000

EXAMPLE 3

Light Trucks and Autos (Class III)
Cost - $50,000
Purchase Date - 7/1
IRS Recommended Useful Life - 4 years
ADR Life - 3 years
No Salvage Value

	Year 1	Year 2	Year 3	Year 4	Year 5
A) Straight Line Method					
Cost	$50,000	---	---	---	---
Current Depreciation	6,250	12,500	12,500	12,500	6,250
Tax Effect @ 46%	2,875	5,750	5,750	5,750	2,875
ITC	1,667	---	---	---	---
Cumulative Tax Effect	$ 4,542	$10,292	$16,042	$21,792	$24,667
B) ADR-200% Declining Balance					
Cost	$50,000	---	---	---	---
Current Depreciation	16,667	22,222	7,407	3,704	---
Tax Effect @ 46%	7,667	10,222	3,407	1,704	---
ITC	1,667	---	---	---	---
Cumulative Tax Effect	$ 9,334	$19,556	$22,963	$24,667	$ ---
C) 10-5-3					
Cost	$50,000	---	---	---	---
Current Depreciation	16,500	22,500	11,000	---	---
Tax Effect @ 46%	7,590	10,350	5,060	---	---
ITC	3,000	---	---	---	---
Cumulative Tax Effect	$10,590	$20,940	$26,000	$ ---	$ ---

Senator NELSON. Our next witness is Mr. Sherlock.

STATEMENT OF NORMAN R. SHERLOCK, EXECUTIVE VICE PRESIDENT, AMERICAN BUS ASSOCIATION

Mr. SHERLOCK. Thank you, Mr. Chairman.

My name is Norman Sherlock, and I am executive vice president of the American Bus Association, which represents private bus operators that provide regularly scheduled service, local commuting, tours and charters, as well as special operations.

The intercity bus industry is comprised of about 1,150 individual bus companies which carry passengers between communities in this country. Although many people visualize the industry as being the two large carrier, Greyhound and Trailways, because of their national marketing identity and programs, actually 277 million of the 360 million passengers carried by the industry last year were carried by other small operators.

We also have about 1,000 members of the travel and tourism industry, 98 percent of whom are small businesses.

As we enter the decade of the 1980's, the intercity bus industry will clearly be called on to play a central role in retaining the mobility of the general public. Bus transportation has already proven to be a critical lifeline to the travel and tourism industry in many cases, and the need for it will be even greater in the future.

Yet, while it is essential that the role of this industry be expanded, it cannot be assumed that the necessary capital will be available to bus companies to meet this demand. Like other businesses, the intercity bus industry needs assistance with capital formation.

We believe that it is timely to enact legislation which will help spur business investment and productivity, reduce the complexity of current tax procedures, and enhance the ability of the intercity bus industry to realize its potential as a fuel saving alternative to individual automobile use.

We support action in the following areas: First, accelerated and simplified depreciation in equipment and in buildings; second, modification of the energy property investment tax credit for bus acquisition so that it will apply to all bus purchases and can be used in lease agreements; third, removal of the limitation on the used equipment investment tax credit.

Senator NELSON. Is that removal of any limitations on used equipment?

Mr. SHERLOCK. Yes.

Senator NELSON. Do you want full removal?

Mr. SHERLOCK. Fourth, enactment of legislation specifically designed to aid small business such as that represented in your bill, S. 2998, with the one modification we just referred to; fifth, modification of the current procedures for refund of the excise tax on fuel used by bus operators; and sixth, a social security tax offset possibly in the form of a credit against income taxes.

Rather than referring to the general small business initiatives, let me talk to those issues which are of unique application to our industry.

With certain modifications, the investment tax credit can provide highly significant assistance to the intercity bus industry.

First, the definition of property which is eligible for the energy property investment tax credit should be modified to remove all restrictions. In the windfall profits tax legislation, the Congress enacted an additional 10 percent energy property investment tax credit for bus purchases, but only if the bus adds to an operator's fleet.

The credit seems to be operating as a disincentive to the release of buses to the used bus market until at least qualification for full credit is assured by the company acquiring the new bus. Thus the incremental nature of the credit may have a recurring impact on the availability of used buses to smaller operators who rely heavily on them.

The limitation on this credit to an increase in seating capacity appears to be unique in the Code, and is counterproductive.

Second, the investment tax credit for used equipment would be especially helpful to small operators, but as I have indicated we feel that the limitation should be removed. The Tax Code will not be written each year to reflect the impact of inflation.

In terms of the fuel excise tax fund, we are very appreciative of the action that you have taken in including that measure in Senate bill 2998. It will be very helpful to our small people who see it only as simply another unnecessary Federal paperwork requirement.

Thank you.

[The prepared statement of Mr. Sherlock follows:]

STATEMENT OF NORMAN R. SHERLOCK, EXECUTIVE VICE PRESIDENT, AMERICAN BUS ASSOCIATION

SUMMARY OF TESTIMONY OF THE AMERICAN BUS ASSOCIATION

It is timely to enact broad-gauge lesislation which reduces the complexity of current tax procedures, enhances the ability of the bus industry to provide a fuel-saving alternative to individual auto use, and helps spur business investment and productivity.

Suggested measures:

(1) Accelerated and simplified depreciation for investment in equipment and buildings.

(2) Modification of the Energy Property Investment Tax Credit for bus purchases.

(3) Enactment of the legislation proposed by Senator Nelson to aid small businesses - S 2136, S.2480, S.653, S.487.

(4) S.2152, doubling the investment tax credit for used equipment is a good step forward, but the credit should not be limited.

(5) Modification of the current procedures for refund of the excise tax on fuel used by bus operators.

(6) Social Security tax offset, possibly in the form of a credit against income taxes.

Mr. Chairman and Members of the Committee:

My name is Norman Sherlock. I am Executive Vice-President of the American Bus Association which represents private bus operators that provide regular scheduled service, local commuting, tours and charters, as well as special operations.

The intercity bus industry is comprised of approximately 1150 individual bus companies which carry passengers between communities in this country. Although many people visualize the industry as being the two large nationally organized carriers, Greyhound Lines and Trailways, many other carriers provide a wide range of services. In fact, of the 360 million passengers carried last year, 277 million were carried by the other 1148 regional or local bus operators.

In fashioning tax policy, it is important to understand the nature of this industry and the role that it plays in transportation, both now and in the future. First, the bus is the most energy efficient mode of transportation today. It requires, for example, less than one-third of the fuel needed to transport an equivalent number of people otherwise carried by either the train or the car. Consequently, its expanded use will save energy and substantially reduce fuel consumed in passenger transportation. Second, the intercity bus industry serves 15,000 communities in this country -- over 14,000 of which are not served by any other form of transportation. As automobile use necessarily declines in the future, it will be the intercity bus operator which will provide mobility to our rural areas and small towns, as well as between urban centers. Third, the bus industry carriers more passengers than any other form of public intercity transportation. The total of 360 million passengers carried last year is more than the airlines and Amtrak combined. Fourth, the intercity bus industry has emerged as a very important factor in maintaining the economic welfare of the travel and tourism industry, an activity that accounts for $128 billion in our national economy.

Tourism is the first, second or third largest industry of at least 40 states. Economists predict that by the year 2000 travel and tourism will be the largest industry in the world. Bus transportation has been a critical lifeline for this industry in many cases, and the need for it will be even greater in the future.

As we enter the decade of the 80's, the intercity bus industry will be called on to play a vital role in retaining the mobility of the general public in the future era of scarce or very expensive gasoline. This mobility is the dominant characteristic of American society today. Our economy and social structure have been developed on the basis of a pervasive use of the private automobile and the airplane, for both business and pleasure. There is nothing quite like the United States in the rest of the world in the degree to which the demand for transportation is so extensive. One frequently refers to the fact that transportation constitutes over twenty percent of our gross national product without totally realizing what that means in the development of policy. If there is any one fact of life in this country, it is the degree to which mobility of people governs the day-to-day characteristics of living.

As a result, our use of energy in transportation is very high. It accounts for twenty-five percent of the total energy utilized in this country and over fifty percent of all oil consumed. Additionally, over half of the total energy consumed in transportation is by passengers being transported in automobiles. Thus, automobile transportation of passengers alone consumed a quantity of oil equal to the total that we import. This simply means that as policy-makers come to grips with the problem of our reliance on imported oil, something must be done to reduce the amount used in transportation.

Instead of forcing a reduction in total travel, we must provide an alternative to the automobile by expanding our fuel efficient forms of public transportation. These alternative forms of public transportation must be made available throughout the country -- urban, rural, and intercity. And, in order to effectively serve as an alternative to the car, public transportation must be as pervasive as the car. It must be of good quality, its availability must be accepted by the general public, it must be reasonably economical and it must be in place, generally speaking, before the need for it becomes critical. People must be drawn, not forced, out of their private automobiles. We have clearly reached the point where national policy in all areas must promote the full use and development of intercity bus transportation as a fuel-saving alternative to individual automobile use. It has been estimated that if one percent of the people who used their cars for intercity travel took the bus instead, it could save 238 million gallons of fuel annually. The need is apparent. Of course, if more severe fuel shortages in the furture make it impossible for people to use their cars, the existence of adequate buses, facilities and service will be critical, not just desirable.

The ability of the intercity bus industry to fulfill its potential as a fuel-saving alternative to individual automobile use will be largely dependent on the outcome of the debate over issues you are considering today. While it is essential that the role of this industry be expanded, it cannot be assumed that the necessary capital will be available to intercity bus companies to meet this demand. Even Greyhound and Trailways, with their access to national capital markets, will have some problem obtaining all the capital they need to expand their services to meet the developing needs of the public as this energy shortage develops. The small carriers will have a still more difficult time.

The industry has been gripped by a decline in its regular route traffic since World War II -- much as was experienced by the rail industry until the Federal government stepped in and created Amtrak to reverse that trend. This long term decline has adversely affected the earnings of the industry and the decade of the 70's has witnessed a steady erosion in its profits margins. Industry earnings pre-tax topped out in 1971 at $101 million and have since declined steadily to a level around $55 million. They rose sharply in 1979 to $88 million, but even with this sharp increase, fell short of the 1971 earnings level. Operating margins similarly declined from approximately 10 percent at the beginning of the decade to 4 percent in 1978 and rose to only 5.4 percent in 1979. The impact of this revenue loss has been compounded by ever-increasing operating costs (particularly for equipment and fuel), and has resulted in an operating ratio which has risen from 89.4 in 1971 to 96.0 in 1978. When you adjust those figures for the current purchasing power of the dollar, the actual decline has been even greater in terms of what it takes to replace equipment.

A recent study of reports for most of the Class I carriers for the years 1977, 1978, and 1979 emphasizes the seriousness of this problem, particularly during periods of inflation. During both 1977 and 1978, the industry suffered actual losses if replacement costs are taken into account. In 1979, a return of 12.4 percent on equity or 4.9 percent of revenues was eroded under replacement accounting to 2.7 percent of equity or 1.2 percent of revenue. Such effective losses, and even the small return in 1979, are obviously insufficient to attract equity capital or borrowed funds or to finance internally an adequate, consistent replacement program. Today many carriers are finding it impossible to finance the number of buses they would like to operate with even modest demand forecasts. The cash flow for other facilities such as terminals and maintenance facilities is still in shorter supply. As the future evolves, this industry will need capital on terms that its historic earnings and cash flow will simply not support. This industry, as others, acquires assistance in capital formation.

It is timely to consider broad-gauge legislation which helps spur business investment and productivity, and reduces the complexity of current tax procedures.

We support action in the following areas:

(1) Depreciation Reform.
In recognition of the impact of inflation on replacement costs, the Internal Revenue Code should be modified to allow for more rapid depreciation as well as a reduction in the complexity of the procedures necessary to obtain such benefits.

Like many other small businesses, the intercity bus industry needs a simplified depreciation scheme of this type since many operators simply have neither the expertise nor the financial capability to wade through the existing complex depreciation rules. A simplified system would allow bus operators to better understand and utilize accelerated depreciation without having to hire expensive technical assistance. Also, the faster write-off would increase the cash flow of the smaller operator and would therefore, expedite further investment in new equipment.

(2) Social Security Tax Offset.
The tax burden on employers and employees for support of the Social Security system has increased dramatically since its inception, and the problem will be worse next year. In 1970, it cost the average bus company $393 per employee in such taxes; by 1978, the cost of such taxes had reached $1103 per employee.

In 1981, it is expected that this will cost the average bus company $1550 per employee in Social Security taxes. That is nearly four times the cost per employee in 1970, and 40 percent higher than in 1978. This dramatic increase will be a heavy burden for all taxpayers and may act as a deterrent to future employment and business growth. It will present a particularly difficult problem for small businesses such as small bus operators that already have cash flow difficulties. The impact of the increased taxes which are to go into effect next year need to be offset, perhaps with a credit against income taxes.

(3) Small Business Incentives.
There are a number of pending proposals sponsored by Senator Nelson which would assist small businesses, including further graduation of corporate income tax rates and a capital gains rollover.

The role of small businesses is vital to our economy, but particularly so in a time of high unemployment. Given the current and projected state of our economy and unemployment, careful consideration should be given to the enactment of a New Jobs Credit.

(4) Investment Tax Credit.
With certain modifications, the investment tax credit can provide highly significant assistance to the intercity bus industry. First, the definition of property eligible for the Energy Property Investment Tax Credit should be modified to remove all restrictions. Second, although we believe there is no reason to maintain a limit on the investment eligibility of used equipment for the tax credit, we urge, at a minimum, adoption of S.2152 which would increase the existing limitation of $100,000 per year to $200,000. Finally we suggest modification of the Energy Property Investment Tax Credit so as to include all leased equipment.

In the windfall profits tax legislation, P.L.96-223, the Congress enacted an additional 10 percent Energy Property Investment Tax Credit for bus purchases, but only if the bus adds to an operator's fleet. The requirement that the additional credit applies only to fleet expansion may presently be contributing to reduced availability of used buses. The credit seems to be operating as a disincentive to the release of buses to the used bus market until, at least, qualification for the full credit is assured by the company acquiring the new bus. Thus, the incremental nature of the credit may have a recurring impact on the availability of used buses to the dependent smaller operators as the existing owners adjust their buying/selling patterns to achieve full utilization of the credit.

The incremental limitation of this additional credit to investment attributable to an increase in operating seating capacity appears to be unique in the Code. The operative logic of the investment tax credit to encourage not only expansion of capacity, but also replacement of machinery and equipment, should extend to the energy property credit for intercity buses, particularly in light of the acknowledged national value of the incentive and the need as a result of the financial condition of this industry.

Smaller operators simply do not have the financial resources under any circumstances to purchase new equipment. However, the price of second-hand buses has risen sharply, reflecting their demand. Used buses in good condition can sell for as much as $50,000 each. Furthermore, the price is escalating by $5,000 or more per year. In five years, the price of a used bus will substantially exceed $100,000. We need the tax credit increased to a level of $200,000 now, although there should be no limit. The tax laws will not be rewritten each year to account for inflation. The increase in the used equipment investment tax credit that operators could take advantage of and the full 20% tax credit would stimulate further purchases of equipment and provide invaluable assistance to bringing the fleet back up to the level that it was. There are now 4,000 fewer buses in the fleet than there were in 1968.

Beyond this, we suggest the status of leasing in relationship to the 10 percent Energy Property Investment Tax Credit be examined and changed. While leasing is not the predominant means by which our operators acquire equipment, it is one means by which an undercapitalized smaller company can place more buses in service. Although the Treasury Department has not yet issued regulations, we understand that its position will be that lessors will not be allowed to take this additional credit, nor can the credit be passed through in lease arrangements so that operators receive the benefit. Thus, in those circumstances where an operator has insufficient capital to purchase a bus and can only rely on a leasing arrangement, he will not receive the benefit of the full credit. It seems counterproductive to raise such barriers to leasing transactions. Certainly, insofar as it inhibits the introduction of more buses into service, the restriction runs contrary to the Congressional intent in authorizing the additional credit in the first place. The Congress in passing the provision for an additional 10 percent Energy Property Investment Tax Credit clearly intended to encourage the acquisition of more buses to be placed into service as part of our national response to the energy dilemma. We suggest that a clarifying provision be adopted so that bus operators will receive the benefit of the 10 percent energy credit when acquiring buses by leasing.

(5) Fuel Excise Tax Refunds.

In 1978, the Congress "exempted" intercity bus operators from the 4 cent a gallon federal excise tax on fuel, for among other reasons, to promote bus travel as a fuel-saving alternative to individual auto use. The law, however, requires a bus operator engaged in intercity, charter, local and special operations to first pay the excise tax and then file for a refund. This constricts the cash flow particularly of smaller operators, and simply is another paperwork exercise that is not necessary. We favor making the relief from the federal excise tax a true exemption.

Mr. Chairman, the realities of our energy-short world are forcing fundamental attitudinal changes on the part of the American public. The public is looking more to bus service and its availability will be critical in this new era of scarce and very expensive energy. This industry is attempting to position itself ahead of the demand with equipment changes and terminal modifications. This ongoing effort can only be realized in a timely fashion by the adoption of meaningful tax reform legislation that recognizes the special needs of private operators. With the changes in tax laws we have suggested, private bus operators will be in a better position to fulfill their full potential as an effective part of the Nation's energy conservation effort. They will be able to help preserve the mobility of people, and maintain the viability of travel and tourism in our country. We urge your favorable consideration of these modifications.

BUS INDUSTRY STUDY CARRIERS
INCOME STATEMENT & FINANCIAL RATIOS
Actual vs. Replacement Costs
1977 through 1979
(000 omitted)

	1977		1978		1979	
	Actual	Replacement Cost	Actual	Replacement Cost	Actual	Replacement Cost
Operating Revenues	$900,550	$900,550	$945,274	$945,274	$1,101,027	$1,101,027
Operating Expenses:						
Depreciation	27,431	76,900	35,617	81,407	40,760	82,144
Non-depreciation	829,021	829,021	872,871	872,871	1,005,932	1,005,932
Total	856,452	905,921	908,488	954,278	1,046,692	1,088,076
Net Carrier Operating Income	44,098	(5,371)	36,786	(9,004)	54,335	12,951
Return on Investment	11.0%	(1.25)	9.5%	(2.0%)	12.4%	2.7%
Operating Ratio	95.1%	100.6%	96.1%	101.0%	95.1%	98.8%

( ) Denotes negative amounts and ratios

Source: Statements in Support of Proposed Increases of 9% in Interstate Passenger Fares and Express Rates, National Bus Traffic Association, Inc. before the Interstate Commerce Commission, filed June 30, 1980 (Statement of President, John F. Grady, Vol. I, page 18).

Attachment 1

Senator NELSON. Thank you very much.

The next witness is Mr. Bruce Hahn, National Tooling & Machining Association.

STATEMENT OF BRUCE N. HAHN, NATIONAL TOOLING & MACHINING ASSOCIATION

Mr. HAHN. Thank you, Senator. I think summarizing will be pretty easy because you did a pretty good job of it when you introduced S. 2998. Our compliments to you and to the original cosponsors, Senators Byrd, Bentsen, Wallop, Moynihan, Durenberger, Stewart, Culver, and Eagleton. It goes a long way in addressing many of the problems identified at the White House Conference.

May I just briefly summarize the 11 points in it for the benefit of the panel and the audience.

One, the capital gains rollover.

Two, the investment credit for new businesses.

Three, the graduated corporate tax rates.

Four, the subchapter S shareholders increasing from 15 to 25.

Five, the used equipment investment tax credit.

Six, accumulated earnings tax raised to $250,000.

Seven, the elimination of midyear W-2's.

Eight, broker/dealer loss reserve.

Nine, the employee stock options.

Ten, inventory accounting.

Eleven, excise tax on motor fuels.

You have covered quite a few of the issues that would be very beneficial to small business, especially in light of the fact that there is a very low revenue loss of something estimated at $75 million. It will go a long way toward helping small business at a very, very low revenue loss.

There is one other major area where small business is in need of help, and in fact all business, and other smaller ones which I will mention.

The big one that is not covered in S. 2998 is in the area of capital cost recovery. We all know, of course, that you are a sponsor of the 10-5-3 bill, and we wholeheartedly endorse the concept in it. We do have a serious concern, as representatives from the Small Business Legislative Council, that only one-half of 1 percent of the small businesses use the ADR system. While the purpose of the 10-5-3 is to get away from the ADR system, it uses the ADR system in phasing it in.

If some sort of a compromise could be reached, if something in the markup could be done to pull from the ADR based phasein small businesses, it would greatly improve the bill. For example, you could take one of the categories, let us say, the 3-year category, and put a $100,000 cap, and let them write off their first $100,000 on that basis in 3 years, and then maybe raise the cap to $200,000 the second year, and so on up to $500,000, then the great majority of small businesses would not have to worry about an ADR based phase-in.

The 10-5-3 bill is even more complicated than the ADR because you are subtracting years from it during the phase-in. Most small companies and most of our members just could not use it. Congressman Nowak, who is chairman of the House Subcommittee on Access to Equity Capital, has introduced his own small business capital cost recovery bill with about 50 cosponsors. It uses caps of $1 million on equipment, and $3 million on buildings. In the Small Business Legislative Council, something like 60 of the national associations have endorsed that concept.

I think some kind of compromise, such as mentioned, between the 10-5-3 and the Nowak proposal could easily be worked out without significantly adding to revenue loss.

Senator NELSON. I think you make a good point.

Mr. HAHN. Several other pieces of legislation that are consistent with the proposals generating from the White House Conference on Small Business are:

First, legislation addressing the real estate tax loss. Transfer of small business ownership is greatly hindered by existing laws. Something needs to be done about that.

Second, a real jobs tax credit. We have the rudiments of a jobs tax credit, but when you consider that yesterday, testifying before the House Ways and Means Committee, somebody made the point that an unemployed person costs the economy $21,000, if you could have a credit for new jobs created, and as I am sure you know small businesses create 9 out of 10 new jobs, bearing in mind the relationship of this $21,000 figure, I think you could greatly reduce the unemployment rolls. It would be very cost effective to the U.S. Treasury.

We also support the small business participating debentures, also mentioned by the Small Business Legislative Council.

That is my statement. Thank you, sir.

Senator NELSON. Thank you, sir.

[The prepared statement of Mr. Hahn follows:]

STATEMENT OF THE NATIONAL TOOLING & MACHINING ASSOCIATION

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

MY NAME IS BRUCE N. HAHN. I AM MANAGER OF GOVERNMENT AFFAIRS OF THE NATIONAL TOOLING & MACHINING ASSOCIATION. OUR ASSOCIATION REPRESENTS THE 12,500 SMALL COMPANIES AND APPROXIMATELY 250,000 WORKERS IN THE CONTRACT TOOLING & MACHINING INDUSTRY.

IN SCHEDULING THESE HEARINGS, CONGRESS HAS COURAGEOUSLY CHOSEN TO FACE SQUARELY A CONTROVERSIAL AND HIGHLY CHARGED ISSUE: WHETHER OR NOT TO ENACT TAX REDUCTIONS IN THE 96TH CONGRESS.

THERE ARE MANY WHO FEEL THAT THIS IS A POLITICAL ISSUE. CONSIDERING THE UPCOMING ELECTIONS, THERE ARE UNQUESTIONABLY POLITICAL OVERTONES. HOWEVER, TAX REDUCTIONS ARE ALWAYS A POLITICAL ISSUE NO MATTER WHEN THEY OCCUR. IN OUR OPINION, THE GOAL OF THIS COMMITTEE SHOULD BE TO FIRST LOOK AT THE VARIOUS PROPOSALS FROM A BI-PARTISAN, NON-POLITICAL STANDPOINT. THE COMMITTEE SHOULD SEEK TO DETERMINE WHETHER OR NOT TAX REDUCTIONS OF ANY SORT ARE IN ORDER IN LIGHT OF THE COUNTRY'S CURRENT ECONOMIC STATUS. BEYOND THAN, THE PRACTICAL IMPACT OF POLITICAL REALITIES WILL ALSO HAVE TO BE CONSIDERED AS THEY AFFECT EACH MEMBER.

WE BELIEVE THAT THE OBJECTIVE FACTS ARGUE STRONGLY FOR BUSINESS TAX REDUCTIONS DESIGNED TO INCREASE THE LONG RANGE PRODUCTIVITY OF AMERICAN INDUSTRY AND THAT THEY FURTHER DEMONSTRATE A NEED FOR LEGISLATION IN THIS CONGRESS. FIRST OF ALL, THERE ARE VERY FEW IN EITHER PARTY WHO ARGUE AGAINST THE NEED TO IMPROVE PRODUCTIVITY IN THIS COUNTRY. INDEED,

OUR ORGANIZATION AND MANY OTHERS TESTIFYING BEFORE THIS COMMITTEE AND OTHERS ON BOTH SIDES OF CONGRESS HAVE CLEARLY DEMONSTRATED THE RELATIONSHIP BETWEEN DEPRECIATION RATES AND PRODUCTIVITY. SIMPLY PUT, DEPRECIATION RATES IN THE UNITED STATES ARE NOW CONSIDERABLY SLOWER THAN THOSE IN MOST OTHER COUNTRIES. AS THOSE COUNTRIES HAVE REDUCED THEIR DEPRECIATION RATES, THEIR PRODUCTIVITY HAS INCREASED AND THEIR PENETRATION INTO THE U.S. MARKET HAS INCREASED.

THE ONLY REMAINING QUESTION IS WHETHER TAX REDUCTION IN THE FORM OF CAPITAL COST REC OVERY SHOULD BE ENACTED AND IF SO, WHEN? THOSE OPPOSED TO TAX REDUCTION ARGUE THAT TO STIMULATE SPENDING DURING THE RECOVERY PERIOD WOULD INCREASE INFLATION AND PROLONG ECONOMIC RECOVERY IN THE UNITED STATES. WHILE IT IS TRUE THAT A SUDDEN SURGE IN CONSUMER SPENDING WOULD STIMULATE INFLATION AND HINDER RECOVERY, WE ALSO BELIEVE THAT TAX REDUCTIONS DESIGNED TO STIMULATE CAPITAL INVESTMENT WILL HAVE THE LEAST INFLATIONARY EFFECT WHILE AT THE SAME TIME PROVIDING THE MAXIMUM POSSIBLE ECONOMIC STIMULANT.

THE REASON IS THAT THIS TYPE OF LEGISLATION WILL HAVE THE LEAST EFFECT ON INDIVIDUAL AND CORPORATE DISPOSABLE INCOME. BESIDES THIS, IT WILL HAVE AN EXTREMELY BENEFICIAL EFFECT ON EMPLOYMENT WHICH IN TURN WILL REDUCE THE FEDERAL DEFICIT BY REDUCING TRANSFER PAYMENTS.

SUCH LEGISLATION, PARTICULARLY IF IT CAN BE DIRECTED TO BENEFIT THE SMALL BUSINESS COMMUNITY, WILL SOLVE SEVERAL OF THE NATION'S MOST PRESSING PROBLEMS WITH THE LEAST COST TO THE TREASURY. FACILITIES,

EQUIPMENT, AND MACHINERY IN THE SMALL BUSINESS SECTOR ARE THE LEAST PRODUCTIVE IN THE COUNTRY. SMALL BUSINESSES, WHO HAVE ALWAYS BEEN CASH POOR, HAVE OFTEN FOUND IT DIFFICULT TO OBTAIN LOANS AT ALL, MUCH LESS TO OBTAIN THEM AT REASONABLE INTEREST RATES. IT HAS BEEN THE SMALL BUSINESSMAN WHO HAS BEEN SQUEEZED OUT OF CAPITAL DURING RECENT AS WELL AS PAST CAPITAL SHORTAGES IN THIS COUNTRY. THE RESULT IS THAT FACILITIES AND EQUIPMENT IN THE SMALL BUSINESS COMMUNITY ARE NOT ONLY THE OLDEST AND LEAST PRODUCTIVE BUT ALSO OFFER THE GREATEST OPPROTUNITY FOR INCREASES IN BOTH IN PRODUCTIVITY AND IN EMPLOYMENT. DESPITE THE FACT THAT SMALL BUSINESSES ACCOUNT FOR LESS THAN HALF OF THE BUSINESS GNP, THEY ACCOUNT FOR NINE OUT OF TEN NEW JOBS IN THIS COUNTRY. THE REASON IS THAT SMALL BUSINESSES TEND TO PURCHASE EQUIPMENT, MACHINERY, AND FACILITIES WHICH CREATE JOBS AS OPPOSED TO THOSE THAT ELIMINATE JOBS. NEW JOBS OF COURSE MEAN FEWER PEOPLE RECEIVING ASSISTANCE FROM THE GOVERNMENT AND THEREFORE FEWER COSTS TO THE GOVERNMENT IN SUPPORTING THOSE WHO ARE OUT OF WORK.

WE STRONGLY URGE THE COMMITTEE TO ENACT CAPITAL COST RECOVERY LEGISLATION THIS YEAR. WHETHER OR NOT THE LEGISLATION IS TO BE EFFECTIVE IN 1980 OR 1981 IS RELATIVELY IMMATERIAL. NO ORGANIZATION SMALL OR LARGE IS GENERALLY IN A POSITION TO MAKE LARGE CAPITAL PURCHASES IN A SHORT TIME. FOR ONE THING, IT WILL TAKE SOME TIME FOR BUSINESSES TO EVALUATE AND DECIDE WHAT ACTION TO TAKE AFTER THE ENACTMENT OF ANY LEGISLATION. FOR ANOTHER, MAJOR CAPITAL ITEMS ARE NOT STORED ON THE SHELF. THEY MUST BE ORDERED OR CONSTRUCTED. IN OUR INDUSTRY, IT MAY TAKE SEVERAL YEARS FROM THE DATE OF THE ORDER BEFORE A MAJOR MACHINE TOOL

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IS INSTALLED. ALTHOUGH CAPITAL COST RECOVERY LEGISLATION WILL HAVE A RELATIVELY MODEST , IMMEDIATE IMPACT ON CAPITAL INVESTMENTS, IT SHOULD BE ENACTED AS SOON AS POSSIBLE IN ORDER TO ENCOURAGE THE PROCESS WHICH WILL RESULT IN CAPITAL IMPROVEMENTS A YEAR OR MORE IN THE FUTURE.

THERE ARE SEVERAL PIECES OF CAPITAL COST RECOVERY LEGISLATION BEFORE CONGRESS. WE ENDORSE THE CONCEPT IN EVERY ONE. PERHAPS THE BEST KNOWN IS THE "10-5-3" BILL. WHILE IT IS WIDELY SUPPORTED ON BOTH SIDES OF THE AISLE, WE FEEL THAT IT WOULD REQUIRE SEVERAL CHANGES BEFORE SMALL BUSINESSES COULD TAKE ADVANTAGE OF IT. FIRST, IT EMPLOYES A PHASE-IN WHICH IS BASED ON THE ASSET DEPRECIATION RANGE. WHILE THE LAUDIBLE GOAL OF THE PHASE-IN IS TO ELIMINATE THIS EXTREMELY COMPLICATED SYSTEM WHILE AT THE SAME TIME REDUCE DEPRECIATION RATES, THE PHASE-IN SYSTEM ITSELF CREATES A DIFFICULT PROBLEM FOR SMALL BUSINESS.

IRS FIGURES SHOW THAT 98% OF SMALL BUSINESSES DO NOT USE THE ASSET DEPRECIATION RANGE. THE REASON THEY DO NOT USE IT IS BECAUSE OF ITS COMPLEXITY. OBVIOUSLY, THEY WILL FIND IT EQUALLY IF NOT MORE DIFFICULT TO USE PHASE-IN BASED ON THE ASSET DEPRECIATION RANGE. THEREFORE, ANY CAPITAL COST RECOVERY LEGISLATION SHOULD HAVE A DIFFERENCT METHOD OF PHASE-IN. WE SUGGEST THAT THIS COMMITTEE CONSIDER MODIFYING IT TO USE PROGRESSIVE CAPS OR CEILINGS ON THE AMOUNT THAT CAN BE PHASED-IN EACH YEAR. YOU MIGHT ALLOW THE FIRST MILLION DOLLARS OF MACHINERY INVESTMENTS TO BE WRITTEN OFF AT THE NEW RATE THE FIRST YEAR, THE FIRST TWO MILLION DOLLARS OF MACHINERY INVESTMENTS TO BE WRITTEN OFF AT THE NEW RATE THE SECOND YEAR AND SO FORTH. THE ADVANTAGE OF THIS

APPROACH WOULD BE THAT YOU COULD "TUNE" THE LEGISLATION BY ADJUSTING THE CEILINGS TO PRODUCE THE APPROPRIATE REVENUE LOSS DESIRED. IT WOULD ALSO ELIMINATE THE PROBLEM OF COMPANIES POSTPONING ALL DECISIONS IN THE FIRST YEARS OF THE BILL'S EXISTENCE IN ORDER TO GAIN MAXIMUM ADVANTAGE WHICH WOULD EXIST ONLY AFTER "10-5-3" BILL IS FULLY PHASED-IN.

CONGRESSMAN HENRY NOWAK, CHAIRMAN OF THE HOUSE SMALL BUSINESS SUBCOMMITTEE ON ACCESS TO EQUITY CAPITAL, HAS OFFERED AN APPROACH WHICH IS SPONSORED BY OVER 50 CONGRESSMEN. HIS PROPOSAL CALLS FOR A 15 YEAR WRITE OFF ON BUILDINGS AND STRUCTURES AND A 4-YEAR WRITE OFF ON EVERYTHING ELSE. IN ORDER TO REDUCE REVENUE LOSS, THE BILL WOULD LIMIT THE INVESTMENT ELIGIBLE FOR THE RAPID WRITE-OFF BY USING THE CEILINGS OF $3 MILLION ON BUILDINGS AND STRUCTURES AND $1 MILLION ON THE REMAINDER. AMOUNTS INVESTED IN EXCESS OF THAT AMOUNT WOULD BE WRITTEN OFF AT CURRENT RATES. BESIDES BEING SIMPLE AND UNCOMPLICATED, THIS APPROACH WOULD RESULT IN THE LEAST REVENUE LOSS TO THE TREASURY WHILE CONCENTRATING INVESTMENTS IN AREAS WHERE THERE IS THE GREATEST OPPORTUNITY FOR INCREASES IN PRODUCTIVITY AS WELL AS IN EMPLOYMENT.

OVER THE PAST MONTH, AN APPROACH THAT WOULD BE A COMPROMISE BETWEEN THE NOWAK BILL AND THE "10-5-3" BILL HAS BEEN DISCUSSED BY A NUMBER OF LOCAL BUSINESS GROUPS AND STAFF MEMBERS IN THE SENATE AND THE HOUSE. IN THIS APPROACH, THERE WOULD BE A PROGRESSIVE CEILING IN THE 3-YEAR CATEGORY WHICH WOULD ENABLE SMALL BUSINESSES TO BYPASS THE COMPLICATED PHASE-IN SYSTEM. ALL CAPITAL INVESTMENTS UNDER $100,000 OTHER THAN

THOSE IN BUILDINGS AND STRUCTURES WOULD BE WRITTEN OFF IN THREE YEARS WITH AN 9%-9% INVESTMENT TAX CREDIT. IN THE SECOND YEAR, THAT CEILING WOULD RISE TO $200,000 AND SO ON UP TO $500,000 IN THE FIFTH YEAR. WHAT THIS WOULD DO WOULD BE TO REMOVE THE COUNTRY'S SMALLER BUSINESSES FROM THE COMPLICATIONS OF A PHASE-IN BASED ON THE ASSET DEPRECIATION RANGE, WHILE LEAVING THE MORE COMPLICATED ACCOUNTING SYSTEMS TO THOSE LARGER COMPANIES SOPHISTICATED ENOUGH TO UTILIZE IT FULLY. WE STRONGLY URGE THIS COMMITTEE TO CONSIDER WITH AN OPEN MIND SUCH AN APPROACH.

ANOTHER PIECE OF LEGISLATION WHICH WOULD ENCOURAGE CAPITAL INVESTMENT BY SMALL BUSINESS SHOULD BE CONSIDERED BECAUSE OF ITS SIMPLICITY AND VERY MODEST COST. THIS IS THE PROPOSAL DOUBLING FROM $100,000 TO $200,000 THE AMOUNT OF USED EQUIPMENT AND MACHINERY ELIGIBLE FOR THE 10% INVESTMENT CREDIT. FOR SOME REASON, USED EQUIPMENT HAS BEEN EXCLUDED FROM THE PREFERENTIAL TAX TREATMENT AFFORDED NEW EQUIPMENT DESPITE THE FACT IT WOULD OBVIOUSLY BE MORE PRODUCTIVE IF IT IS REPLACING OTHER EQUIPMENT AND WOULD CERTAINLY CREATE JOBS IF IT REPRESENTS EXPANSION. THIS MODEST PROPOSAL, SPONSORED BY SENATOR NELSON IN THE SENATE AND CONGRESSMAN NOWAK IN THE HOUSE, WOULD BARELY MAKE UP FOR INFLATION, SINCE THE ORIGINAL $100,000 LIMIT WAS ENACTED AND WOULD CAUSE MINIMAL EFFECT ON THE TREASURY.

WE WOULD BE REMISS IF WE DID NOT POINT OUT THE NUMBER ONE PRIORITY FOR TAX REDUCTION AS IDENTIFIED BY SMALL BUSINESS IN THIS COUNTRY AT THE WHITE HOUSE CONFERENCE ON SMALL BUSINESS. OVER 1600 DELEGATES TO THAT CONFERENCE CALLED FOR REPLACING THE PRESENT CORPORATE TAX RATE SCHEDULE

WITH MORE GRADUATED RATES COVERING THE FIRST $500,000 OF INCOME RATHER THAN THE FIRST $100,000. WITHIN THE EXPANDED RANGES, THE RATES WOULD ALSO BE REDUCED. ALTHOUGH THIS PROPOSAL HAS NOT RECEIVED THE ATTENTION THAT OTHERS HAVE, IT IS THE EASIEST TO IMPLEMENT, THE EASIEST FOR SMALL BUSINESSES TO UNDERSTAND AND APPLY, AND WOULD PROVIDE THE SAME BENEFITS TO THE ENTIRE BUSINESS COMMUNITY. ON THE OTHER HAND, IN FAIRNESS, IT MUST BE RECOGNIZED THAT IT MAY RESULT IN FEWER PROFITS REDIRECTED INTO CAPITAL INVESTMENT THAN WOULD RESULT UNDER THE AFORE-MENTIONED PROPOSALS.

THERE HAS BEEN AN ALARMING TREND OVER THE PAST 50 YEARS IN THE BUSINESS ENVIRONMENT IN THIS COUNTRY. AMERICA, ONCE A NATION OF SMALL BUSINESSES, IS BECOMING LESS AND LESS SO WITH EACH PASSING YEAR. IN 1960, MANUFAC-TURING CORPORATIONS UNDER $10 MILLION IN ASSETS ACCOUNTED FOR OVER 20% OF THE TOTAL BUSINESS ASSETS IN THE MANUFACTURING SECTOR. THOSE COM-PANIES WITH UNDER $250 MILLION IN ASSETS HELD ALMOST HALF OF THE TOTAL ASSETS IN THE SAME SECTOR. TODAY, THAT PICTURE HAS CHANGED DRAMATICALLY. MANUFACTURING FIRMS WITH UNDER $10 MILLION IN ASSETS CONTROL LESS THAN 10% OF THE TOTAL ASSETS FOR MANUFACTURING CORPORATIONS. ALL THOSE WITH UNDER $250 MILLION IN ASSETS CONTROL ABOUT 25% OF THE TOTAL ASSETS FOR MANUFACTURING CORPORATIONS. WHAT THIS PROVES IS THAT SMALL BUSI-NESSES IN THIS COUNTRY ARE GRADUALLY BECOMING EXTINCT. THE MAIN REASON FOR THIS CAN BE SUMMARIZED IN ONE WORD: CAPITAL. SMALL BUSINESSES CAN'T GET CAPITAL AND THEY CAN'T KEEP IT. IT IS NOT PRACTICAL FOR A SMALL BUSINESSMAN TO SELL HIS COMPANY TO EMPLOYEES, ANOTHER SMALL BUSINESS PERSON, OR HIS FAMILY. FIRST OF ALL, HE WOULD BE SUBJECT TO

CAPITAL GAINS TAX. SECONDLY, IT IS UNLIKELY THAT THE AFOREMENTIONED INDIVIDUALS WOULD HAVE OR COULD BORROW THE NECESSARY CAPITAL. FROM A PRACTICAL POINT OF VIEW, THE ONLY REAL OPTION IS EXCHANGING FOR STOCK WITH A LARGE CORPORATION TO AVOID THE IMMEDIATE CAPITAL GAINS TAX.

CONGRESS CAN DO SEVERAL THINGS TO REVERSE THIS TREND. FIRST, THERE SHOULD BE A DEFERRAL OF TAXES FOR ROLLOVERS OF INVESTMENT AFFECTING SMALL BUSINESSES. A SMALL BUSINESSMAN SHOULD BE ABLE TO INVEST HIS PROCEEDS IN ANOTHER SMALL BUSINESS WITHOUT CAPITAL GAINS TAXES IF DONE IN A REASONABLE PERIOD OF TIME. THIS IS SIMILAR IN CONCEPT TO THE TREATMENT OF AN INDIVIDUAL SELLING A HOUSE AND LATER REINVESTING IN ANOTHER HOUSE.

CONGRESS SHOULD CONSIDER THE CREATION OF A SMALL BUSINESS CAPITAL DEBENTURE WHICH WOULD ENCOURAGE INVESTMENT IN SMALL BUSINESSES. OUR PRESENT TAX STRUCTURE DISCOURAGES INDIVIDUALS, CORPORATIONS AND OTHER GROUPS ACTIVE IN THE INVESTMENT MARKET FROM INVESTING IN SMALL BUSINESS. THIS NEW FINANCIAL INSTRUMENT WOULD MAKE INVESTMENTS IN SMALL BUSINESS ENTERPRISE ATTRACTIVE TO INVESTORS AND ACCEPTABLE TO THE BORROWERS.

ANOTHER IMPORTANT STEP THAT CONGRESS COULD TAKE WHICH IS CONSISTENT WITH NATIONAL POLICY WOULD BE THE IMPLEMENTATION OF A MEANINGFUL JOBS TAX CREDIT. THE JOBS CREDIT WAS LIMITED ON JANUARY 1, 1979. THE PRESENT "TARGETED JOBS CREDIT" IS A VERY MINOR CONSEQUENCE AND IS USED VERY LITTLE TODAY. WITH THE COST OF ONE UNEMPLOYED PERSON BEING IN EXCESS OF $20,000 PER YEAR, IT WOULD BE SOUND ECONOMIC POLICY TO

ALLOW A REASONABLE PORTION OF THAT AMOUNT AS A CREDIT FOR NEW JOBS CREATED. OUR HUMAN RESOURCES ARE THE NATION'S MOST VALUABLE ASSET. A SUBSTANTIAL AND MEANINGFUL CREDIT FOR INVESTMENT IN PEOPLE WOULD BE WISE FISCAL AND ECONOMIC POLICY.

LASTLY, WE STRONGLY URGE RECONSIDERATION OF ESTATE TAX LAWS. THESE LAWS DO MUCH TO FOSTER THE DISSOLUTION OF SMALL BUSINESSES IN THIS COUNTRY. IN VIEW OF THE ALARMING RATE OF DETERIORATION OF THE SMALL BUSINESS COMMUNITY IN THE NATIONAL ECONOMY, THE TREND NEEDS TO BE REVERSED NOT ACCELERATED. WE STRONGLY URGE THIS COMMITTEE TO EASE TRANSFER OF BUSINESSES TO HEIRS TO SLOW DOWN THE EXTINCTION OR ABSORPTION OF SMALL BUSINESS BY BIG BUSINESS.

ALL OF THESE PROPOSALS CAN BE ENACTED IN A PACKAGE CONSISTENT WITH REASONABLE REVENUE LOSS EXPECTATIONS. WE RECOGNIZE THE HIGHLY CHARGED ATMOSPHERE IN WHICH THE COMMITTEE WILL BE DEALING OVER THE UPCOMING MONTHS. WE APPRECIATE THE OPPORTUNITY TO TESTIFY HERE TODAY AND ASK ONLY THAT YOU CONSIDER THESE PROPOSALS ON THEIR MERITS.

THANK YOU.

Senator NELSON. The next witness is Mr. Philip Ranno, president of the National Association of Metal Finishers.

STATEMENT OF PHILIP RANNO, PRESIDENT, NATIONAL ASSOCIATION OF METAL FINISHERS

Mr. RANNO. Thank you, Mr. Chairman.

My name is Philip Ranno. I am the president of the Ranno Electro Plating Corp., in Saddle Brook, N.J., and also the president of the National Association of Metal Finishers. With me today are Mr. Dollard Carey, executive director of the National Association of Metal Finishers, headquartered in Chicago; and Mr. John Holloman, special counsel, from the firm of O'Connor & Hannon.

The National Association of Metal Finishers represents an industry of approximately 5,000 independent job shops which provide electroplating and similar metal finishing services. Our customers use these treated metals for products which cover a wide range of consumer, industrial, defense products. Without us, these metals would quickly corrode and the products would be unusable.

A typical electroplating firm has average annual gross sales of $665,000, employment of 15 to 20, and capitalization of $250,000. My own particular firm has 25 employees, and annual gross sales of $1.5 million. We are obviously small businessmen.

I want to address a specific issue concerning accelerated depreciation and the investment tax credit as they apply to pollution control equipment. As you know the 10-5-3 bill does not address this particular issue.

Our industry is one of the first to feel the full effect of the EPA water pretreatment rules. These standards are scheduled to go into effect in October of 1982.

What will be the effect of these rules on productivity, on profitability, on capital investment, and—the real crux of the issue—on survival for metal-finishing job shops? Our members today are facing the question: Can I afford to stay in business?

EPA's own statements, or their estimates, I should say, are that these water pretreatment rules could lead to the closure of 19.9 percent of the firms in our industry. That, I submit to you, is an incredible figure. Let me read it to you just as EPA said it.

"EPA estimates that 587 metal finishing job shops, employing 9,653 workers may close as a result of these regulations."

Horrendous as this 20 percent closure rate may sound, we in the industry believe that this rate is unrealistically low, and could be doubled in today's business climate.

The EPA estimated that the closure rate could be reduced, assuming the availability of 20-year SBA loans at an interst rate of 6.75 percent. However, the SBA will not make loans to firms whose ability to survive is so impaired, even if this is due to the fact of meeting Government regulations. We in the industry doubt that many firms in our industry will get any relief from SBA loans at all.

Our member firms recognize that our manufacturing processes lead to wastes which should be controlled. We are working with the industry to reduce these effluents, and are willing to live with pollution control regulations as long as they are reasonable, and do not put an exorbitant percentage of our members out of business.

Many of our members have lived for years with strict State and municipal standards. However, the EPA rules will require even the most advanced of our members to make additional investments in nonproductive, and I underline, nonproductive pollution control equipment which can be often as great as the firm's entire capitalization.

These investments do nothing to improve productivity, or upgrade our production processes. In some instances, they can decrease it. Therefore, I am asking for special consideration under the tax laws for investments in pollution control facilities for firms like my own.

This special consideration would be in the form of a 2-year depreciation on all water pollution abatement equipment along with the 10 percent investment tax credit. For example, if a firm must invest $100,000 in a piece of pollution abatement equipment, we are asking for 2-year accelerated depreciation plus the normal $10,000 tax credit.

I must emphasize that the 10-5-3 capital cost recovery proposals as they now stand do nothing to solve the problem which I am describing to you. Investments in pollution control equipment already qualify for 5-year accelerated depreciation.

Therefore, Mr. Chairman, and members of the committee, we are asking that our Government help us. We recognize that our Nation has made a basic social decision to reduce the effluents from manufacturing. We do not believe that the American people nor the Congress want to do this in a way that puts 20 percent or more of an industry out of business, and its employees out of jobs.

For small businesses heavily affected by pollution control costs, special treatment under the next tax reduction act is essential. Our industry must begin now with engineering studies in ordering equipment if we are to have it in place and working by late 1982. We ask, therefore, that this question be addressed in the context of the reform of the business taxes to go into effect in fiscal year 1981.

Thank you for your patience.

Senator NELSON. Thank you very much, Mr. Ranno.

[The prepared statement of Mr. Ranno follows:]

STATEMENT OF PHILIP RANNO, PRESIDENT, NATIONAL ASSOCIATION OF METAL FINISHERS

Mr. Chairman, I am Philip Ranno, President of Ranno Electro Plating Corporation of Saddle Brook, New Jersey, and of the National Association of Metal Finishers. With me are Dollard Carey, Executive Director of the National Association of Metal Finishers, headquartered in Chicago; and John Holloman, Special Counsel, from the firm of O'Connor and Hannon. I will keep my remarks brief, but would appreciate the opportunity to submit additional material at a later date, before the closing of the record of these hearings.

The National Association of Metal Finishers represents an industry of approximately 5,000 independent job shops which provide electroplating and similar metal finishing services. Our customers use these treated metals for a wide range of consumer, industrial, and defense products. Without us, these metals would quickly corrode and the products would be unusable.

A typical electroplating firm has average annual gross sales of $665,000, employment of 15-20, and capitalization of $250,000. My own firm has 25 employees, and annual gross sales of $1.5 million. We are obviously small businessmen.

I want principally to address a specific issue concerning accelerated depreciation and the investment tax credit, as they apply to investments in pollution control equipment. As you know, the 10-5-3 bill does not address this issue.

I would, however, make two opening comments on the general economic and tax issues before you:

- First, on the basic advisability of a tax cut. Although the current recession has had far different effects in different parts of the country, the impact on our member firms in Michigan and other areas which serve the automotive industry has been disastrous. At least 12 electroplating firms in the Detroit area have gone out of business in the last eighteen months, and others are struggling to keep their doors open. We believe that special measures are needed to aid the automotive industry, which in turn would help many of our members to survive.

- Second, I am appalled, as I know you are, at the consistently low rates of capital formation and productivity improvement in our country. We are rapidly losing our competitive edge over manufacturers in other parts of the world. Our net rate of investment in productive new capital--after adjustment for replacement and inventory--is only three percent. We believe that the next changes in our tax laws must be heavily weighed toward business, rather than individual tax reduction, and must be tailored specifically toward improving productivity and capital formation.

Let me turn now to the electro-plating industry. I need to make a digression into the related subject of the effects of federal regulations, and particularly of pollution control regulations, upon our industry. The relationship of this problem to productivity and to depreciation schedules will be evident.

Our industry is one of the first to feel the full effect of EPA water pretreatment rules. These standards are scheduled to go into effect in October, 1982.

What will be the effect of these rules on productivity, on profitability, on capital investments, and--the real crux of the issue--on survival for metal-finishing job shops? Our members today are facing the question--can I afford to stay in business.

- EPA's own estimates are that these water pretreatment rules could lead to the closure of 19.9 percent of the firms in our industry. That, I submit, is an incredible figure. Let me read it to you just as EPA said it:

> "(d) Impacts on the Job Shop sector. Independent metal finishing job shops may suffer significant adverse economic impacts as a result of the regulations. EPA estimates that 587 metal finishing job shops, employing 9,653 workers may close as a result of the regulations. This represents 19.9 percent of the job shops in the industry (21.5 percent of the indirect dischargers), and 13.9 percent of the employment in the job shop sector."

Horrendous as this 20 percent closure rate may sound, we in the industry believe that this closure rate is unrealistically low, and could be doubled in today's business climate.

- EPA estimated that this closure rate could be reduced -- reduced to "as low as 5.4 percent" (and the employment loss to 4,670 jobs)-- "assuming the availability of 20-year (SBA) loans at an interest rate of 6.75 percent." There are, of course, several problems with this assumption. First, SBA loan rates are currently well above 6.75 percent. Second, in the current fiscal year, the funding for all SBA economic injury loans, including all industries and a number of EPA programs, was $60 million far less than this one industry will need to comply with the EPA pretreatment rules. Third, the SBA will not in any case make loans to firms whose ability to survive is so impaired -- even if this impairment is due to the costs of meeting government regulations -- that the ability to repay the loan is in doubt. For the above reasons we in the industry doubt that many firms in our industry will get any relief from SBA loans.

Our member firms recognize that our manufacturing processes lead to wastes which should be controlled. We are working to reduce these effluents, and are willing to live with pollution control regulations -- as long as they are reasonable and do not put an exhorbitant percentage of our members out of business. Many of our members have lived for years with strict state and municipal standards. However, the EPA rules will require even the most advanced of our members to make additional investments in non-productive pollution control equipment which can be often as great as our firms' entire present capitalization. Further, the economies of scale in pretreating waste water means that the burden, per unit of output, falls most heavily on smaller firms.

We know, understand, and share your concerns regarding productivity and capital formation. These investments to meet EPA standards are "end of the pipe" treatment which does nothing to improve productivity or upgrade our production processes, and in some instances can decrease it. They are a drain on capital which stands in the way of alternative investments which could increase productivity.

Therefore I am asking for special consideration, under the tax laws, for investments in pollution control facilities for firms like my own. This special consideration would be in the form of a two-year depreciation on all water pollution abatement equipment, along with the ten percent investment tax credit which we are now entitled to under the present five-year schedule for pollution control equipment. As you know, a one-year depreciation of investments required to meet government regulation, with a maximum limit on the benefits to be obtained from this provision, was one part of the recommendation in the area of capital formation made by the White House Conference on Small Business.

Investments eligible for this special accelerated depreciation should be limited to technology certified by EPA or state pollution control agencies as required to meet state or federal pollution control requirements. I should emphasize that the 10-5-3 capital cost recovery proposals, as they now stand, would do nothing to solve the problem which I am describing to you. Investments in pollution control equipment already qualify for a five-year accelerated depreciation.

Therefore, Mr. Chairman and members of the committee, we are asking that our government help us, as citizens and as businessmen, to comply with government regulations, while at the same time preserving our businesses, our competitiveness, and our productivity. For our industry, and perhaps for small firms in a few other industries, getting over this one or two year hurdle of investment in pollution control equipment is essential if we are to continue to provide our services as part of the American manufacturing community.

We recognize that our nation has made a basic social decision to reduce the effluents from manufacturing. We do not believe that the American people and the Congress want to do this in a way that puts twenty percent of an industry out of business, and its employees out of their jobs. For small businesses heavily affected by pollution control costs, special treatment under the next tax reduction act is essential. Our industry must begin now with engineering studies and ordering equipment, if we are to have it in place and working by late 1982. We ask, therefore, that this question be addressed in context of the reform of business taxes, to go into effect in fiscal 1981.

Thank you for your attention. We will submit additional material for the record and look forward to working with you.

ENVIRONMENTAL PROTECTION AGENCY

40 CFR Part 413

[FRL 1263-8]

Effluent Guidelines and Standards; Electroplating Point Source Category; Pretreatment Standards for Existing Sources

AGENCY: Environmental Protection Agency.

ACTION: Final rule.

SUMMARY: This regulation limits the concentrations or mass and requires pretreatment of certain pollutants which may be introduced into publicly owned treatment works by operations in the Electroplating Point Source Category. The purpose is to limit those pollutants which interfere with, pass through, or are otherwise incompatible with the operation of such treatment works. The Clean Water Act requires these standards to be issued.

DATES: Effective date: The regulations shall become effective October 9, 1979.

Compliance date: The compliance date shall be October 12, 1982.

FOR FURTHER INFORMATION CONTACT: Ernst P. Hall, Effluent Guidelines Division, (WH-552) Environmental Protection Agency, 401 M St. S.W., Washington, D.C. 20460. (202) 426-2576.

Organization of this Notice

SUPPLEMENTARY INFORMATION: On March 28, 1974, EPA promulgated a regulation adding Part 413 to Chapter 40 of the Code of Federal Regulations (39 FR 11510). That regulation (the "Phase I regulation") with subsequent amendments (the "Phase II regulation") (40 FR 18130, April 24, 1975) established effluent limitations guidelines for existing sources in five subcategories, and standards of performance and pretreatment standards for new sources in one subcategory. Revisions and additions setting forth effluent limitations guidelines based on "best available technology economically achievable" (BAT), pretreatment standards for new and existing sources, and standards of performance for new sources were also proposed for five subcategories (30 FR 11515, March 28, 1974 and 40 FR 18140, April 24, 1975). The history of rulemaking for the category by the Agency prior to December 1976 is described in greater detail in 41 FR 53018 (December 3, 1976).

On December 3, 1976, the Agency suspended the promulgated effluent limitations guidelines based on "best practicable control technology currently available" (BPT). The effluent limitations guidelines based on BAT, new source performance standards, and pretreatment standards for Subpart A of the Electroplating Point Source Category (41 FR 53018) were revoked. The Agency also withdrew its notices of proposed rulemaking for the category (41 FR 53070). The Agency took this action to reevaluate the appropriateness of the limitations and standards established earlier in light of new data and further analysis.

On July 12, 1977, the Agency issued interim final pretreatment standards which incorporated the additional study and analysis (42 FR 35834, July 12, 1977). However, these standards applied only to cyanide, hexavalent chromium, and pH and required plants discharging less than 152,000 liters (40,000 gallons) per day to comply only with amenable cyanide standards. On May 14, 1979 these standards were suspended (44 FR 15029). Therefore, as of this date no pretreatment standards are in effect for this industry.

On February 14, 1978 pretreatment standards were proposed that would require all plants to control hexavalent chromium, lead, cyanide and cadmium (43 FR 6560). In addition, plants discharging more than 38,000 liters (10,000 gallons) per day would be required to control discharges of additional metals. The Agency, after making certain changes in response to comments received, is promulgating this regulation in final form.

Pretreatment standards are being promulgated for process wastewater pollutants introduced into publicly owned treatment works (POTW) from existing sources which fall within the following subcategories of the Electroplating Point Source Category: Electroplating of Common Metals Subcategory (Subpart A); Electroplating of Precious Metals Subcategory (Subpart B); Anodizing Subcategory (Subpart D); Coatings Subcategory (Subpart E); Chemical Etching and Milling Subcategory (Subpart F); Electroless Plating (Subpart G) and Printed Circuit Boards (Subpart H). The content of the standards is discussed in detail below under Summary of Standards.

I. Legal Authority

This regulation is being promulgated pursuant to section 307(b) of the Clean Water Act, as amended, 33 U.S.C. § 1317(b) (the Act), which requires the establishment of pretreatment standards for pollutants introduced into publicly owned treatment works. This regulation is also being promulgated in compliance with the Settlement Agreement in *Natural Resources Defense Council Inc. v. Train*, 8 ERC 2120 (D.D.C. 1976), as modified March 9, 1979.

II. Summary of Standards

This regulation establishes "categorical" pretreatment standards, containing specific numerical limitations based on an evaluation of available technologies in a particular industrial subcategory. The specific numerical limitations are arrived at separately for each subcategory, and are imposed on pollutants which may interfere with, pass through, or otherwise be incompatible with publicly owned treatment works (POTW). For plants with a daily flow of 38,000 liters (10,000 gallons) per day or more, the promulgated standards specifically limit indirect discharges of cyanide and the following metals: lead, cadmium, copper, nickel, chromium, zinc, and silver. Additionally, these regulations limit total metal discharge which is defined as the sum of the individual concentrations of copper, nickel, chrome and zinc. For plants with a daily process wastewater flow of less than 38,000 liters (10,000 gallons), these standards limit only lead, cadmium, and cyanide in order to limit the closure rate in the industry while contributing to significant environmental improvement.

The hexavalent chromium limitations which appeared in the proposed regulation have not been included in this final regulation. The Agency believes that hexavalent chromium limitations are probably unnecessary where total chromium limitations are established. Accordingly, plants discharging 10,000 gallons per day or more will be required to meet a total chromium limitation as originally proposed. The Agency also has eliminated the hexavalent chromium limitation for plants discharging less than 10,000 gallons per day. This was done in order to help reduce the cost of this regulation to the industry. The Agency believes that in most instances the environmental effect of eliminating this requirement will not be significant.

Alternative mass-based standards which are equivalent to the concentration-based standards are also set forth in this regulation. These optional standards may replace the concentration standards where mutually agreed to by the discharger and the publicly owned treatment works. The methodology which was used to develop these limitations is set forth in the Development Document.

Optional TSS limitations have been promulgated by the Agency to reduce self-monitoring costs. TSS and pH limitations replace the Cu, Ni, Cr, Zn, and total metal limitations. Indirect dischargers using this optional limitation are prohibited from using strong chelating agents, must reduce hexavalent chromium wastewaters, and are required to neutralize their wastewater streams with calcium oxide or calcium hydroxide.

The present regulation should be read in conjunction with the General Pretreatment Regulation, 40 CFR Part 403, 43 FR 27736 (June 26, 1978). That regulation governs abnormal discharges which interfere with publicly owned treatment works and establishes mechanisms and procedures for enforcing national categorical pretreatment standards for existing and new sources. The General Pretreatment Regulation prohibits discharges into a POTW with a pH lower than 5.0 and discharges of such volume or strength as to cause POTW interference. These provisions require indirect dischargers of less than 10,000 gallons per day to install pH control and to slowly bleed their toxic waste batch dumps into a POTW.

III. Overview

These pretreatment standards cover all firms performing operations in the Electroplating Point Source Category that introduce effluent into publicly owned treatment works. These operations include electroplating, anodizing, conversion coating, electroless plating, chemical etching and milling, and the manufacture of printed circuit boards. These standards cover both firms performing these processes as their primary line of business and so-called captive operations that perform these processes as part of the manufacture of a product. The plants covered by these regulations are found throughout the United States but are concentrated in heavily industrialized areas.

The printing and publishing industry (SIC 2700) and the iron and steel industry (SIC 3300) are excluded from this pretreatment regulation even though they perform similiar operations. Future electroplating point source category regulations are expected to cover electroplating operations in these industries as well.

The standards require limitations on the discharge of pollutants that are toxic to human beings as well as to aquatic organisms. These pollutants include cadmium, lead, chromium, copper, nickel, zinc, silver, and cyanide. The Agency has put a high priority on the reduction of these pollutants from the nation's waters, primarily because of their toxic nature.

These standards cover a large number of indirect discharges that account for a significant amount of the toxic substances under consideration entering the environment. Revised estimates by the Agency indicate that compliance with these standards could prevent up to 140 million pounds per year of toxic pollutants from entering the ambient waters or concentrating in the sludge from municipal treatment systems.

The Agency's estimate of the quantity of metal pollutants which would be prevented from being discharged into POTWs by this regulation has increased from 40,000,000 to 140,000,000 pounds per year. This revised estimate is based on projected mean concentrations of each pollutant removed as a result of compliance with the regulation. This estimate increased because of a substantial increase in calculated industrial process flow for the plants affected by this regulation and the use of mean instead of median raw waste pollutant values. The Agency's estimate of pollutants discharged to POTWs indicates that electroplating is a major contributor of these pollutants to POTWs.

However, this environmental improvement is not attained without a significant economic impact. Economic analyses by the Agency indicate that many firms whose primary business is metal finishing or printed circuit board manufacturing are vulnerable to adverse economic impact.

After considerable restudy and based on public comments, the Agency believes it has found methods of reducing the projected economic impact of these pretreatment standards without seriously compromising the environmental improvement that this regulation would accomplish. Most importantly, plants whose metal finishing process wastewater flow is less than 10,000 gallons per day must meet a less stringent level of control than do plants with greater flows. Because of their high toxicity, however, cadmium, lead, and cyanide are controlled for all flows. Reducing the requirements on these smaller facilities (or facilities with smaller flows) significantly reduces the projected economic impact of the standards while relaxing controls on less than three percent of the flow to publicly owned treatment works.

Nonetheless, the projected economic impacts of these standards are a major concern to the Agency. The potential adverse effects of this regulation can be substantially reduced through the use of Small Business Administration economic injury loans.

The Agency has been working with the Small Business Administration to insure that loans and other financial assistance programs will be available to eligible firms affected by these standards.

On December 27, 1977, the President signed the Clean Water Act, P.L. 95-217, 91 Stat. 1566, which made significant changes in the Federal water pollution control laws. Included in the amendments is a provision allowing, under certain conditions, a variance from categorical pretreatment standards based on pollutant removal by municipally owned treatment works. This amendment to Section 307(b) of the Federal Water Pollution Control Act Amendments of 1972, P.L. 92-500, provides:

"If, in the case of any toxic pollutant under subsection (a) of this section introduced by a source into a publicly owned treatment works, the treatment by such works removes all or any part of such toxic pollutant and the discharge from such works does not violate that effluent limitation or standard which would be applicable to such toxic pollutant if it were discharged by such source other than through a publicly owned treatment works, and does not prevent sludge use or disposal by such works in accordance with section 405 of this Act, then the pretreatment requirements for the sources actually discharging such toxic pollutant into such publicly owned treatment works may be revised by the owner or operator of such works to reflect the removal of such toxic pollutant by such works."

The list of toxic pollutants specified under section 307(a) is a list of pollutants reprinted in the House of Representatives Committee Print No. 95-30, which includes all the pollutants controlled by present pretreatment regulations. Information on how removal allowance may be obtained can be found in the General Pretreatment

Regulations, 40 CFR Part 403, 43 FR 22736 (June 26, 1978).

IV. Technical Basis for Standards

The technical analysis upon which this regulation is based includes an identification of the principal wastewater pollutants generated by this category, a consideration of the extent to which these pollutants pass through publicly owned treatment works or are incompatible with publicly owned treatment works, and a study of the various pretreatment technologies which are available for controlling the discharge of such pollutants. Information gathered in a technical study of direct and indirect dischargers for this category was the primary basis for assessing available pretreatment technologies. Data gathered earlier in support of the direct discharge limitations under sections 301 and 304 as well as data submitted by industry were used also. The data and the analysis used in developing these limitations are summarized in Section XII. The details of these studies are set forth in the "Development Document for Existing Source Pretreatment Standards for the Electroplating Point Source Category" (the Development Document).

V. Upset and Net-Gross Provisions

The Upset provision contained in this regulation was modeled after § 122.14(1) of the National Pollutant Discharge Elimination System (NPDES) regulations, 40 CFR Part 122. An explanation of § 122.14(1) is contained in the preamble to the NPDES regulations, 44 FR 32863 (June 7, 1979). The primary difference between the two regulations is that in the electroplating pretreatment regulation an Industrial User must submit notice of an upset to its POTW and Control Authority. In the NPDES regulation, a direct discharger notifies the Regional EPA Administrator or the Director of the State water pollution control agency of an upset.

The net-gross provision contained herein was modeled after § 122.16(e) and (f) of the NPDES regulations. An explanation of § 122.16(e) and (f) is contained in the preamble to the NPDES regulations, 44 FR 32885 (June 7, 1979). The primary difference between the two regulations is procedural: Industrial Users apply to EPA for net-gross credits within sixty days after the applicable categorical pretreatment standard is promulgated, whereas direct dischargers apply for credits at the time they apply for NPDES permits. For purposes of this provision, no net-gross credit shall be given for pollutants found in city water even if the water originates from the same source to which the User's POTW discharges.

VI. Monitoring Requirements

The Agency is specifying self-monitoring requirements as a part of the regulation for this category. The meaning of "average performance" is also detailed and provision is made for calculating performance requirements as a function of the number of samples taken during the sample period.

The self-monitoring frequently required for individual dischargers is a function of the plant's electroplating wastewater discharge. The minimum self-monitoring frequency requirement varies from once per month for plants discharging less than 38,000 liters (10,000 gallons) per day to three times per week for plants discharging more than 950,000 liters (250,000 gallons) per day. The minimum self-monitoring frequency requirements were set to minimize economic impacts while maximizing the control of discharges.

As a part of the Agency's approach to self-monitoring, the Agency is also defining average performance requirements. The Agency originally had proposed daily maximum limitations and 30 day average limitations. Comments from both dischargers and publicly owned treatment works operators indicated a great deal of uncertainty as to the application of the 30 day limitation and the associated self-monitoring cost. Since the self-monitoring requirements are now part of the regulation and do not require self-monitoring for 30 consecutive days, a great deal of attention was directed to defining "average limitations". The new mechanism for determining average limitations makes the average limitation a function of the number of samples included in the average. This approach is consistent with the statistical method used for determining the limitations and with the statistical principle that the fewer the number of measurements in a sample, the more variable will be the average of the measurements. Mathematically, the standard deviation of sample means is inversely proportional to the square root of the number of measurements in the sample. A table has been provided to allow the POTW and the discharger to calculate an appropriate average limitation for each pollutant for any number of individual self-monitoring samples.

Some commenters asked that average limitations be eliminated entirely. This alternative was rejected because it would lessen the extent of real control over the operation of the treatment systems. It is axiomatic that an average is more representative of the overall operation of any system than is a single measurement. Statistically, the more measurements in an average, the greater the "power" of statistical tests. From a regulatory standpoint it is desirable to develop measures of plant performance with the maximum power or statistical usefulness in drawing conclusions about the overall performance of the system.

Average limitations calculated through use of the table provided in the regulation are of equal stringency. Thus, a treatment system capable of meeting the average limitation for thirty samples should also meet a limitation calculated on the basis of six samples.

The method developed for calculating average limitations for numbers of samples can be used by the POTW, State, or municipality to develop local limitations. At a minimum, the local control authority must set average limitations based on the minimum number of self-monitoring samples required to be taken per month. In addition, the local authority and the discharger must calculate and apply average limitations based on the actual number of samples taken per month. If the discharger chooses to take more samples than the minimum number required, then he must report all samples and meet limitations based on the actual number of samples.

VII. Economic Impact Analysis

Executive Order 12044 requires EPA and other federal agencies to perform regulatory analyses of certain regulations, 43 FR 12661, March 23, 1978. EPA's proposed regulations for implementing Executive Order 12044 require a Regulatory Analysis for major significant regulations involving annual compliance costs of $100 million or more, or meeting other specified criteria, 43 FR 29891, July 11, 1978. When these criteria are met, the proposed regulations require EPA to prepare a formal Regulatory Analysis, including an economic impact analysis and an evaluation of regulatory alternatives, such as: 1) alternative types of regulations; 2) alternative stringency levels; 3) alternative timing; and 4) alternative methods of ensuring compliance.

Section 6(b) (6) of Executive Order 12044 exempts from the requirements of the order regulations "that are issued in response to an emergency or which are governed by short-term statutory or judicial deadlines." The pretreatment standards for electroplaters are subject to a court ordered requirement of promulgation by May 15, 1977, *NRDC* v. *Train*, 8 ERC 2120 (D.D.C. 1976). Further delay in the promulgation of these standards would not be in the interest of the environment or the Nation, and would subject the Agency to a possible citation for contempt of court. Accordingly, the pretreatment standards for existing sources in the electroplating point source category are exempt from a formal Regulatory Analysis, as decided by the Director of the Office of Analysis and Evaluation. Nonetheless, this rulemaking satisfies most of the substantive requirements for a Regulatory Analysis. Although the Clean Water Act does not require consideration of alternative timing, or alternative methods of ensuring compliance, EPA has considered alternative stringency levels, and alternative types of regulations. Moreover, the Agency has performed a detailed analysis of the economic impacts of the regulation. A complete description of the analysis is set out in a report entitled "Economic Analysis of Pretreatment Standards for Existing Sources in the Electroplating Point Source Category" (August, 1979). This document is available on request from Ms. Sandra Jones, Office of Analysis and Evaluation (WH-586), U.S. Environmental Protection Agency, 401 M St. S.W., Washington, D.C. 20460.

(a) Background.—The primary financial data for this analysis were supplied by respondents to surveys of over 11,000 establishments identified as engaged in electroplating operations by Dun & Bradstreet lists, Underwriters Laboratories lists, or in the subscription list of a major trade journal. Over 2,100 responses to these surveys were coded for analysis by a computer program to determine the impacts of compliance with the regulations on the respondents' short-term viability and long-term profitability.

The computer program was used to compare the investment requirements for compliance, and associated annual costs, with balance sheet and income statement information to determine the projected financial status of the plants after all compliance requirements had been met. If the plant's estimated profitability, after compliance, was negative, or if the projected debt retirement burden, after investment, was too high to be paid out of the annual cash flow, the computer analysis indicated that the plant was a candidate for closure.

To guide the choice of parameters and assumptions for the economic analysis, the Agency and its contractors consulted with bankers, equipment suppliers, municipal government officials, economic development experts, municipal treatment works officials, professional groups, and electroplaters in three communities where pretreatment ordinances similar to EPA's proposed regulations were in effect. The communities were, Grand Rapids, Michigan; Muncie, Indiana; and Waterbury, Connecticut.

Although the data gathered in these three cities were not intended to verify the economic analysis of the national impacts of the pretreatment standards, they did indicate that the assumptions used in the analysis were substantially correct. A full description of the Agency's findings in the three cities is presented in a report entitled "Analysis of Economic Impacts of Pretreatment Ordinances on the Metalfinishing Industry in Three Communities" (October 21, 1977). This document is available on request from Ms. Sandra Jones, Office of Analysis and Evaluation (WH-586), U.S. Environmental Protection Agency, 401 M St., S.W., Washington, D.C. 20460.

(b) Coverage of the regulations.—These pretreatment standards for plants discharging to publicly owned treatment works (POTW) apply to three groups of electroplating operations: 1) Independent shops performing the metal finishing processes covered by the regulations as their primary line of business (job shops); 2) Independent manufacturers of printed circuit boards (printed board manufacturers); and 3) Captive establishments performing the regulated processes as part of the manufacture of some product by the same firm (captive shops). Summary statistics on the job shops, printed board manufacturers, and captive shops that discharge to publicly owned treatment works are presented in Table 1 below. For captive shops, which do not sell their services to other firms, the average value added by metal finishing is shown in place of sales.

Table 1.—Summary Characteristics of the Three Industry Sectors (Indirect Dischargers)

	Job shops	Printed board manufacturers	Captive shops
Number of Plants	2,734	327	4,722
Total Employment (1,000's)	62.8	20.6	2,930
Total Production Employment (1,000's)	46.8	11.9	870
Total Sales (million of dollars per year)	1,889	494	5,077
Total Process Water Flow (million gallons per day)	88.3	6.1	1,163

Table 1 shows the preponderance, among indirect dischargers, of production employment, value of metal finishing services, and process water flow, in the captive sector of the industry.

(c) Costs. The economic analysis considers two cost components. The first is the capital cost, or the amount of investment required for installation of pollution control equipment to comply with the regulations. Capital cost estimates are based on the total cost of equipment that the Agency estimates will enable a discharger to meet the pretreatment standards, including the planning required to design a treatment system, and the installation of the system itself. To the extent that there are other less expensive systems, not considered by the Agency, that will achieve the same treatment levels at less cost, the Agency's estimated capital costs are an overstatement of the capital outlays that dischargers in the industry will face. Capital costs shown here are based on extensive observation of equipment in place in the industry, and on manufacturers' quotations for design, supply and installation of treatment equipment.

The second relevant cost component is the total annual cost of compliance for each plant. The annual cost is the sum of all the outlays required in each year for operation and maintenance (O&M) of the pollution control system, sludge disposal, energy usage associated with the operation of the system, and principal and interest payments on the initial investment. The annual costs shown below are adjusted for the tax reductions associated with reduced profitability of the plant.

Table 2 presents the estimated total capital and annual costs of compliance with the regulations, for all indirect dischargers in each of the three sectors described above, and for all indirect dischargers in the electroplanting point source category. These costs represent the increments between reported levels of treatment in the industry and levels required by the pretreatment standards. In Table 2, and throughout this report, all costs are expressed in 1976 dollars.

Table 2.—Estimated Capital and Annual Costs of Compliance

[In thousands of dollars]

	Capital cost	Annual cost
Job Shops	$167,600	$52,500
Printed Board Manufacturers	16,500	6,800

Table 2.—*Estimated Capital and Annual Costs of Compliance—Continued*

[In thousands of dollars]

	Capital cost	Annual cost
Captive Shops	1,134,400	424,800
Total All Regulated Facilities	1,340,300	483,900

As Table 2 demonstrates, a large proportion of the capital and annual cost of compliance is incurred in the captive sector of the industry. Captive shops are projected to spend more than five times the amounts required of all independent shops combined, for both the initial investment in equipment and the subsequent annual costs of compliance. This disparity reflects the much larger flows from production processes in captive plants, and the consequent higher average cost of installation of larger tanks and treatment facilities. The average estimated capital cost for captive shops is $240,000, and the average estimated capital cost for job shops is $87,400.

(d) Impacts on the Job Shop Sector. Independent metal finishing job shops may suffer significant adverse economic impacts as a result of the regulations. EPA estimates that 587 metal finishing job shops, employing 9,653 workers, may close as a result of the regulations. This represents 19.9 percent of the job shops in the industry (21.5 percent of the indirect dischargers), and 13.9 percent of the employment in the job shop sector (15.4 percent of employment in job shops that discharge to publicly owned treatment works).

Industry has criticized certain assumptions used in EPA's economic model, claiming that if more realistic assumptions were made, closure rates in the job shop subcategory would be between 30 percent and 60 percent or higher. These estimates were derived by selectively changing assumptions which industry argues minimize closures while ignoring others which maximize closures. Moreover, industry estimates do not consider the potential effect of SBA loans, which could reduce closures in the job shop subcategory to as low as 5.4 percent.

EPA's economic model, like all models, is a simplification of reality to allow an estimation of economic impacts. The 19.9 percent closure rate EPA estimates is an approximation, not a "worst case" outside limit. Nevertheless, due to the use of some very conservative assumptions and the enormous potential impact of SBA assistance, which EPA did not even consider in its model, there is no reason to conclude that real world closures will be as high as those predicted by industry.

Because of the wide variety of products plated, the proportion by which production in the industry might decline as a result of the regulation would have little meaning. The 587 plants that are projected possibilities for closure, however, represent $251 million in sales, 12.4 percent of estimated sales for all job shops (13.3 percent of the sales of indirect dischargers). The job shops projected to close account for only four percent of the profits before tax generated by indirect dischargers in the job shop sector, although profits in plants that do not close will also decline, in the short run, as a result of compliance with the regulations.

The average price of electroplating services from job shops is expected to rise by approximately 7.0 percent as a result of the regulations.

(e) Impacts on the printed board manufacturers.—The impacts of the regulations on the manufacturers of printed circuit boards are not expected to be as great as on the job shops. The Agency estimates that 10 manufacturers of printed circuit boards, employing 321 workers, may close. These plants are 2.5 percent of all printed circuit board manufacturers (3.1 percent of the printed circuit board indirect dischargers), and represent 1.3 percent of employment in this sector (1.6 percent of employment in printed board plants that discharge to publicly owned treatment works).

The price of printed circuit boards is expected to rise by approximately 1.7 percent as a result of the increase in production costs caused by the treatment requirements of the regulations.

(f) Impacts on captive shops.—Captive shops in the industry are not expected to suffer severe adverse impacts from the regulations. None of the plants where metal finishing operations occur is projected to close as a result of the regulation, however, captive plating lines in as many as 140 plants may be shut down, as the plants turn to job shops for their supply of plating services. These 140 plants employ approximately 2,610 metal finishing workers, or about 2.2 percent of the wet metal finishing employees in the captive sector (3.0 percent of employees in captive shops that are indirect dischargers).

The final cost of production of those products produced by firms with captive operations is expected to rise by one percent or less as a result of the regulations.

(g) Combined impacts of the regulations.—It is difficult to combine most of the impacts described above into a single set of statistics that would express the effects of the regulations on the electroplating point source category as a whole. Potential plant closures, for instance, are meaningful as a measure of impact only for independent job shops and printed board manufacturers. One parameter that can be used to judge the aggregate impacts of the regulation is the percentage employment loss for the industry as a whole. The total number of jobs that may be affected is 12,584. This represents 5.9 percent of the 214,000 estimated employees in the category. There are 94,000 total employees in the independent firms plus 120,000 metal finishing employees in the captive shops. Among indirect dischargers, the projected employment impact is 8.6 percent of 148,000 jobs.

(h) Limits of the analysis.—The discussion above has mentioned some of the limitations, such as the difficulty of estimation of production impacts, that are inherent in the economic analysis of the electroplating industry. Beyond these, there are two major drawbacks to the plant-level financial analysis performed by the Agency. They are in the estimation of employment and price effects.

The Agency's estimate of employment impact due to the regulation is based on the employment represented by the plants that are projected to close. Because the Agency's analysis concentrates on the ability of individual plants to bear the costs of compliance, it cannot compare market equilibrium price and production levels before and after compliance. Therefore, the Agency cannot predict the growth effects on plants that successfully comply with the pretreatment standards.

In the past, however, the demand for electroplating services has appeared to be extremely price inelastic, and growing, because of the small percentage of cost of production that electroplating represents for all of the products that require metal finishing, and because of the lack of alternatives to the metal finishing production step. This strong demand suggests that the customers of any plating shops that close are likely to turn to surviving metal finishers for their plating services, and that these finishers will increase production and employment in response to their new customers' requests. Any increase in employment due to this process will reduce the net employment loss in the industry below the gross projected employment losses described above.

Because electroplating represents only a small portion of the final product cost, the price increases described above are overstatements of the percentage increases in the prices of the finished goods. The cost of plating does not exceed 8 percent of the aggregate cost of production in any manufacturing sector. This means that an increase of 7.0 percent in plating costs, as projected above for job shops, translates into an increase of less than 0.5 percent in the prices of the products that job shops plate.

(i) SBA financial assistance.—All of the estimated impacts of the regulations on job shops and printed circuit board manufacturers can be dramatically reduced by federal financial assistance programs for small business. The plant closures projected in the economic analysis result from the unavailability of long-term financing and high commercial interest rates, which lead to annual carrying costs on loans which are larger than can be supported by the plants' annual cash flow. SBA Economic Injury Loans, for which almost all electroplating job shops qualify, are available at interest rates substantially below commercial rates, and for periods up to 30 years. Details of the SBA loan program are presented in Section XI of this document.

To test the effect of Economic Injury Loans, EPA reestimated the impacts of the regulations, assuming availability of 20-year loans (to correspond to the average lifetime of pollution abatement equipment), at an interest rate of $\boxed{6.75}$ percent. ~~This sole change in the~~ assumptions of the analysis reduced the projected closures in the job shop sector from 19.9 to 5.4 percent of the firms, and projected employment loss from 13.9 to 6.7 percent of the jobs. In absolute terms, SBA loans could reduce the number of projected job shop closures from 587 to 148, and the estimated employment loss in the job shop sector from 9,653 to 4,670.

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The economic impacts of these pretreatment standards clearly depend in large measure on the effective delivery of Economic Injury Loans to electroplaters. The Environmental Protection Agency has worked closely with the SBA to ensure that these loans are delivered expeditiously. Future efforts to facilitate the delivery of SBA loans will include the expansion of a current memorandum of understanding with SBA adding specific references to steps that will be taken to aid electroplaters. In addition, the Agency is examining private sources of expertise in SBA programs to develop a mechanism for dissemination of information about the Economic Injury Loan Program and to provide all assistance necessary to secure prompt delivery of investment capital to eligible electroplating firms.

VIII. Environmental Considerations

The Electroplating Point Source Category consists of an estimated 9400 firms discharging effluent from metal finishing processes either directly to the Nation's waters or indirectly through publicly owned treatment works (POTWs). Of these, an estimated 6600 discharge approximately one billion gallons a day of metal finishing process water to publicly owned treatment works and are covered by these pretreatment standards.

The pollutants discharged by these plants include the following substances toxic to human beings and aquatic organisms: cadmium, lead, chromium (both hexavalent and trivalent), copper, nickel, zinc, silver, and cyanide. These pollutants are only partially removed by municipal treatment systems and pass through to the Nation's waters in varying degrees. The fraction of the metals that does not pass through the municipal system concentrates in the municipal sludge where it hampers the use of the sludge as fertilizer and soil conditioner. These pollutants can also interfere with the efficient operation of the publicly owned treatment works.

The Nation's water quality will be improved by these standards. Cities that have promulgated and enforced similar regulations on metal finishers in the past report substantial reductions in toxic pollutants.

Environmental considerations are discussed in more detail in the section entitled Technical Summary and Basis for Regulations under subsection (2)(ii) of Section XII below entitled, "Origins and Characteristics of Wastewater Pollutants."

IX. Availability of Documents

The EPA technical and economic reports which support this regulation are available for inspection at the EPA Public Information Reference Unit, Room 2922 (EPA Library), Waterside Mall, 401 M St., S.W., Washington, D.C. 20460, at all EPA Regional Offices, and at State Water Pollution Control Offices.

Copies of the technical development document will be available from the Superintendent of Documents, Government Printing Office, Washington, D.C. 20402. Copies of the economic analysis document will be available through the National Technical Information Service, Springfield, Virginia 22151.

X. Compliance Schedule

Section 307(b) of the Clean Water Act specifies "a time for compliance not to exceed three years from the date of promulgation" of the standard. Because of the high projected economic impact of these pretreatment standards, the Agency believes that the maximum compliance deadline as set forth in section 307(b) should apply. The time for compliance with these categorical pretreatment standards will thus be three years from the effective date of these regulations. States or local governments may wish to adopt the substantive pretreatment standards and make these standards part of the state's laws or local ordinances.

XI. Small Business Administration Financial Assistance

The analysis of the economic impact of these pretreatment standards indicates that Small Business Administration (SBA) financial assistance could significantly reduce the adverse impact of these standards. EPA estimates that the projected closure rates for metal finishing job shops of 19.9 percent could possibly be reduced to 5.4 percent by the use of available SBA loan programs by firms that meet applicable criteria. This would prevent the closing of 439 firms and loss of 4,923 jobs. The Agency has been working with the Small Business Administration to insure that these benefits of fewer closures will be realized. The intent of this work has been to make sure that all firms that must comply with these pretreatment standards and that are eligible for SBA assistance will be helped without undue delay.

There are two SBA programs that may be important sources of funding for the Electroplating Point Source Category. They are the SBA's Economic Injury Loan Program and Pollution Control Financing Guarantees.

Section 8 of the Federal Water Pollution Control Act (FWPCA) authorizes the SBA, through its Economic Injury Loan Program, to make loans to assist any small business concern in effecting additions to or alterations in equipment, facilities, or methods of operation, in order to meet water pollution control requirements under the FWPCA if the concern is likely to suffer a substantial economic injury without such assistance. This program is open to firms of 250 or fewer employees and in some instances to firms employing up to 1000 employees. Thus, this program is open to essentially all independent job shops in the Electroplating Point Source Category. Loans can be made either directly by SBA or through a bank using an SBA guarantee of ninety percent of the loan. The interest on direct loans depends on the cost of money to the federal government and is currently set at 7⅝ percent. Loan repayment periods may extend up to thirty years depending on the ability of the firm to repay the loan and the useful life of the equipment. SBA loans made through banks are at somewhat higher interest rates and are currently at 11¼ percent.

Analyses by the Environmental Protection Agency indicate that many firms in the Electroplating Point Source Category would be eligible for direct and indirect SBA loans. For further details on the Federal loan program write or telephone any of the following individuals at EPA Headquarters or in the ten EPA Regional offices:

Coordinator—Mr. Sheldon Sacks, Environmental Protection Agency, Financial Assistance Coordinator, Office of Analysis & Evaluation (WH-586), 401 M Street SW., Washington, D.C. 20460, Telephone: (202) 755-3624.

Region I—Mr. Glenn John, Environmental Protection Agency, J. F. Kennedy Federal Office Building, Room 2203, Boston, Massachusetts 02203, Telephone: (617) 653-6570.

Region II—Mr. Gerald DeGaetano, Air & Environmental Applications Section, Environmental Protection Agency, 26 Federal Plaza, New York, New York 10007, Telephone: (212) 264-4711.

Region III—Mr. Chuck Sopp, Environmental Protection Agency, Curtis Building, 3EN40, 6th and Walnut Streets, Philadelphia, Pennsylvania 19106, Telephone: (215) 597-9433.

Region IV—Mr. John Hurlebaus, Environmental Protection Agency, 345 Courtland Street, N.E., Atlanta, Georgia 30308, Telephone. (404) 881-4793.

Region V—Mr. Chester Marcyn, Contingency Plan Coordinator, Surveillance and Analysis Branch, Enforcement Division, Environmental Protection Agency, 536 South Clark Street, Chicago, Illinois 60005, AC (312) 353-2318.

Region VI—Ms. Jan Horn, Attorney, Water Enforcement Division, Water Division, Environmental Protection Agency, 1st International Building, 1201 Elm Street, Dallas, Texas 75270, Telephone. (214) 767-2700.

Region VII—Mr. Donald Sandifer, Engineering Branch, Water Division, Environmental Protection Agency, 324 East 11th Street, Kansas City, Missouri 64106, Telephone (816) 374-2725.

Region VIII—Mr. Gerald Burke, Sanitary Engineer, Office of Grants, Water Division, Environmental Protection Agency, 1860 Lincoln Street, Denver, Colorado 80203, Telephone: (303) 837-3961.

Region IX—Ms. Linda Powell, Permits Branch, Enforcement Division, Environmental Protection Agency, 215 Fremont Street, San Francisco, California 94111, Telephone (415) 556-3450.

Region X—Mr. Dan Bodien, Special Technical Advisor, Enforcement Division, Environmental Protection Agency, 1200 6th Avenue, Seattle, Washington 98101, Telephone. (206) 442-1270.

Headquarters—Mr. Donnel Nantkes, Legal Counsel, Grants Contracts and General Administration Division, Environmental Protection Agency, 401 M Street, S.W., Washington, D.C. 20460, Telephone: (202) 426-8830.

Interested persons may also contact the Assistant Regional Administrators for Finance and Investment in the Small Business Administration Regional offices for more details on Federal loan assistance programs. For further information, write or telephone any of the following individuals:

Region I—Mr. Russell Berry, Assistant Regional Administrator for Finance and Investment, Small Business Administration, 60 Batterymarch, 10th Floor, Boston, Massachusetts 02203, Telephone: (617) 223-3891.

Region II—Mr. John Axiotakis, Assistant Regional Administrator for Finance and Investment, Small Business Administration, 26 Federal Plaza, New York, New York 10007, Telephone: (212) 264-1452.

Region III—Mr. David Malone, Assistant Regional Administrator for Finance and Investment, Small Business Administration, 1 Bala Cynwyd Plaza, 231 St. Asaphs Road, West Lobby, Suite 646, Bala Cynwyd, Pennsylvania 19004, Telephone: (215) 596-5962.

Region IV—Mr. Merritt Scoggins, Assistant Regional Administrator for Finance and Investment, Small Business Administration, 1401 Peachtree Street, N.E., Atlanta, Georgia 30309, Telephone. (404) 881-2008.

Region V—Mr. Larry Cherry, Assistant Regional Administrator for Finance and Investment, Small Business Administration, 219 South Dearborn Street, Chicago, Illinois 60604, Telephone: (312) 353-4533.

Region VI—Mr. Donald Beaver, Assistant Regional Administrator for Finance and Investment, Small Business Administration, 1720 Regal Row, Suite 230, Dallas, Texas 75202, Telephone: (214) 749-1265.

Region VII—Mr. Richard Whitley, Assistant Regional Administrator for Finance and Investment, Small Business Administration, 911 Walnut Street, 23rd Floor, Kansas City, Missouri 64106, Telephone. (816) 374-3927.

Region VIII—Mr. James Chuculate, Assistant Regional Administrator for Finance and Investment, Small Business Administration, 1405 Curtis Street, Executive Tower Building—22nd Floor, Denver, Colorado 80202, Telephone. (303) 327-3988.

Region IX—Mr. Charles Hertzberg, Assistant Regional Administrator for Finance and Investment, Small Business Administration, 450 Golden Gate Avenue, San Francisco, California 94102, Telephone. (415) 556-7782.

Region X—Mr. Jack Welles, Regional Administrator for Finance and Investment, Small Business Administration, 710 2d Avenue, Dexter Horton Bldg.—5th floor, Seattle, Washington 98104, Telephone: (206) 399-5679.

In addition to the Economic Injury Loan Program, the Small Business Investment Act, as amended by Public Law 94-305, authorizes SBA to guarantee the payments on qualified contracts entered into by eligible small businesses to acquire needed pollution facilities when the financing is provided through taxable and tax-exempt revenue or pollution control bonds. This program is open to all eligible small businesses including electroplating and metal finishing firms. Bond financing with SBA's guarantee of the payments makes available long term (20-25 years), low interest (usually 5 to 7 percent) financing to small businesses on the same basis as that available to larger national or international companies. For further details on this program write to the SBA, Pollution Control Financing Division, Office of Special Guarantees, 1815 North Lynn Street, Magazine Bldg., Rosslyn, Virginia 22209, (703) 235-2900.

XII. Technical Summary and Basis for Regulation

This section summarizes the basis for pretreatment standards for existing sources in the electroplating point source category.

(1) General methodology

The pretreatment standards were developed in the following manner: The point source category was first studied to determine whether separate standards were appropriate for different segments within the category. The raw waste characteristics for each such segment were then identified. This included an analysis of: the source, flow, and volume of water used in the process employed; the sources of waste and wastewaters; and the constituents of all wastewater. The compatibility of raw waste characteristics with municipal treatment works was then considered. Wastewater constituents suspected of passing through or interfering with publicly owned treatment works were identified.

The Agency identified the control and treatment technologies existing within each segment. This included identification of each distinct control and end-of-pipe treatment process which exists or is capable of being designed for each segment. It also included a determination of the effluent quality resulting from the application of each of the technologies in terms of the amount of constituents and the chemical, physical, and biological characteristics of pollutants. The problems, limitations, and reliability of each treatment and control technology were identified. The Agency additionally studied the non-water quality environmental impacts, of such technologies upon other pollution problems, including air, solid waste, noise, and radiation. The energy requirements of each control and

Senator NELSON. Our next witness is Mr. Sidney Lieberstein, vice president, Machinery Dealers National Association.

STATEMENT OF SIDNEY LIEBERSTEIN, VICE PRESIDENT, MACHINERY DEALERS NATIONAL ASSOCIATION

Mr. LIEBERSTEIN. Senator, my name is Sidney Lieberstein, president of Perfection Machinery Sales in Wheeling, Ill., and by the way with a number of frustrated customers in Wisconsin, and in deference to Senator Heinz, in Pennsylvania as well.

I am also vice president of Machinery Dealers National Association. With me is our general counsel, Robert Taft, Jr. I welcome this opportunity to address the committee.

MDNA is a national trade association that represents the metal working industry after market. Our 500-member firms probably account for over 70 percent of the used machine tools sold in the United States. Our industry supplies machine tools to meet the requirements of the metal working industry, and their firms are almost entirely dependent upon used machine tools to expand their productive capacity, and 90 percent of all new U.S. machine tools are sold to only 10 percent of the companies.

Our members are in daily business contact with the small business manufacturing segment, and we feel uniquely qualified to be one of their spokesmen. Because capital equipment is generally acquired from larger manufacturers and usually resold to smaller manufacturers, our members are familiar with capital formation activities of both large and small businesses.

We believe that any comprehensive tax legislation should target small business capital formation problems because, although some are similar, many are different from the problems of large businesses. This difference was recognized by the Joint Economic Committee in the White House Conference on Small Business report.

We are concerned about the future of small businesses in America. We fear that in our present economy they will not be able to generate sufficient capital to start new businesses, to expand their current capacity, to even survive.

The potential of our economy over the long term to increase the standard of living for the average American, and to create a job for every American who wants to work, is in fact in jeopardy. Steps to increase productivity are sorely needed. From the small business perspective, this can be achieved through measures that will stimulate the purchased machinery and equipment.

Capital stock formation among small business has been impeded by high-interest rates, restricted ability of credit, regulatory burdens imposed by the Government, and tax laws which discriminate against small business.

At this time, we believe the Congress should focus its attention on reforming our tax laws in such a manner as to stimulate capital stock formation among small business through a simplified and accelerated capital cost recovery system and a removal of discrimination in the investment tax credit.

The small businesses of this country need reform of the investment tax credit, and call for a change in the present law which limits the amount of used equipment eligible for the investment tax credit to $100,000.

While there is no limitation on the investment credit available for new equipment, similarly the carryback/carryforward provisions available for new equipment are not allowed to purchasers of used equipment. This discriminatory tax treatment impacts directly and primarily upon small business which is already hindered by its inability to externally or internally generate the capital necessary to buy new equipment.

This discriminatory ceiling must be eliminated, and the carry-back/carry-forward provisions must also be available for similar situated used property. We must allow small business to receive the same tax incentives provided to big businesses.

We know, of course, of your support under Senate bill 2998. Investment tax credit limitation is primarily a small business issue, and traditionally small businesses purchase used equipment.

We strongly recommend a simple change in the tax code dealing with the tax credit available for used capital equipment investments. Remove the ceiling on the amount of used equipment eligible for the investment tax credit. This needed correction will also significantly reduce the core component of inflation among the smaller manufacturers.

Give us equality. Reforms are essential to allow the generation of capital necessary for renewal and upgrading of our Nation's industrial plants. The existence of the metal working industry, more than 85 percent of which is small and medium size businesses, is vital to our economy. We are not seeking preferential, only equal treatment. We ask only that you remove the bias against used machine tools and the small businesses to which they are essential.

Thank you.

Senator NELSON. We thank you.

[The prepared statement of Mr. Lieberstein follows:]

SUMMARY OF PRINCIPAL POINTS OF
STATEMENT OF MACHINERY DEALERS NATIONAL ASSOCIATION
BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE
JULY 31, 1980

This is the testimony of Sidney Lieberstein, Vice President of Machinery Dealers National Association (MDNA). The 500 MDNA member firms are small businesses which account for over 70% of the used machine tools sold in the United States. Because used capital equipment is acquired from large manufacturers and usually resold to small manufacturers, MDNA members are in the unique position to see the relationship between large and small businesses. Its opinion of what influences a small firm's investment decision comes from experience. We believe that any comprehensive tax legislation should target capital formation problems of smaller businesses.. We strongly recommend the removal of the ceiling on the amount of used equipment eligible for the investment tax credit and the creation of a simplified and accelerated capital cost recovery system.

Under present law, there is a $100,000 limitation on the amounts of used equipment eligible for the investment tax credit, but there is no limitation on the investment tax credit available for new equipment. Similarly, the carryback/carryforward provisions available for new equipment are not allowed to purchasers of used equipment.~~who must, therefore,~~ ~~take the entire tax credit in one year or lose it.~~ This discriminatory tax treatment impacts directly and primarily upon small businesses which are already hindered by their inability to externally or internally generate the capital necessary to buy equipment. Capital stock formation among small business has been impeded by high interest rates, restricted availability of credit, regulatory burdens imposed by government, and tax laws which discriminate against small business. A small business cannot afford to buy new machinery and therefore needs tax incentives which will enable it to buy the used equipment it needs to start a new business or increase the productivity and capacity of its current business.

The Joint Economic Committee and the White House Conference on Small Business both recognized the disparity between large and small businesses as they are affected by inflation and current tax policy. Both have called for tax measures targeted to small business that will enable smaller firms to retain a greater proportion of their earnings for reinvestment in capital improvements and plant expansion. The current disparity between the investment tax credit available to new and used equipment is in effect a Congressionally mandated discrimination against small business. This disparity directly dilutes the ability of small business to compete with large firms. It enables larger firms to retain a greater proportion of their earnings than smaller firms are allowed for reinvestment in capital improvements and plant expansion. It allows new foreign machinery a competitive edge through the investment tax advantage over equally efficient and price competitive used domestic machinery.

The benefits to our economy which can be derived from removal of this discriminatory ceiling are: more competitive small business, stimulation of captial investment, development of creative and innovative products and processes, starting new businesses, helping small business maintain its market share and survive, expansion of capacity and productivity, increased employment, improved balance of payments, increased demand for new domestic machine tools, reduction in inflation, generation of more tax revenues, and equal opportunity for growth of all businesses.

Small and medium sized businesses account for 87% of the new jobs created in the United States. Because small businesses employ a low ratio of capital to labor, each purchase of a used machine will translate into more jobs. Such small business growth would have its greatest affect in decaying cities where structurally unemployed have the most difficulty finding job opportunities. It offers young people the opportunity to use jobs and small businesses to gain the work experience needed for entry into jobs that lead to highly skilled careers. Allowing small businesses the opportunity to grow through use of a full investment tax credit offers both economic and social benefits to our society.

STATEMENT OF

MACHINERY DEALERS NATIONAL ASSOCIATION

Mr. Chairman and Members of the Committee,

My name is Sidney Lieberstein. I am President of Perfection Machinery Sales, Inc. of Wheeling, Illinois. I am also Vice President of Machinery Dealers National Association (MDNA). For the past 20 years I have been buying and selling used capital equipment. With me is Robert Taft, Jr. of Taft, Stettinius & Hollister, General Counsel of the Machinery Dealers National Association.

MDNA welcomes the opportunity to once again urge an immediate reform of the Tax Code to encourage capital formation among smaller corporate taxpayers. We strongly recommend a simple change in the provision dealing with the tax credit available for used capital equipment investments: remove the ceiling on the amount of used equipment eligible for the investment tax credit. Although simple, this needed correction will significantly reduce the core component of inflation among smaller manufacturers.

This improvement offers four ingredients we believe essential to adequately encourage capital formation: the potential to increase productivity; the potential to increase employment; the potential to increase tax revenue; and, the potential to treat everyone equally.

MDNA represents the metalworking industry aftermarket. Our 500 member firms are small businesses which probably account for over 70 percent of the used machine tools sold in the United States. MDNA also speaks for hundreds of thousands of small and medium sized manufacturing firms in the United States. Because used capital equipment is generally acquired from larger manufacturers and usually resold to smaller manufacturers, our members are in the unique position to see the relationship between large and small businesses. Our opinion of what influences a small firm's investment decision comes from experience. We believe that any comprehensive tax legislation should target capital formation problems of smaller businesses because, although some are similar to, many are different from the problems of large businesses.

We are concerned about the future of small business in America. We fear that in our present economy, we will not be able to generate sufficient capital to start new businesses, to expand our current capacity, or to even stay in business. Inflation has taken a heavy toll.

We share the concern of the Joint Economic Committee about the potential of our economy over the long term to increase the standard of living for the average American, to create a job for every American who wants to work, and to help hold down the cost of living by increasing the supply of goods and reducing the price of goods on the shelves of the nation's businesses.

<u>Decline in Productivity</u>

For the first time in 20 years the 1979 Annual Report of the Joint Economic Committee was a unified report endorsed by both the majority and minority members of the Committee. We agree with its unanimous conclusion that an increase in productivity is vital to improvement in our economic standard of living and in the reduction of inflation. The fall in productivity in our country has been well documented, and this ominous trend has been the subject of discussion and concern of all of us for many years. The Council of Economic Advisors, in their 1978 report, referred to the productivity slow-down as "one of the most significant economic problems in recent years." As Chairman of the Federal Reserve, William Miller testified before the Senate Finance Committee on September 6, 1978, that:

> Inflation is our most important economic concern today. . . . The only way I know that we are going to break the cycle of wages chasing prices and prices chasing wages is to begin to realize productivity gains so that the prices do not have to go up in order to maintian profitability. Capital accumulation is a critical ingredient in the long-range growth of labor productivity and the raising of living standards. . . . Throughout the 1970's, the ratio of capital stock to labor has fallen ever shorter of its earlier growth trend line, and this, undoubtedly, has been a significant factor in the slower growth of productivity that we have experienced over this period. . . .(part 5, page 1173 et seq.)

This testimony was echoed in the 1979 Joint Economic Committee Report, which was issued on March 15, 1979:

> The lower rate of productivity growth in recent years is one of the causes of today's inflation, worker dissatisfaction, the deficit in our balance of payments, and the weakening of the international position of the dollar. Productivity gains provide the means by which historically disadvantaged minorities can increase their economic welfare. Thus, the adverse effects of a low rate of productivity growth extend far beyond economic issues. . . . (p. 119)

> One factor cited in virtually all studies of the productivity slow down as a major or a paramount cause is the low capital stock due to the recent inadequate levels of investment. If the capital stock-labor force ratio is to rise, that investment (gross investment less depreciation) must be sufficiently large so that the capital stock grows more rapidly than the labor force. This was the case until 1974, when the capital stock-labor force ratio peaked at $10,604 (in 1972 dollars) per person. Since then, investment has been inadequate relative to the rapid labor force growth, and the ratio has fallen by nearly 3 percent. This will adversely affect economic growth for several years in the future. (p. 130-131)

In its Summary of its 1980 Report, the Joint Economic Committee found that in 1979 the "U.S. posted its worst inflation record in more than 30 years and productivity actually declined by 2 percent. . . ." (p. 13) The 1980 Report concluded that a "growing small business sector offers an unique opportunity for addressing basic long-term structural problems by improving productivity, lowering inflation, and creating more jobs." (p. 71) Recommendation No. 23 of the 1980 Joint Economic Committee Report is as follows:

> When Congress enacts business tax incentives, it should pay particular attention to their effect on the ability of small businesses to obtain capital for growth and investment. (p. 73)

We agree with the conclusions of these authorities that further steps to increase productivity are sorely needed. From small business perspective, this can be achieved through measures that will stimulate the purchase of used machinery and equipment. Capital stock formation among small business has been impeded by high interest rates, restricted availability of credit, regulatory burdens imposed by government, and tax laws which discriminate against small business. At this time, we believe that the Congress should focus its attention on reforming our tax laws in such a manner as to stimulate capital stock formation among small businesses through a simplified and accelerated capital cost recovery system and the removal of discrimination in the investment tax credit available for used equipment.

Allow a Full Investment Tax Credit
for Used Machinery and Equipment

In addition to the depreciation proposals which have been discussed before this Committee, the small businesses of this country need reform of the investment tax credit. The Report of the White House Commission on Small Business, as its first goal, recommended equalizing the tax burdens on small business relative to large corporations. "The ability to attract and retain earnings relates directly to tax incentives built into the tax structure. . . . The major areas of imbalance, however, are in depreciation methods, inventory accounting, and tax credits." (p. 27) Under present law, there is a $100,000 limitation on the amount of used equipment eligible for the investment tax credit, but there is no limitation on the investment credit available for new equipment. Similarly, the carryback/carryforward provisions available for new equipment are not allowed to purchasers of used equipment, ~~who must, therefore, take the entire tax credit in one year or lose it~~. This discriminatory tax treatment impacts directly and primarily upon small business which is already hindered by its inability to externally or internally generate the capital necessary to buy new equipment. In order to increase productivity in small and medium sized businesses, this discriminatory ceiling on the amount of used property eligible for the investment tax credit must be eliminated; and the carryback/carryforward provisions available for eligible new property must also be available for similarly situated used property. We must allow small business to receive the same tax incentives provided to big businesses. The investment tax credit limitation is primarily a small business issue. Traditionally, small businesses purchase used capital equipment; large businesses basically purchase newly manufactured capital equipment. If used machinery and equipment is eligible for the full investment tax credit, the following benefits at least can be expected:

a. the ability of small business to compete, to maintain its current market share, and to expand its output and productivity will improve;

b. employment in the most labor-intensive part of the capital equipment industry will increase;

c. the current demand for less expensive machine tools will be alleviated and the incentive to turn to imported new machine tools will be reduced;

d. the demand for new domestic machine tools should increase;

e. any short-term inflationary impact of the tax credit will be reduced to the extent used machinery is purchased; and

f. the full benefit of the investment tax credit as an incentive for capital formation will be available to <u>all</u> businesses, <u>equally</u>.

In its 1980 Report, the Joint Economic Committee expressed its concern about the disparity between large and small businesses as they are affected by inflation and current tax policy. It called for tax measures targeted to small business:

> In the past, the tendency of Congress has been to enact tax incentives which on the surface treat all firms equally but fail to acknowledge that most small businesses are unable to take advantage of them for a variety of reasons specifically related to the size of the business. Tax incentives need to be developed that will enable smaller firms to retain a greater proportion of their earnings for reinvestment in capital improvements and plant expansion. These programs should be targeted directly to small businesses. (p. 75)

The investment tax credit law does not treat "all firms equally" but rather creates a blatant discrimination against small businesses. I don't believe that Congress ever debated the issue of whether it should enact a tax policy that discriminates in favor of large businesses and against small businesses, but it did adopt such a policy by placing a ceiling on used equipment tax credits. The removal of the used equipment ceiling will give all businesses an equal opportunity for the use of the investment tax credit and will amount to a targeted change in our tax laws for the benefit of small businesses which in turn will benefit our overall economy.

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Competitive Ability of Small Business

Of all the challenges facing small business, the ability to compete in an inflationary economy is perhaps the most difficult. The cost of obtaining capital for production equipment is high for everyone, especially those who cannot borrow at the prime rate. Those firms purchasing used capital equipment do not have a chance to offset some of their cost by taking the tax credit. This contrasts with large corporations borrowing at prime and purchasing new equipment with the unlimited tax credit. Because large and small companies do compete, smaller firms are disadvantaged. The arbitrary limit on tax credit available for used equipment investments directly dilutes the ability of small business to compete with large firms.

Larger firms buy new machine tools that are either highly automated multi-operational machines or numerically controlled equipment, often designed for a specific purpose. Confining the investment credit to only equipment with the latest technology helps primarily the largest enterprises and basically ignores the largest segment of our economy which needs this tax credit the most. Normally, small and medium-sized companies are competing in industries dominated by a handful of giant corporations.

Even so, with effective tax incentives small businesses can provide the cutting edge of competition in our economy. The 1980 Report of the Joint Economic Committee found that:

> Small business has historically provided the backbone of employment growth and inflation fighting innovation and com-

> petition in our economy. . . they are able to move faster and use resources more effectively than large companies. However, much of the innovation and diffusion process is dependent on whether the entrepreneurial risk-takers in the economy can raise enough money to convert new ideas into more productive technology. (p. 71)

The investment tax credit can be particularly helpful to a small business because it aids cash flow immediately, thereby making its financial statement more attractive to potential investors and lending institutions. It can enable a small business to generate more cash internally as well as external financing.

We believe that our government must adopt policies which will reverse the decline of small business in this country. Much of the reason for this decline lies in the inability of small businesses to acquire capital at the same costs as large businesses or to acquire it at all. These points were stressed in the Final Report of the 1978 hearings on the Future of Small Business Subcommittee on Antitrust, Consumers and Employment:

> We must recognize the necessity for major changes in our governmental policies--at both the Executive and Congressional levels--with regard to the preservation of competition and free enterprise. . . including a reformulation of government policy on such matters as tax structure and industry regulation. . . . (House Report 95-1810)

We believe that small business is crucial to the survival of a free enterprise system and that governmental policy must be adopted which will allow catch-up programs to enable faster growth for small business than in the past.

Small business is an effective force even in heavily concentrated markets, but its position is fraught with difficulties. The tax laws should not further handicap small businesses struggling to compete with industrial giants. We urge, therefore, that used equipment, as well as new equipment, qualify for the full 10 percent credit to offset tax liability, with full carryback/carryforward options and with no $100,000 limit on eligible used property. If the additional handicap of this tax discrimination is removed, small businesses will be able to maintain their market share and to compete against the larger domestic and foreign corporations.

<u>The Ability of Small Businesses to Increase Productivity</u>

The decline in our productivity is caused by several conditions. A partial cause is the antiquated and poorly designed facilities. Another partial cause is the utilization of inefficient equipment, and yet another partial cause is the overall age of our country's industrial machinery. The 1977 <u>American Machinist Inventory</u> showed that the majority of machine tools in use today, in small and large companies, are over 20 years old and less than 11 percent are five years old or less. An urgent need for upgrading and/or renewal of equipment exists.

Therefore, to increase a plant's production capacity, or to develop a new production line, many machines must be acquired. Major corporations renew equipment which is 7 to 10 years old with new equipment, some of which cost over a million dollars. Medium to small firms renew equipment which is 15 to 18 years old with used equipment, usually 7 to 10 years old, some of which cost over $300,000. Very small or new firms may renew their equipment which is 25 years old or more with used equipment which is 15 to 18 years old. Such upgrading of equipment translates into increased productivity for a small business. If the full investment tax credit is allowed for used capital stock, it will speed up the process of renewal and upgrading of all of our industrial plants. The demand for used equipment will increase the price and market for a large firm's used equipment. This will encourage the large firm to sell its used equipment and buy new capital stock to replace the used. This will result in a significant increase in productivity throughout the economy.

Improving productivity does not necessarily require acquisition of younger machines. Often small manufacturers can increase their productivity by purchasing used equipment manufactured in the same year as its current equipment but more efficiently designed for its particular production needs.

In its 1980 Report, the Joint Economic Committee makes a convincing case for the importance of small business in improving the productivity of our system:

> In the area of innovation and productivity, the National Science Foundation has found that one out of every four of the most significant industrial product and process innovations since World War II was developed by firms of less than 100 employees, while one-half were accounted for by firms with less than 1,000 employees. (p.71)

I believe that further investigation would reveal that an extremely high percentage of those innovative products and processes were made or developed on used equipment.

When the small businessman is denied tax incentives to replace current equipment with used machines that are either more sophisticated or more appropriate for his operation our economy looses. His alternatives are to make do with existing equipment, to merge, to be acquired, or to close up shop.

For these same reasons, a full investment tax credit with a carryback and carryforward provision should apply to tax credits for eligible used machinery, as well as eligible new machinery. To penalize the manufacturer who installs $1 million of used machinery in a single year over the manufacturer who merely installs $100,000 worth, simply makes no sense in a sluggish economy and times of slowing economic growth.

<u>Allowance of the Full Investment Credit</u>
<u>for Used Machinery Would Create Jobs</u>

The investment credit should not only stimulate productive capability but it should also stimulate immediate employment. The members of the Committee are keenly aware of the unemployment problems with which the country is beset. Moreover, this Committee knows that the small business sector offers the greatest potential for increasing employment. The purchase of used machinery not only increases productivity but also directly creates new jobs. As noted earlier, small businesses increase productivity primarily with used equipment. Small business also is responsible for 55 percent of all employment in the private sector.

A 1979 study by the Massachusetts Institute of Technology, The Job Generation Process, shows that job creation and replacement is achieved through the small business sector. The data shows that the largest number of new jobs emanated from very small firms with 20 employees or less. For the period 1969 to 1976, these small firms generated 66 percent of all new jobs in the United States. Businesses with 500 or more employees, by contrast, created only 13 percent of the new jobs. Firms of intermediate size accounted for the remaining 21 percent.

If the investment tax credit ceiling on used equipment were eliminated, it would translate into more cash for a small business to reinvest in more and upgraded used equipment which results in new jobs. In its 1980 Report the Joint Economic Committee found that:

> Given the historical tendency of small business to employ a relatively lower ratio of capital to labor than large business, each additional dollar invested in small business is likely to generate more jobs than if it were invested in large business. A policy of small business growth would have its greatest effect in decaying cities where structurally unemployed have the most difficulty finding job opportunities. Traditionally, young people in this country use jobs in small businesses to gain the work experience needed for entry into jobs that lead to highly skilled careers. (p. 72)

It is my experience that there is a direct relation between increased installation of used machinery and increased employment. Furthermore, the small business owner is the last to lay off his employees. He has a strong social conscience which is reflected in his dedication to his employees and his community.

Alleviating the Shortage of Used Capital Stock

Today there is demand for late model used machinery. In many instances, later year domestic used machinery and newly manufactured foreign machinery are price competitive. The new foreign machine has an advantage since there is an unlimited tax credit, with carryback and carryforward provisions available to its purchasers; but purchasers of used domestic equipment, which may be as efficient as new foreign equipment, are limited to a $100,000 ceiling with no carryback or carryforward privilege. Industries seeking to retool are faced with three choices:

1. making do with inadequate equipment;
2. purchasing imported new machine tools; or
3. acquiring more efficient used machinery.

If a manufacturer retains his inadequate machinery, there is no increase in productive capability and the goal of economic growth is frustrated. Retooling with imported machine tools is obviously undesirable, both in its ultimate effects on the domestic machine tool industry and in its adverse effect on the balance of payments. Only by retooling with more efficient used machinery can the maximum economic benefits to the nation be realized. The full investment tax credit should apply to purchases of used machinery so these benefits can be realized, and so that foreign new machinery is not given a tax advantage over equally efficient domestic used machinery.

Investment Credit and Inflation

While acknowledging the investment tax credit's effectiveness in stimulating capital investment, most economists recognize its potential to cause short-term inflation. This is a function of the lead time to implement investment decisions and the concomitant increase in prices for scarce supplies. In many instances, the lead time to place new equipment in service is as much as thirty-six months. The installation of used machinery, however, does not have this undesired inflationary impact since the equipment already exists and the time taken to install it is usually a matter of days, not months.

Inflation has made the $100,000 limit on the amount of eligible used equipment against which the credit can be applied woefully inadequate. The cost of both new and used machinery has increased dramatically since the $50,000 limit was imposed in 1962. In 1975, the limitation was increased to $100,000. Whatever basis there may have been for a limitation has been severely weakened because of inflation. In 1975 the MDNA found that the average price for 44 randomly selected machine tools then 20 years old, came to $13,000. In 1978 we found that the same 44 machine tools, now 23 years old, are fetching an average of $16,000. In 1979 these same machines, now 24 years old, sold for an average of $17,500. Such dramatic jumps in price are typical with all machine tools. Indeed, prices of used machine tools have increased more than 250% since 1962. The average cost of used machines sold by our members is $22,000. Today, I believe it would cost approximately $500,000 to start a small machine shop which would employ 10 people. Furthermore, an established manufacturer has hardly begun to retool before he realizes that the $100,000 investment tax credit ceiling offers him very little assistance at all.

Not only has inflation caused a continuing increase in prices for used equipment, but technological advances have dramatically increased prices. The most striking advance in the machine tool business has been the development of computer-directed or numerically controlled tools. However, the technological superiority of these machines is matched by their greater costs. Today, the average used numerically controlled machine costs $80,000. The price of such a machine on the used market reflects its original costs. As more of these machines appear on the used machine market, the average cost of available used machines will again increase, thereby making the existing limitation even more inadequate.

The failure of Congress to eliminate the limitation currently imposed on purchases of used property eligible for the credit penalizes the users of such property - and the users are small businesses.

<u>A Full Investment Tax Credit for Equipment Will Encourage Economic Growth and Stability in the Small Business Sector</u>

We believe what influences a firm's decision in used capital equipment is not fully understood, and we believe more companies make larger investments in used equipment than is perceived. Two most common factors in the decision to buy used equipment are cost and availability. Market and/or production conditions strongly influence capital investment decision. When a smaller manufacturer has the opportunity to increase sales it often requires an immediate increase in production capacity. Most newly produced U.S. manufacturing equipment has from an 18 to 30 month delivery period, and this lag time would probably cancel the additional sales. Because they are so highly leveraged, some smaller manufacturers are not able to increase their productive capacities even with available used equipment because of the limitation on available investment tax credit. Even when a smaller manufacturer wishes to increase production efficiency and has the time available to acquire newly manufactured equipment, he often does not have adequate financing available to purchase highly expensive replacement machines.

It is becoming increasingly difficult to imagine competitive smaller manufacturers in the 1980's unless the capital retention opportunities for these businesses are made equal to larger manufacturers today--regardless of a wise decision to shorten and simplify capital recovery. The cash flow which results from the tax credit is urgently needed by smaller firms either for additional equipment expenditures or other corporate investments of labor, research, marketing, or facilities. This advantage to the cash position of a small business will also add to its credit worthiness in the eyes of potential lenders or investors. Appendix A illustrates this situation. When a small screw machine company began operating in Des Moines, Iowa it received a $10,000 credit for the $290,000 investment in used capital equipment. The decision to purchase used equipment was based on availability and cost. Nonetheless, this company could have used well the full $29,000 credit, perhaps for an additional sales representative, office equipment, etc.

Pending Legislation and the Full Investment Tax Credit for Used Equipment

During the past year both the Senate and House Small Business Committees have identified the used equipment issue in their capital formation recommendations. When introducing his proposal to double the current arbitrary limitation last year (S. 2152), Senate Small Business Committee Chairman Nelson explained:

> Small businesses which are predominate in many areas of machine and equipment use could play a major part in revival of production if the government policy encourages them to upgrade their stock of capital equipment. Under current conditions and policy, the trends are in the wrong direction. This bill (doubling the limitation) could be a major step to removing the arbitrary and artificial limitation on such purchases.

When Congressman Henry Nowak introduced similar legislation in 1979 (H.R. 6171) to double the limitation, the Congressman noted in hearings before his Small Business Subcommittee on Access to Equity Capital that it became clear that raising the limit would provide partial relief while the basic questions of the bias against used equipment is studied. There are other bills pending which would raise the limit to $500,000, such as H.R. 6744 by Congressman Winn and H.R. 6873 by Congressman Quillen. Earlier this year, two proposals introduced in the House of Representatives by Congressman Frenzel (H.R. 6544), and Congressman McDade (H.R. 6734) called for the removal of the arbitrary limitation to help small businesses retain more earnings and thereby generate the necessary capital to grow and increase their productivity. Congressman Neal Smith, Chairman of the House Small Business Committee testified in favor of these bills on July 23, 1980 before the House Ways and Means Committee.

Earlier this year, in hearings before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee, the National Federation of Independent Businesses, the Small Business Legislative Council, and the National Association of Wholesale Distributors specifically requested the removal of the arbitrary limitation. During the past several months, many small business groups have called for this reform because the full investment credit for used equipment would support a high level of capital investment and improve productivity among small business--the largest segment of our economy. See Appendix B for a list of some of the business organizations who support this reform.

We are grateful to Senator Nelson and Congressman Nowak for identifying this discriminatory ceiling and for introducing legislation to partially resolve the immediate problem. Their proposals will be helpful, but they will not solve the problem nor pave the way for the growth necessary for small business in the 1980s. It will require small business organizations to come back time and time again to make their case as inflation drives prices through the new ceiling.

In 1975, the Senate Small Business Committee recommended that the limitation be removed and Senator Nelson sponsored the necessary remedial legislation. The Senate Finance Committee approved his proposal, and the Senate passed a tax bill which included the elimination of a ceiling on investment tax credit available for used equipment. The Conference Committee resolved the issue by doubling the limitation from $50,000 to $100,000. We believe that the Conference Committee should have accepted the Senate proposal. If it had, we would not be here today, and the small business sector would have been able to grow substantially in the five years that have passed. The discrimination and bias in favor of big business which is inherent in the current tax credit law would have been eliminated in favor of an equal opportunity for small business to grow, compete, and be more productive.

When the 1962 decision to generally not allow the investment tax credit for used equipment was made, it was felt that if the credit were provided there would be a strong inducement in the tax laws for businesses to sell used equipment to each other as often as possible. To suggest that the elimination of the limitation would actually encourage a churning of these types of assets indicates the need for a clearer understanding of the industrial machinery market. In my opinion, this assumption is ambiguous and lacks substantiation. Under examination, it is impossible to imagine a situation where the disrupton of business and the uncertain condition of the other equipment would justify the anticipated abuse. Fixed assets are expensive to remove, transport, and install. The larger these assets the smaller the likelihood this possibility would even be considered. The decision to trade fully depreciated assets involved the type of risk inconsistent with prudent business practices. Except in extremely rare cases, for corporate taxpayers with the ability to acquire newly manufactured equipment, capital outlays for used equipment would simply lack common sense. Actually the objective of the tax credit will be more fully realized by also encouraging capital formation with used equipment because it would be more profitable to upgrade than to churn existing assets. Finally, the recapture provisions of the Tax Code make it difficult to make a profit on churning.

The elimination of the limitation will be cost effective. Based on our discussion with a Treasury Department statistician, we believe the revenue loss would be $190 million in 1981, $214 million in 1982, and $240 million in 1983. Contrast these figures with those projected by the Joint Committee on Taxation for raising the ceiling from $100,000 to $200,000: $178 million in 1981, $188 million in

1982, and $199 million in 1983. The differences in revenue loss between eliminating the ceiling entirely and raising it to $200,000 is minimal in comparison to the symbolic and real growth value of a full investment tax credit for used equipment. It would establish the policy of Congress for small business growth. This revenue loss will be easily recouped through increased tax revenues generated from the sales of the used equipment, increased profits from more productive small businesses and new incomes from new jobs created. In addition, the social benefits of increased productivity, reduced inflation, more products at cheaper prices on the shelves, more jobs and better balance of payments position will further justify the necessary changes in our tax code.

Capital Cost Recovery Legislation

Several bills have been introduced which would allow the rapid recovery of capital costs through depreciation reform. On January 23, 1979, Senator Nelson introduced S. 110, the "Small Business Depreciation Reform Act of 1979." On June 27, 1979, Congressman Jones and Congressman Conable introduced H.R. 4646, the "Capital Cost Recovery Act of 1979." A similar bill was introduced in the Senate as S. 1435 by Senators Bentsen, Chafee, Nelson, and Packwood. On August 2, 1979, Congressman Nowak, Chairman of the Subcommittee on Access to Equity Capital and Business Opportunities, of the Small Business Committee, introduced H.R. 5096, the "Small Business Capital Formation Tax Act of 1979." Today, representatives of small business organizations have testified in favor of such legislation. We enthusiastically endorse the concept of all four of these proposals. In order to stimulate capital investment and increase productivity thereby, we must reform the current tax system for depreciation of equipment. These bills would permit a small business to recover more rapidly capital that it has invested in machinery and equipment.

In its 1979 Report, the Joint Economic Committee found that one of the deterrents to investment spending has been the interaction of inflation and current tax law. The Joint Economic Committee concluded that:

> Some of the provisions of the corporate income tax code which were designed in a noninflationary economy, act as a deterrent to investment in the current inflation. Depreciation allowances based on historical costs do not allow sufficient deductions to recover replacement costs. Similarly, profits on inventory in one sense may be illusory, because inventory must be replaced at current cost. On the other hand, in inflationary periods, corporations benefit from reductions in the real value of outstanding debts. . . . (P.132).
>
> Some of the tax changes in the Revenue Act of 1978 will stimulate investment. But these are not sufficient. We believe that per dollar of revenue loss, liberalization of depreciation allowances would be the most effective stimulant. (P. 133)

As Chairman of the Federal Reserve, William Miller emphasized accelerated depreciation as a needed tax change in his testimony before the Senate Finance Committee on September 6, 1978:

> Accelerated depreciation is a very efficient way to encourage investment. The tax benefits of faster depreciation accrue to a firm only after new plant and

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> equipment has been put in place. In addition, enlarged depreciation allowances would redress the serious drag on real corporate profitability that has occurred in recent years as inflation has caused replacement costs to exceed depreciation deductions by a wide margin. (emphasis added) (part 5, page 1173 et seq.)

We agree with the conclusions of the Joint Economic Committee and Mr. Miller and urge the passage of legislation which would allow the rapid depreciation of used equipment and machinery over a maximum period of five years. For many of the reasons previously stated with regard to the full investment tax credit, such depreciation tax reform would aid small businesses in generating the capital necessary to buy used machinery, resulting in expanded capacity and increased productivity.

We are concerned that the $50,000 limitation in H.R. 5096 and the $25,000 limitation in S. 110 on the amounts which may be depreciated impose too low of a ceiling to be a meaningful stimulant to small business investment in used machinery and equipment. As I pointed out earlier in my testimony, the cost of both new and used machinery has increased dramatically. In 1978, the average cost of all used machines sold by our members was $20,000. Perhaps the $25,000 or $50,000 limits would accomodate the small service company or retail store. However, a small manufacturer has hardly begun to retool before he has exceeded the limitations provided for in those two bills. Such limitations are even more detrimental when applied to used computer-directed or numerically controlled tools. As I pointed out earlier, the average used numerically controlled machine cost $70,000. From a small business perspective, a one million dollar ceiling on the amount of annual depreciation would encourage the investment in capital which would ultimately lead to increased productivity of small businesses in our country. However, for the entire machine tool industry, an unlimited annual depreciation should encourage the most capital investment.

The simplification of our tax laws with respect to depreciation, which would result from all of these proposals, would be of great benefit to small businesses. Small businesses cannot afford a cadre of tax lawyers and accountants to plan their capital investment. Being able to understand the simplified depreciation schedule, the small business person would be more encouraged to increase investment in machinery and equipment. Under existing law, a great deal of time is wasted by small business executives in trying to comprehend our complex depreciation laws and in computing the allowable depreciation for their equipment. One result is that depreciation accounting is one of the leading causes of errors on small business tax returns. Simplification of the depreciation system will result in savings of money and time for both small businesses and the government tax officials who must process the current complex returns.

In some cases, the current depreciation tax laws are so complex that small businesses have chosen not to use the depreciation allowable. For example, the Asset Depreciation Range (ADR) System was used in 1974 by only .7 percent of all corporations, or 11,042 corporations out of a total of 1.6 million. Yet this system shortens the useful life of assets by up to 20 percent. While 94 percent of the firms with over $1 billion worth of assets use ADR, only 1 percent of the firms that have assets of less than $500,000 used ADR. (93.3 percent of the firms in this country are small businesses that have assets less than $500,000). It is clear that small business does not use ADR. We believe that it will use the simplified system.

The rapid capital cost recovery will protect the capital investment of small business against the erosion of inflation, which currently causes replacement costs to exceed depreciation deductions. Small businesses will be able to reinvest their capital in more or upgraded equipment. With the resulting increase in productivity, the entire economy will benefit and we will have scored another victory in our constant battle against inflation.

Furthermore, we need the proposed rapid capital cost recovery system in order to be competitive with other industrialized nations which have already adopted rapid capital cost recovery systems. For example, Canada has adopted a two-year depreciation system for most machinery and equipment, and Britain has adopted a capital recovery time of a single year. This has resulted in an accelerated capital stock renewal process which I analyzed earlier in my testimony. Used equipment is being replaced more rapidly by new equipment, and small businesses are replacing old used equipment with later year more advanced used equipment. The result is a more modernized overall industrial plant for those countries. The high demand for used machinery in these countries, we believe, is at least partially caused by the greater supply of used equipment created by the two or one-year depreciation system. We must adopt a similar rational tax policy which will stimulate domestic economic growth and allow us to be competitive in the international arena. If such steps are not taken, we will see increasing balance of payment deficits and further devaluation of the dollar.

Conclusion

In summary, we must reverse the decline in productivity in our country through the increased capital formation which will be stimulated by reform of our tax laws through removal of discrimination in the investment tax credit and through a simplified and accelerated capital cost recovery system. Between these two reforms, we believe small business will benefit more by allowing it an equal opportunity to full use of the investment tax credit on its purchase of used machinery and equipment. The tax credit is applied to taxes due, while the value of the depreciation deduction hinges on the amount of capital stock owned and the tax rate applicable to each company. However, we believe that both reforms are necessary and must be enacted in the very near future. These reforms will allow the generation of capital necessary to the renewal and upgrading of our nation's industrial plants. They will give small business a fighting chance against inflation and an opportunity for catch-up growth which we need in order to compete effectively against large domestic and international corporations. Most importantly, we can increase the productivity of our country, achieve real growth, and assure a better standard of living for all Americans.

Thank you Mr. Chairman and members of the Committee.

Appendix A: This attachment is one of many prepared by MDNA members for the House Small Business Committee in 1979.

COMMITTEE ON SMALL BUSINESS
USED CAPITAL EQUIPMENT INFORMATION

1. CITY: Chariton & West Des Moines, Iowa

2. TYPE OF BUSINESS: Contract Machinery & Screw Machine Products

3. MACHINERY USED IN OPERATION TODAY:

TYPE OF MACHINES	USED PRICE	NEW PRICE
Potter & Johnson 400 Auto. Turret Lathe	$30,000.00	$95,000.00
Warner & Swasey 1-3/4" 5 Spindle Auto Screw	$27,500.00	135,000.00
" " " " " " " "	27,500.00	135,000.00
Warner & Swasey 2-1/4" " " " "	40,000.00	150,000.00
" " " " " " "	40,000.00	150,000.00
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Jet Milling and Drilling Machine	600.00	1,600.00
Bridgeport Vertical Millling Machine	4,750.00	5,800.00
Jet Engine lathe	1,800.00	2,500.00
Warner & Swasey No. 2 Turret Lathe	2,500.00	45,000.00
Rockford Grinder	1,000.00	2,250.00
Rockford Horzontal Band ~~XXXX~~ Saw	600.00	1,200.00
Wilton Drill Press	350.00	810.00
(Use other side for additional machines)	500.00	1,135.00
(SUBTOTAL FROM OTHER SIDE)		
MATERIAL HANDLING EQUIPMENT CRANES	3,600.00	8,000.00
TRUCKS		
INSPECTION EQUIPMENT		
ACCESSORIES, PERISHABLES & SPECIAL TOOLINGS (TOTAL)	35,000.00	62,000.00
(CHUCKS, ETC.; DRILLS, ETC; JIGS, ETC.)		
TOTALS	295,600	1,095,295

TYPE OF MACHINES	USED PRICE	NEW PRICE
Wilton Drill Press V.S..	$400.00	$910.00
Rockford Drill Press	100.00	225.00
SUBTOTAL	$500.00	$1,135.00

4. OTHER INFORMATION:

* Approximate Annual Sales (this year) $ *1,000,000 initial year*
* Total Number of Employees *8*
* Total Operating Costs $ *65,000* per month

(Includes: payroll, occupancy, sales, production, debt-financing costs)

Annual payroll $ *250,000*

Office Equipment $ *10,000*

Plant Size *7,000* sq. ft.

This company would not be in business today if used equipment were not available when the company was started in 1978. The decision to begin this business was one very large order from a larger coporation. $250,000 was available through a bank loan and the delivery time for newly manufactured screw machines is 18 months.

APPENDIX B

INVESTMENT TAX CREDIT

The decline in our productivity is caused by several conditions. For the first time in twenty years, the Joint Economic Committee Annual Report of 1979 unanimously concluded that an increase in productivity is vital to the improvement of our economic standard of living and to the reduction of inflation. A partial cause of this situation is the antiqdated production facilities of many American manufacturers. Another partial cause is the utilization of inefficient equipment; and yet another partial cause is the overall age of our country's industrial machinery. The most recent U.S. survey of machine tools shows only 11% of the industrial machinery in use today is less than five years old; 76% is at least ten years old. Equipment renewal and upgrading are necessary in both large and small manufacturing companies. Increasing productivity through equipment renewal is best achieved for small business through the purchase of affordable used machinery and equipment.

Under present law there is a $100,000 limitation on the amount of used equipment eligible for investment tax credit, but there is no limitation on the investment credit available for new equipment. This discriminatory tax treatment impacts directly and primarily on small business which is already hindered by its inability to externally or internally generate capital necessary to buy new equipment.

In order to increase productivity and competition, the discriminatory ceiling on the amount of used property eligible for a tax credit must be eliminated; and, the carryover provisions available for new property must also be available for similarly situated used property. Traditionally, small businesses purchase used capital equipment; large businesses basically purchase newly manufactured capital equipment. The cost of obtaining capital for production equipment is high for everyone, especially those who cannot borrow at the prime rate. Firms purchasing used capital equipment do not have a chance to offset some of their costs through this tax credit. Confining the investment credit to only equipment with the latest technology helps primarily the largest enterprises and basically ignores the numerically greater small business segment of our economy which needs this tax credit the most. Because the small business sector offers the greatest potential for increasing employment, there is normally a direct relationship between increased installation of used machinery and increased employment.

RESOLVED

Small Business Legislative Council urges and supports changes in the IRS Code to allow a full investment tax credit for used machinery and equipment. This full investment tax credit will allow small businesses to receive the same tax incentive provided to big businesses and would allow small businesses to compete, to maintain their current market share, and to hopefully expand output and productivity.

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Small Business Legislative Council*

July 30, 1980

The position paper -- Investment Tax Credit -- is supported, as of this date, by 51 members of the Small Business Legislative Council:

American Assn. of MESBICs
Washington, DC

American Assn. of Nurserymen
Washington, DC

American Metal Stamping Assn.
Richmond Heights, OH

Assn. of Diesel Specialists
Kansas City, MO

Assn. of Indep. Corrugated Converters
Washington, DC

Assn. of Physical Fitness Centers
Bethesda, MD

Automotive Warehouse Distribs. Assn.
Kansas City, MO

Bldg. Service Contractors Assn. Intl.
Vienna, VA

Business Advertising Council
Cincinnati, OH

Christian Booksellers Assn.
Colorado Springs, CO

Direct Selling Association
Washington, D.C.

Eastern Manufs. & Importers Exhibit
New York, NY

Electronic Reps. Assn.
Chicago, IL

Independent Bakers Assn.
Washington, DC

Indep. Business Assn. of Michigan
Kalamazoo, MI

Indep. Sewing Machine Dealers of America
Hilliard, OH

Intl. Franchise Assn.
Washington, DC

Local and Short Haul Carriers Natl Conf.
Washington, DC

Machinery Dealers Natl. Assn.
Silver Spring, MD

Manufacturers Agents Natl.
Irvine, CA

*Of the National Small Business Association

Marking Device Assn.
Evanston, IL

Menswear Retailers of America
Washington, DC

MN Assn. of Commerce & Industry Small
Business Council, St. Paul, MN

Narrow Fabrics Institute
New Rochelle, NY

Natl. Assn. of Catalog Showroom Merchs.
New York, NY

Natl. Assn. of Floor Covering Distribs.
Chicago, IL

Natl. Assn. of Plastic Fabricators
Washington, DC

Natl. Assn. of Plastics Distribs.
Jaffrey, NH

Natl. Assn. of Retail Druggists
Washington, DC

Natl. Candy Wholesalers Assn.
Washington, DC

Natl. Coffee Service Assn.
Chicago, IL

Natl. Electrical Contractors Assn.
Bethesda, MD

Natl. Family Business Council
West Bloomfield, MI

Natl. Home Improvement Council
New York, NY

Natl. Independent Dairies Assn.
Washington, DC

Natl. Insulation Contractors Assn.
Washington, DC

Natl. Meat Assn.
Washington, DC

Natl. Office Machine Dealers Assn.
Des Plaines, IL

Natl. Paper Box Assn.
Haddonfield, NJ

Natl. Paper Trade Assn.
New York, NY

Natl. Parking Assn.
Washington, DC

Natl. Patent Council
Arlington, VA

Natl. Pest Control Assn.
Vienna, VA

Natl. Small Business Assn.
Washington, DC

Natl. Society of Public Accountants
Washington, DC

Natl. Tire Dealers & Retreaders Assn.
Washington, DC

Natl. Tooling and Machining Assn.
Washington, DC

Natl. Tour Brokers Assn.
Lexington, KY

Power & Comm. Contractors Assn.
Washington, DC

Printing Industries of America
Arlington, VA

Sheet Metal & Air Cond. Contrs.
Natl. Assn., Vienna, VA

CAPITAL INVESTMENT RECOVERY

Small business has seen its role in the U.S. economy dwindle for decades. Much of the reason for its decline lies in its inability to get the capital to be able to compete with large business in this country. The corporate giants, meanwhile, have access to the capital they need at the lowest available rates. They continue to increase their share of the Gross National Product at the expense of small business.

This competitive country must redirect its economic structure to return to the principles of private enterprise upon which it was founded. At the rate we are going there will soon be no small business in America. The American dream of starting one's own business and making it a success will be nothing more than a dream. No one man or woman will be able to come close to competing with the major corporations.

The U.S. Congress can help restore the American dream by passing legislation facilitating the recovery of capital. But it must be of genuine help for the small business and not a tool for big business to continue to take over and freeze out small business as it has been doing for years. The corporate giants, with their easy access to capital at the lowest rates, would use any legislation to accelerate expansion to the disadvantage of small business if there is not a ceiling on the benefits. The small retailer would get little joy from his newly won benefits if he found a major corporate chain was using them to open a store next door. This would happen without a ceiling. The small manufacturer would find the same thing. Whatever he was able to invest in new productive equipment would be more than matched by the well-heeled giant that had been running him out of business anyway. In some industries, major corporations who presently subcontract would find it a greater advantage to manufacture themselves should legislation without a ceiling be passed.

Any tax bill accelerating depreciation should provide a 10% investment tax credit for all equipment, machinery, and furnishings. It would allow them to be depreciated over four years. This type of capital investment could be depreciated as much as four or five times faster than presently allowed. These breaks would be targeted to small business by limiting to $1 million the amount of total investment in equipment, machinery and furnishings upon which accelerated depreciation would be allowed.

Buildings and fixtures would also be depreciated much faster. These types of investments could be written off in 10 years. This type of investment could be depreciated as much as six times faster than under present rules. This break would also be targeted to small business by limiting to $1 million per year the amount of investment in buildings and fixtures upon which accelerated depreciation would be allowed.

Over 97-1/2% of all U.S. companies would be able to use this legislation to full advantage. Most of the remaining 2-1/2% of companies, which account for 79% of the investment in this country, could use it up to the ceiling amounts. Thus this bill both would help small business and significantly reduce the revenue loss that would occur if there were no ceilings on benefits.

RESOLVED

Increased capital investment by small business is essential if this basic American institution is to survive and prosper. SBLC endorses legislation that will encourage increased capital investment by small businesses. The combined effect of more rapid depreciation and increased investment tax credit will assure small business a greater return on its investment in such capital, thereby making small business more profitable, and better able to compete in all markets.

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Small Business Legislative Council*

July 31, 1980

The position paper -- Capital Investment Recovery -- is supported, as of this date, by 51 members of the Small Business Legislative Council:

American Assn. of MESBICs
Washington, DC

American Assn. of Nurserymen
Washington, DC

American Textile Machinery Assn.
Washington, DC

Amusement & Music Operators Assn.
Chicago, IL

Assn. of Indep. Corrugated Converters
Washington, DC

Assn. of Physical Fitness Centers
Bethesda, MD

Automotive Warehouse Distribs. Assn.
Kansas City, MO

Building Service Contractors Assn.
Intl., McLean, VA

Business Advertising Council
Cincinnati, OH

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New York, NY

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Kalamazoo, MI

Indep. Business Assn. of Washington
Bellevue, WA

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Hilliard, OH

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Natl. Assn. of Retail Druggists
Washington, DC

Natl. Beer Wholesalers Assn. of Am.
Falls Church, VA

Natl. Burglar & Fire Alarm Assn.
Washington, DC

Natl. Candy Wholesalers Assn.
Washington, DC

Natl. Coffee Service Assn.
Chicago, IL

Natl. Concrete Masonry Assn.
Herndon, VA

Natl. Electrical Contractors Assn.
Bethesda, MD

Natl. Family Business Council
West Bloomfield, MI

Natl. Home Furnishings Assn.
Washington, DC

Natl. Home Improvement Council
New York, NY

Natl. Independent Dairies Assn.
Washington, DC

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Des Plaines, IL

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Alexandria, VA

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Vienna, VA

Natl. Precast Concrete Assn.
Indianapolis, IN

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Lexington, KY

Natl. Wine Distrib. Assn.
Chicago, IL

Power & Comm. Contractors Assn.
Washington, DC

Sheet Metal & Air Cond. Contrs.
Natl. Assn., Vienna, VA

Senator NELSON. Our final witness on this panel is Mr. J. Stephen Putman, president of F. L. Putnam & Co., on behalf of the National Association of Securities Dealers.

STATEMENT OF J. STEPHEN PUTNAM, PRESIDENT, F. L. PUTNAM & CO., NATIONAL ASSOCIATION OF SECURITIES DEALERS

Mr. PUTNAM. Thank you, Mr. Chairman, and Senator Durenberger.

My name is Steve Putnam, and as you have mentioned, I am president of the securities firm of F. L. Putnam and Co., which is headquartered in Boston, Mass., with branches in Florida, and throughout the Northeast. In the past year, incidentally, we have underwritten $5 million in first time market offerings, and $7 million in tax incentive investments.

Doug Parrillo, NASD vice president of regulatory policy and procedures is with me today.

I am appearing before you today as both a member of the broker-dealer community, and also a member of the joint industry/Government committee on small business financing, a committee created by the NASD in the fall of 1978 to address the capital-raising problems of small business.

Composed of securities industry members, this committee has been assisted by representatives of the Securities Industry Association, the Securities and Exchange Commission, the Department of the Treasury, the U.S. Small Business Administration, the National Association of Small Business Investment Co.'s, the National Venture Capital Association, the White House Conference on Small Business, and the chief counsel to the Senate Select Committee on Small Business.

The work of this joint committee culminated in the preparation of a special report entitled, "Small Business Financing: The Current Environment and Suggestions for Improvement." We presented this report to the U.S. Senate Select Committee on Small Business on May 22, 1979.

With your permission, I would like to submit a copy of the report for the record.

Senator NELSON. We will receive the report, but we will have to make a decision as to whether we ought to print it in full in the record. It will be accepted either for our files or for the record.[1]

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

One of the things, as you will recall, that we found in this report was that small business financing was facing a growing number of impediments to capital formation, and we made suggestions for improvement of that environment. Many of these have been directed to Congress and many of them resulted in certain bills concerning taxation and Federal securities law.

Some of these you have in front of you now, including Senate bill 653, Senate bill 1967, Senate bill 2168, and Senate bill 2239. Again, I would like to reiterate our support of these particular bills.

Obviously the need for capital formation is probably the most pressing need that we have today. Certainly the vote of the White

[1] The report was made a part of the committee file.

House Conference put that as No. 1 in the problem area. The first five recommendations that they made related to capital formation.

I cannot speak to all these bills today, but I would like to speak to a bill that really is not a tax reduction, but we feel could be extremely helpful in capital formation, and that is Senate bill 1967.

As you will recall, this closely tracks one of the principal recommendations of our joint committee, and was introduced by you and also Senator Packwood on November 1, 1979. What it will do is create a tax deferred reserve equal to the cost of carrying certain securities under the Federal securities laws. It has a limitation of $1 million for each particular firm, therefore it is not going to become a windfall for any particular broker/dealer.

Furthermore, since it does have that limitation, the impact on the Treasury is very small. Furthermore, it is a deferral of taxes as opposed to a tax reduction. What it really does is speedup the process of recovering what could be recovered in bad markets because you could get that particular tax benefit back again, but it would not come back again fast enough to provide the capital necessary in a severe market decline.

We also feel that this particular bill will definitely assist the small broker/dealers who have declined by 37 percent over the past 10 years. We feel it will allow new financing for these smaller firms because the broker/dealers who underwrite these particular issues will know that there will be a market made in those issues after the stock has dropped.

In conclusion, I would again like to endorse all the bills that I mentioned, and others that I have not had time to mention, and urge you to put this particular bill, Senate bill 1967, high on the list of priorities since the impact is small as far as Treasury is concerned, and the impact will be significant.

Thank you, Mr. Chairman.

Senator NELSON. Thank you.

[The prepared statement of Mr. Putnam follows:]

STATEMENT
OF
J. STEPHEN PUTNAM
ON BEHALF OF THE
NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
BEFORE THE
U. S. SENATE COMMITTEE ON FINANCE

July 31, 1980

Mr. Chairman and members of the Committee, my name is J. Stephen Putnam and I am President of the securities firm of F. L. Putnam & Company, which is headquartered in Boston, Massachusetts, with branch offices in Florida and throughout the northeast. With me today are Frank J. Wilson, NASD Senior Vice President, Regulatory Policy and General Counsel, Douglas F. Parrillo, NASD Vice President, Regulatory Policy and Procedures, and Raymond Cocchi, NASD Director of Congressional and State Liaison.

I am appearing before you today as both a member of the broker-dealer community and as a member of the Joint Industry/Government Committee on Small Business Financing, a committee created by the NASD in the fall of 1978 to address the capital-raising problems of small business. Composed of securities industry financing experts, this Committee was assisted by representatives of the Securities Industry Association, the Securities and Exchange Commission, the Department of the Treasury, the U. S. Small Business Administration, the National Association of Small Business Investment Companies, the National Venture Capital Association, the White House Conference on Small Business and the Chief Counsel to the Senate Select Committee on Small Business.

The work of this Joint Committee culminated in the preparation of a Special Report entitled, Small Business Financing: The Current Environment and Suggestions for Improvement. It was presented to the U. S. Senate Select Committee on Small Business, chaired by Senator Nelson, on May 22, 1979, at a time when, I am pleased to say, I was serving as Chairman of the NASD's Board of Governors. With your permission, Mr. Chairman, I would like to submit that Report for the record. In this Report, our Joint Committee concluded that small businesses face an uncertain future unless barriers to investment in these enterprises are eliminated. To that end, the Committee made a number of recommendations, most of which were directed to the Congress and many of which concerned taxation and federal securities laws. Several of these recommendations have since been incorporated into legislative initiatives, many of which are before this committee today.

As this Committee is aware, capital formation is a very complex subject. It is a multifaceted process involving a continuous interaction of many marketplace forces both economic and regulatory. In its examination of the capital formation problems of small business, our Joint Committee found that over the years, numerous obstacles have developed in the capital-raising process and these impediments have reached the point that large numbers of smaller businesses are now being prevented from attracting the capital they need to develop and grow. Because of the complexity of the issue, we do not believe that the solution to the capital formation problems of small business will be found in a single legislative initiative. Rather, we believe that the means for improving the environment for small business financing lies in a well-balanced and coordinated series of initiatives which will collectively address this matter. Although each individual legislative initiative in this area represents a step in the right direction, what is required is a comprehensive plan of action which will attack the problem on many fronts. Earlier this year, this committee held hearings at which the NASD testified on a number of bills which are designed to aid small business. We believe many of these bills are meritorious and if enacted, will contribute, in an appreciable way, to the strengthening of our nation's economy by allowing small business to remain the leading creator of jobs, innovation and technology.

My specific comments today concern S.1967, a bill introduced by Senator Nelson on November 1, 1979.

S.1967, which closely tracks one of the principal recommendations of our Joint Committee, would allow market makers to place up to $1 million earned from market making activities in securities of companies with equity capital outstanding of $25,000,000 or less into a ten year, tax-deferred "profit reserve." Additions to the reserve for any one year would not be permitted to exceed 30 percent of the fair market value of average equity positions carried for such market making purposes during that year. Since the amount of money going into the reserve in any one year would be directly tied to the amount a firm invests in market making positions in smaller companies, S.1967 is in a very real sense a long-term capital incentive. For the average securities firm, it would take a considerable amount of time for it to reach the $1,000,000 cap. From an impact study of our Joint Committee's proposal, which was somewhat broader in scope than S.1967, we found that for calendar year 1977, a total of 487 broker-dealer market makers would have been able to defer somewhere in the vicinity of $20,000,000 in tax liabilities, or about $40,000 per firm, on gross revenues from market making in over-the-counter securities of approximately $330 million. Although $20,000,000 in deferred tax reserves represents a modest impact on the Treasury, the benefits to the small business sector of the nation's economy by means of S.1967 would be substantial.

In that connection, it is important to note too that by virtue of the $1,000,000 maximum, S.1967 would not result in a windfall to any broker-dealer, large or small. The benefits derived from S.1967 will be directly linked to the contribution a firm makes to improving the depth and liquidity of markets. What S.1967 will do is bring about more and better markets in securities of smaller issuers, particularly by smaller, local broker-dealers. These are the firms that have provided local investors and local issuers with a full range of investment services. For many local businesses that were not of interest to venture capital groups or major underwriting houses, it has been the local, regional broker-dealer that has brought them public and provided secondary markets for their securities. The contraction of the broker-dealer community since the early 1970's, a phenomenon which has not spared the local, regional firm, has hit small business the hardest since many of the large national firms do not find the sponsorship of small firms to be an economically attractive activity.

S.1967 will substantially improve the ability of small businesses to raise the funds necessary to promote their growth, particularly small, developing companies which are not considered high-technology firms. (Although there has been some resurgence of late in the new-issue market, it has been limited mainly to the high technology, fast growth companies. Broad-based support for small, developing companies, outside of the high technology area, has yet to materialize.)

By improving the prospects for aftermarkets in their securities — markets with adequate depth and liquidity — S.1967 will facilitate the raising of equity capital by smaller businesses. Clearly, an investor is not going to purchase a stock in a small business which he may not be able to sell or sell only at a price substantially lower than what he paid. To bring about better markets, incentives to encourage risk market making in the securities of smaller companies by existing broker-dealers and new entrants to the securities business are needed. The availability of tax-deferred reserves would provide one such incentive by giving a broker-dealer some limited form of protection against losses incurred in the performance of his market making function. The use of reserves would serve to smooth out the tax consequences which accrue to the broker-dealer community, particularly smaller broker-dealers, by recognizing the cyclical nature of the securities business. These tax-deferred reserves would provide a much-needed cushion during periods when markets are declining and the need for a viable market making community the greatest.

In our opinion, this bill is of critical importance, particularly as the number of securities firms engaged in risk market making continues to decline in the face of an increased need on the part of small businesses for additional sources of new capital. Endorsements of S.1967 by the Homestead Small Business Tax Conference sponsored by the Small Business Committee of the Section of Corporation, Banking and Business Law of the American Bar Association and the Small Business Legislative Council of the National Small Business Association, evidence a growing support for the measure. Also, co-sponsorship of the bill by Senator Packwood and expressions of interest in S.1967 by several members of the Senate indicate to us a growing appreciation of the problem and the need for independent securities firms to render capital-raising assistance to small businesses.

* * * *

Members of the Committee, that concludes my testimony. I want to thank the Chairman for this opportunity to appear before you today and at this time, I would be happy to answer any questions you might have.

Thank you for your attention.

* * * * *

Senator NELSON. We designed this package to include the measures that we thought would do the most good, and that is the reason that we did not include in here 10-5-3. This was targeted toward independent entrepreneurs.

Thank you very much, gentlemen, for your thoughts and your testimony.

We have one more witness, who was not here at the time he was called. Senator Durenberger has graciously agreed to stay for that presentation.

Senator DURENBERGER. Mr. Shaker, if you would proceed.

STATEMENT OF WILLIAM H. SHAKER, EXECUTIVE VICE PRESIDENT, NATIONAL TAX LIMITATION COMMITTEE

Mr. SHAKER. I am William Shaker. I am executive vice president of the National Tax Limitation Committee, representing Lewis Uhler, our president.

On behalf of our directors, and more than one half million members, I express our appreciation for this opportunity. During the course of the last week or so, we have followed the testimony before your committee with a great deal of interest. Our 500,000 members, and indeed all Americans want and need tax relief now—not in 1981, 1982, but right now.

We say, tax relief, because no one is really advocating a tax cut that would allow citizens to pay less this year than they did a year ago. Instead the advocates of various tax cuts are merely trying to slow down the rate at which our taxes are increasing.

Americans are now paying a greater percentage of their income in taxes than at any time since World War II. Unless tax relief is enacted immediately, 1980 will see taxes go up $64 billion. The President's budget shows another $88 billion tax increase planned for 1981. It is imperative that Congress enact meaningful tax relief and spending cuts right away.

Indeed, many of those who have appeared here to argue that we cannot cut taxes because of the deficit we face this year are the very people who are in a position to reduce that deficit. What they are really saying, therefore, is the taxpayer must pay for their mistakes, and to us that is far from acceptable.

The current line from the White House is even less acceptable to our members. The idea that it is unwise or even immoral to discuss cutting taxes in an election year seems to us simply outrageous.

In a democratic system, the people have the right to expect major policy questions to be debated at the one time that they are in a position to influence their elected representatives, and their leaders. The American people have a right to expect those who aspire to public office in this country to share their concern about economic problems, inflation, and yes, even taxes. That, after all, is what our political system is all about.

That is why it was so shocking the other day to read that a high administration official came before the committees of Congress last week to denounce what he termed "political tax cuts." He was, I realize, merely reflecting the President's view, but that hardly excuses him.

We can understand the President's desire not to talk about taxes. In the past 4 years, while no one was watching, his administration quietly let our taxes rise to a sum equal to nearly $4,000 per American family. That is the amount of increase in the last 4 years.

Senator DURENBERGER. You might say that the increase in the last 4 years exceeds that of the first 200 years of the history of this country, which is another way to put the same emphasis.

Mr. SHAKER. That is very significant.

Within this election year the increase has been more than $1,000 per American family. That, we also think, is outrageous.

At the same time, some Members of Congress started to talk about tax relief as an expenditure of Government money, as if the taxpayer's money is not his, but theirs, and that by giving him relief they are irresponsibly giving away money that properly belongs in the U.S. Treasury.

Well, it ain't so. It never was, and it never will be. The Government does not have the right to take everything it wants, only what it legitimately needs, and what the people allow it to take.

To break the spend/tax/inflation cycle will require immediate and significant cuts in spending. A tax cut alone will not be enough. We have urged, as a long-term solution, a constitutional amendment to limit Federal spending—the Heinz-Stone amendment—which, Mr. Chairman, you are a cosponsor of. But we also recognize today that short-term remedies are needed.

There is no program, no agency, no department of this Government that could not save money between now and the end of the current fiscal year. We don't advocate cutting essential social services, or the capability that this Nation needs to defend itself.

But when the kind of waste detailed by a subcommittee of the Senate last week is allowed to go on, when Government agencies are allowed and even encouraged to go on year-end spending binges that cost the taxpayers billions of dollars, things simply are out of control.

In conclusion, we urge that at least one-fourth of the 1980 tax increase be given back to the American people, and that at least one-half of the tax increases planned for future years be rescinded.

Senator DURENBERGER. I have just one question. It seems to me the limitation on spending by the ability of this country to generate the income to finance that spending, or the constitutional amendment you referred to, is only half or one part of the discipline this system needs. The other, which we have been working on now for some time, is indexing the tax bracket to inflation.

Does your organization have a position on this. If so, what is it, and what efforts are being put into selling that concept to taxpayers around this country?

Mr. SHAKER. What we are recommending in our detailed testimony is that part of the planned tax increases be given back. We are recommending that part of the 1980 tax increase be given back in the form of job producing kinds of tax relief. Then in 1981, 1982, and into the future years, one-half of planned tax increases be provided as tax relief and be given back pro rata in relationship to the amount of the planned increases in the various sectors.

I think indexing the tax brackets for inflation is certainly a very equitable way to provide the tax relief to the individual. Indexing would certainly remove Government's incentive to inflate.

Senator DURENBERGER. Thank you very much for your testimony, and your testimony in full will be made part of the record.

Mr. SHAKER. Thank you very much.

[The prepared statement of Mr. Shaker follows:]

TESTIMONY OF THE NATIONAL TAX LIMITATION COMMITTEE

- Lewis K. Uhler, President -

Senate Finance Hearings on Tax Cut Proposals

Senate Finance Committee

July 31, 1980

Presented by

William H. Shaker, Executive Vice President

SUMMARY OF POINTS

1) Planned tax increases for 1981, 1982, and 1983 total $250 billion.

2) Scheduled tax increase for 1980 will amount to $64.3 billion. Planned tax increase for 1981 will total an additional $88 billion.

3) We urge that tax relief equal to one-quarter of the 1980 tax increase be enacted for fourth quarter 1980, and that one-half of the tax increases planned for 1981 and 1982 be rescinded.

4) 1980 tax relief to be effective immediately, and 1981 tax relief to be effective October 1, 1980.

5) The recommended amount for 1980 of $15.5 billion should be allocated to job-producing tax relief, and tax relief for future years be allocated between job-producing tax relief and tax relief for individuals pro rata based on planned tax increases.

6) Immediate and significant cuts in federal spending must also be made. NTLC will specify recommendations in this area.

7) NTLC urges an amendment to the U.S. Constitution to limit federal outlays as a long-term solution, but recognizes today that short-term remedies are also needed.

8) This program of tax relief and spending control will pare federal spending to 18.7% of GNP by 1984 at a savings of $184 billion.

TESTIMONY

During the course of the last week or so we have followed the testimony before your committee with a great deal of interest. Our 500,000 members want and need tax relief now -- not in 1981 or 1982, but right now.

We say tax relief because they know as well as most of the witnesses that have appeared before you that no one is really advocating a tax cut that would allow the citizens of this country to pay less this year than they did a year ago. Instead, the advocates of various tax cuts are merely trying to slow down the rate at which our taxes are increasing.

And we all know that federal spending and taxes are increasing at an unprecedented rate. Americans are now paying a greater percentage of their income to the government than at any time since World War II.

Unless tax relief is enacted immediately, 1980 will see taxes go up $64 billion; and the President's Budget shows another $88 billion tax increase planned for 1981.

Under the circumstances, it is imperative that Congress enact meaningful tax relief and spending cuts right away. The arguments against doing so strike us as less than persuasive.

Indeed, many of those who have appeared here to argue that we can't cut taxes because of the deficit we face this year are the very people who are in a position to reduce that deficit. What they are really saying therefore is that the taxpayer must pay for <u>their</u> mistakes and to us that is far from acceptable.

The current line from the White House is even less acceptable to our members. The idea that it is unwise or even immoral to discuss cutting taxes in an election year seems to us outrageous.

In a Democratic system the people have a right to expect major policy questions ~~to be~~ debated at the one time that they are in a position to influence their elected representatives and leaders.

Frankly, we believe that the question of taxes and spending ought to be a major focus of political debate this fall. The American people have a right to expect those who aspire to public office in this country to share their concern about economic problems, inflation, and, yes, even taxes. That, after all, is what our political system is all about.

That's why it was so shocking the other day to read that a high Administration official's testimony last week denounced what he termed "political" tax cuts. He was, I realize, merely reflecting the President's view, but that hardly excuses him.

Senator Long's response to this as reported in The Washington Post was precisely on point. You will recall that he indicated then that he didn't know when there wouldn't be a political dimension to such a discussion. He was right, of course, and we're sorry that the Administration doesn't recognize the truth in this.

We can understand the President's desire not to talk about taxes. In the past four years while no one was watching, his government quietly let our taxes rise by a sum equal to nearly $4,000 per American family, with over $1,000 per family taken out of our hide in this election year, alone.

And at the same time, some members of Congress have started to talk about tax relief as an expenditure of government money -- as if the taxpayer's money is not his, but theirs, and that by giving him relief they are irresponsibly giving away money that properly belongs in the U.S. Treasury.

Well, it isn't so. It never was -- and it never will be. The government does not have a right to take everything it wants -- only what it legitimately needs and what the people allow it to take.

As this committee and the Congress analyzes the specific proposals before it, however, we would urge that they be viewed in context.

The problem today is not just that individual and business taxes are too high. They are high and the Administration is resisting the pressure to lower them because we are facing huge deficits at the federal level which are, in turn, fueling the inflationary pressure that drives people into still higher tax brackets.

In short, we find that we have consciously or unconsciously managed to construct a closed circle in which each problem makes the others worse.

Thus, we are told that we can't cut taxes because that would increase the deficit. But the current tax rates are discouraging investment, increasing unemployment, and thereby requiring increased federal spending which also tends to increase the deficit.

And, indeed, we are now told that these very problems are the cause of the higher deficits.

Cutting the tax rates as some are proposing will help break that circle as will the accelerated and simplified depreciation proposals that others are urging, but if nothing else is done, we won't have solved anything.

To break the spend/tax/inflation circle will require immediate and significant cuts in government spending. A tax cut alone won't be enough.

We have urged a long-term solution in the form of a Constitutional spending limit, but we recognize today that short-term remedies are also needed.

Our testimony provides additional detail for our tax relief proposal, along with specifics for reducing government spending.

Suffice it to say that there is no program, no agency, no department in this government that couldn't save money between now and the end of the current fiscal year. We don't advocate cutting essential social services or the capability this nation needs to defend itself.

But when the kind of waste detailed by a sub-committee of the Senate last week is allowed to go on; when government agencies are allowed and even encouraged to go on year-end spending binges that cost the taxpayers billions of dollars, things are out of control.

The job of this government -- of the Executive and Legislative branches -- must be to take control now. The tools are there and must be used; spending can be deferred. Funds can be impounded to save money so that you can provide the citizens of this country with the relief they need and have every right to expect.

In conclusion, we urge that at least one-fourth of the 1980 tax increase be given back to the American taxpayer; and that at least one-half of the tax increases planned for future years be recinded.

And we urge at the same time that you take whatever steps might be necessary to give voice to the urgent need for a halt to runaway government spending.

Addendum

Scheduled Tax Increases for 1980, 1981, and 1982

The President's 1981 budget shows planned tax increases for the next three year period ending in 1982 of $253 billion. $64.3 billion of this tax increase was planned for 1980 and another $88 billion increase for 1981. $50 billion of the 1981 tax increase is attributable to bracket creep, the windfall tax, and increases in the social security taxes.

The overall increase in tax burden over this three year period is 69.8%. Individual income taxes will be up $101 billion or 46.3%. Social Security taxes are scheduled to rise $75.5 billion or 52.7% and corporate taxes are scheduled to increase $70.3 billion or 85%.

Tax Relief Urged

We urge that tax relief equal to at least one-fourth of the planned tax increases be enacted at once for 1980; and one-half of 1981 and 1982 tax increases be recinded; and tax relief equivalent to at least one-fourth of the planned tax increases be granted for 1983 and in 1984. We recommend that this be allocated between individual tax relief and job-producing tax relief in proportion to the amount of planned tax increases for these two categories. The proposed allocation of this tax relief is summarized in Table II.

This program of tax relief and spending control will pair federal spending to 18.7% of the Gross National Product by 1984 at a savings to the taxpayer of $184 billion over five years. The Jones Spending Limit bill (HR 4610) at 18.5% of GNP and eight other spending limit statutes pending in the House would produce spending at less than our recommended level of 18.7%.

Both Congress and the President have the power to cut federal waste immediately (during the fourth quarter, 1980).

Wasteful and excessive federal spending can be curtailed immediately. The first place to start would be a slow down in the practice of "federal dumping."

Both the President and the Congress have the power to make such cuts -- and to make them in fiscal year 1980. We could care less which branch of government makes these cuts -- but it is essential that they be made.

The Congressional Budget and Impoundment Control Act of 1974 grants the President certain powers to control (with the active or negative consent of the Congress) the rate at which funds are spent. The Act impowers the President to curtail spending through the device of deferrals and rescisions.

During the last two years of the Ford administration (the first two years that the Act was in effect), the President proposed rescisions and deferrals which, on the average, amounted to 5.76% of federal outlays: 60% of Ford spending cutbacks were approved and put into effect.

Applying the same percentages to the 1980 budget would produce $34 billion in spending cutback proposals and $21 billion in actual spending reductions.

Federal Dumping

Restraining year-end splurges and budget obligations by the federal agencies is essential.

Unspent appropriations are obvious targets for budget reductions -- a fact understood by administrators, budget officers, and legislators. From one perspective, unexpended balances represent an opportunity for cost savings. But they are also a point of vulnerability. Thus, agency administators often strive to expend their entire appropriation, a practice which has come to be known as "use it or lose it" or "federal dumping."

For example, the General Accounting Office found that in the last two months of fiscal year 1979, HUD obligated 47.2% of its annual budget. GAO says this practice has continued since the year 1976. Further, the obligations (to be used for low income housing and public housing assistance) were partly "deobligated" once they had served their purpose in maintaining the budget level. As a result, many housing project sponsors who had been earlier advised by HUD of tentative funding approval found their funds had been withdrawn, creating what one House member has called "a multi-billion dollar slush fund."

In addition to HUD, notable surges in fiscal year 1979 obligations during August and September included EPA, 41.7%; Commerce, 30.3%; Interior, 23.1%; HEW, 22.9%; DOE, 22.8%; and the Postal Service, 22.1%.

The General Accounting Office charges that these practices are used to "prevent funds from lapsing, to give the appearance of greater achievement than has actually transpired, or to recognize the potential liabilities that are at best speculative."

According to the General Accounting Office, seven of the major federal agencies extended more than 20% of the total 1979 outlays during the last two months of the fiscal year. One approach would be to limit agency spending in the last two months to no more than the rate of spending during the previous ten months; with provision for necessary exceptions to be authorized by the director of the Office of Management and Budget.

Applying NTLC's proposed year-end spending limit to these seven agencies would have produced a savings of $21.22 billion in 1979.

We attempted to learn of obligations so far incurred in 1980 but found that there is no current central compilation of agency obligations. The only documentation that we know of is a treasury report that runs four to five months behind.

Nonetheless, it is reasonable to assume that savings of similar magnitude can be achieved in 1980.

Calculations of these savings is given in Table III.

PLANNED TAX INCREASES[1]

	Percentage Increase from Previous Year			
Type of Tax	1980	1981	1982	% Increase over the 3 year period
Individual Income Tax	9.6%	15.0%	16.1%	46.3%
Social Security Tax	14.5%	15.5%	15.2%	52.7%
Corporate Taxes	21.9%	16.2%	17.7%	85.0%
All Taxes	13.8%	17.2%	27.4%	69.8%

[1] Source: derived from Budget Receipts by Source, The Budget of the U.S., Fiscal Year 1981, p.39

TABLE 1

65-969 O - 80 - 69 (pt.3)

TAX RELIEF ALLOCATION

	Amount of Tax Relief (billions of $'s)				
	1980	1981	1982	1983	1984
Job of Producing Tax Relief	15.5	36	56	60	69
Tax Relief for Individuals		40	69	92	115
Cumulative Tax Relief	15.5	76	125	152	184

TABLE II

1979 Year-End Federal Dumping

FY 1979 (billions)

Agency	Total 1979 outlays	Outlays during Jan. - July	August & September outlays		Total 1979 outlays if last 2 months spending constrained to spending rate during 1st 10 months	Savings available for Tax Relief under year-end spending limit
			$'s	%		
HUD	$34.072	$17.965	$16.107	47.2%	$21.558	$12.514
EPA	$ 5.356	$ 3.118	$ 2.238	41.7%	$ 3.742	$ 1.614
HEW	$62.687	$48.327	$14.360	22.9%	$57.992	$ 4.695
Commerce	$ 2.991	$ 2.084	$ .907	30.3%	$ 2.500	$ .491
Interior	$ 6.026	$ 4.631	$ 1.395	23.1%	$ 5.557	$ .469
Postal Service	$14.774	$11.501	$ 3.273	22.1%	$13.801	$ .973
DOT	$6.201	$ 4.781	$ 1.420	22.8%	$ 5.737	$ .464
	TOTAL POTENTIAL SAVINGS					$21.22

TABLE III

Senator DURENBERGER. The hearing is adjourned.

[Whereupon, at 2:05 p.m., the committee adjourned, to reconvene subject to the call of the Chair.]

[By direction of the chairman the following communications were made a part of the hearing record:]

TESTIMONY OF
REPRESENTATIVE CLARENCE J. BROWN

MR. CHAIRMAN,

THIS IS A POLITICAL YEAR. SPEECHES ARE LONG. TEMPERS ARE SHORT.

BUT TIME IS SHORT TOO, BOTH FOR THIS CONGRESS AND FOR THE ECONOMY. SO I SHALL BE BRIEF.

I URGE THE COMMITTEE TO TAKE SHELTER FROM THE POLITICAL STORM BY BASING A TAX CUT ON SOUND ECONOMIC PRINCIPLES WITH AS LITTLE POLITICAL INVOLVEMENT AS POSSIBLE.

THIS SAME APPROACH HAS TURNED THE HIGHLY PARTISAN, IDEOLOGICALLY DIVERSE JOINT ECONOMIC COMMITTEE INTO A UNITED BIPARTISAN VOICE FOR ECONOMIC GROWTH WITHOUT INFLATION.

THE LAST FIFTEEN YEARS OF VARIOUS TYPES OF TAX CHANGES, GYRATING INFLATION RATES, AND SUPPLY SHOCKS HAVE RATTLED THE ECONOMIC PROFESSION AS MUCH AS THE ECONOMY. OLD THEORIES HAVE BEEN DONE IN. NEW CONSIDERATIONS HAVE BEEN PUSHED TO THE FRONT. LET ME LIST THEM, IN SOMEWHAT ABBREVIATED FORM.

1. TAX CUTS DO NOT WORK SIMPLY BY REDUCING THE AVERAGE TAX BURDEN AND GIVING PEOPLE OR BUSINESSES MORE MONEY TO SPEND, BECAUSE THE GOVERNMENT BORROWS THE MONEY RIGHT BACK. IT IS THE SHAPE OF THE TAX CUT THAT MATTERS, NOT THE SIZE. DEMAND MANAGEMENT IS A MUCH WEAKER TOOL THAN PEOPLE USED TO THINK.
2. TAX RATES -- NOT TAX DOLLARS, TAX RATES -- CONTROL THE AFTER TAX RATES OF RETURN TO VARIOUS ACTIVITIES. SPECIFICALLY, MARGINAL TAX RATES -- NOT AVERAGE TAX RATES --

GOVERN THE REWARD TO ADDED INVESTMENT, ADDED SAVINGS, AND ADDED LABOR. TO ENCOURAGE MORE SAVING, INVESTMENT, WORK EFFORT, AND GROWTH, AS OPPOSED TO CONSUMPTION AND LEISURE, IT IS THE MARGINAL RATES THAT MUST BE LOWERED. IT IS THE RISE IN THESE RATES FOR THE LAST FIFTEEN YEARS THAT HAS STRANGLED SUPPLY AND BROUGHT AN END TO GROWTH. THIS IS NOT POLITICAL HYPE. IT IS AN ECONOMIC FACT OF LIFE WHICH ECONOMISTS TRIED TO IGNORE FOR FORTY YEARS, AND WHICH THE INFLATION OF THE LAST FEW YEARS HAS MADE SO OBVIOUS THAT IT HAS BEEN REDISCOVERED WITH MUCH PAIN AND ANGUISH.

3. INVESTMENT AND FEDERAL DEFICITS ARE FINANCED BY MONEY THAT HAS BEEN SAVED OR BORROWED. THIS BORROWED MONEY CAN BE NEW MONEY OR OLD MONEY. IF THERE IS ENOUGH PERSONAL AND BUSINESS SAVING TO FINANCE BOTH THE DEFICIT AND A HEALTHY AMOUNT OF INVESTMENT, THEN THE BORROWING IS OLD MONEY AND THE COUNTRY WILL GROW WITHOUT INFLATION. IF SAVING IS TOO LOW, THEN INVESTMENT IS CROWDED OUT UNLESS THE FEDERAL RESERVE BUYS UP THE BONDS WITH NEW MONEY, WHICH CREATES INFLATION.

4. TAX CUTS WHICH GO STRAIGHT INTO SAVINGS ENLARGE THE SAVINGS POOL FOR FINANCING DEFICITS AND INVESTMENT. THEY ARE NOT INFLATIONARY. LARGER DEPRECIATION ALLOWANCES GO STRAIGHT INTO CORPORATE SAVING AUTOMATICALLY, ENLARGING TOTAL NATIONAL SAVING BY AS MUCH AS THE DEFICITS, AND WILL ENCOURAGE FURTHER SAVING VIA RETAINED EARNINGS BESIDES. IN THE SAME FASHION, CAREFULLY DESIGNED PERSONAL SAVINGS INCENTIVES ARE AVAILABLE (I HAVE INTRODUCED TWO) WHICH WILL ENCOURAGE INCREASES IN PERSONAL SAVINGS FAR LARGER THAN THE COST OF

THE BILLS TO THE TREASURY. THAT IS THE CRITERION ON WHICH TO MEASURE THE VALUE OF A SAVINGS INCENTIVE.

5. FINALLY, THERE IS NO NEED TO SLASH REVENUES TO RESTRUCTURE THE TAX CODE. THE REVENUE INCREASE FROM THE EFFECT OF INFLATION ON THE PROGRESSIVE INCOME TAX IS ENORMOUS, MOUNTING TO WELL OVER $100 BILLION ANNUALLY BY 1985. THIS IS REVENUE GROWTH IN EXCESS OF THE RATE OF INFLATION, IN EXCESS OF THE AMOUNT NEEDED TO KEEP GOVERNMENT SPENDING CONSTANT IN REAL TERMS. THERE IS NO NEED TO KEEP IT. IT CAN BEST BE USED TO GET SAVINGS, INVESTMENT, AND EMPLOYMENT GROWING AGAIN. I REFER YOU TO RECENT TESTIMONY BEFORE THIS COMMITTEE BY DR. MARTIN FELDSTEIN FOR A STRONG ENDORSEMENT OF THIS VIEW.

PROMPT ACTION TO IMPROVE DEPRECIATION ALLOWANCES AND SAVINGS INCENTIVES ARE THE TWO MOST IMPORTANT SUPPLY SIDE STEPS THE COMMITTEE COULD TAKE. IT IS CERTAINLY TRUE THAT ANY TAX CUTS UNDER CONSIDERATION FOR THE NEXT FEW YEARS SHOULD BE SUPPLY SIDE TAX CUTS. IT IS <u>NOT</u> TRUE, HOWEVER, THAT ALL SUPPLY SIDE TAX CUTS ARE FOR BUSINESS. PERSONAL TAX RATE REDUCTIONS THAT RAISE THE SUPPLY OF SAVINGS OR LABOR ARE ALSO ON THE SUPPLY SIDE. IN SEEKING TO BALANCE BUSINESS TAX REDUCTION WITH PERSONAL TAX CUTS, THE COMMITTEE SHOULD NOT ASSUME THAT IT MUST WASTE THE PERSONAL PART OF THE TAX PACKAGE BY GIVING UP REVENUE IN AN INFLATIONARY DEMAND SIDE WAY.

I URGE THE COMMITTEE TO TAKE THE FOLLOWING STEPS.

1. REPORT OUT A DEPRECIATION BILL TO RAISE THE AFTER-TAX REWARD TO INVESTMENT, TO COUNTER THE EFFECT OF INFLATION ON THE DEPRECIATION ALLOWANCES, WHICH NOW PRODUCES

EFFECTIVE TAX RATES SHARPLY HIGHER THAN STATUTORY RATES. THE ASSET LIVES LAID DOWN BY TREASURY ARE FUNDAMENTALLY ARBITRARY, AND BEAR NO RELATIONSHIP TO THE TRUE RATE OF ECONOMIC DEPRECIATION AND OBSOLESCENCE OF EQUIPMENT IN A COMPETITIVE HIGH TECHNOLOGY WORLD. THE COMMITTEE SHOULD NOT HESITATE TO ABANDON THE USEFUL LIFE CONCEPT IN FAVOR OF EITHER THE CONABLE-JONES OR ULLMAN APPROACHES, OR EVEN FIRST YEAR WRITE-OFF. THE FASTER THE WRITE-OFF, THE BETTER.

2. REPORT A BILL TO REDUCE THE MARGINAL TAX RATES ON SAVINGS INCOME. THIS CAN BEST BE DONE BY SEPARATING INTEREST, DIVIDEND AND CAPITAL GAINS INCOME FROM EARNED INCOME. I HAVE A BILL WHICH DOES THIS, H.R. 6400. EACH TYPE OF INCOME, EARNED INCOME ON THE ONE HAND AND INTEREST, DIVIDEND AND TAXABLE CAPITAL GAINS ON THE OTHER, WOULD START OVER IN THE 14 PERCENT BRACKET. EACH COULD RISE TO A MAXIMUM TAX OF 50 PERCENT. THE IDEA IS TO MOVE SAVINGS INCOME INTO THE LOWER BRACKETS, INSTEAD OF STACKING THE TWO TYPES OF INCOME ON TOP OF EACH OTHER TO REACH THE HIGHEST BRACKETS. THESE HIGH RATES IN CURRENT LAW ENCOURAGE CONSUMPTION AND THE USE OF TAX SHELTERS, AND DISCOURAGE AND MISALLOCATE SAVING. H.R. 6400 IS SIMPLE; IT SHARPLY INCREASES THE RATE OF RETURN TO SAVING; IT IS CHEAPER THAN ROLLOVER BECAUSE TAXES ARE NOT DEFERRED FOR YEARS -- THEY ARE PAID ANNUALLY, ALTHOUGH AT REDUCED RATES.

ANOTHER GOOD APPROACH IS A 25 PERCENT EXCLUSION OF ALL INTEREST AND DIVIDEND INCOME IN EXCESS OF THAT ALREADY COVERED BY THE $200-$400 100 PERCENT EXCLUSION. I HAVE PROPOSED THIS IN H.R. 6375. THE POINT IS TO GET THE TAX RATES DOWN AND THE INCENTIVES UP ON ANY ADDED SAVINGS INCOME, WITHOUT CEILINGS WHICH CUT OFF THE INCENTIVES.

A TABLE COMPARING THESE TWO BILLS AND THE ROLLOVER APPROACH (H.R.5779) IS ATTACHED.

3. IF A LESS TARGETED GENERAL TAX CUT IS TO BE CONSIDERED, IT SHOULD ALSO BE A REDUCTION IN THE MARGINAL TAX RATES, OR AT LEAST A SUBSTANTIAL WIDENING OF THE TAX BRACKETS. CHANGES IN THE PERSONAL EXEMPTION, THE STANDARD DEDUCTION, AND OTHER SUCH "FIRST DOLLAR" CREDITS DO NOTHING TO IMPROVE INCENTIVES AT THE MARGIN, WHERE THEY COUNT.

LET ME END BY EMPHASIZING THE MAIN LESSON OF THE LAST FIFTEEN YEARS. IT IS THE SHAPE OF THE TAX CUT THAT MATTERS, NOT THE SIZE. A TAX CHANGE WILL SUCCEED OR FAIL DEPENDING ON WHETHER OR NOT IT CHANGES MARGINAL TAX RATES AND INCENTIVES. THE AMERICAN PEOPLE AND THE AMERICAN ECONOMY ARE READY TO GROW. ALL WE NEED IS TO GET BACK A LITTLE OF THE AFTER-TAX INCENTIVE THAT INFLATION HAS TAKEN AWAY.

DUAL RATE STRUCTURE (H.R.6400) VS. ROLLOVER (H.R.5779) VS. 25% DIVIDEND/INTEREST EXCLUSION (H.R.6375)

AFTER-TAX INCOME FROM INVESTING AN EXTRA $100 AT 7% OVER TIME FOR INDIVIDUALS IN VARIOUS TAX BRACKETS.

	TAXPAYER A	TAXPAYER B	TAXPAYER C	TAXPAYER D
Income[1]	$20,000	$40,000	$120,000	$240,000
Interest and dividends[2]	1,800	3,000	25,000	75,000
Current tax bracket[3]	24%	43%	64%	70%
Bracket, under H.R.6400[4]	14%	16%	32%	50%
Tax rate, under H.R.6375[5]	18%	32.25%	48%	52.5%

Years Invested	A: H.R.6400	A: H.R.5779	A: H.R.6375	B: H.R.6400	B: H.R.5779	B: H.R.6375	C: H.R.6400	C: H.R.5779	C: H.R.6375	D: H.R.6400	D: H.R.5779	D: H.R.6375
1	$ 6	$ 5	$ 6	$ 6	$ 4	$ 5	$ 5	$ 3	$ 4	$ 4	$ 2	$ 3
5	34	31	32	33	23	26	26	14	20	19	12	1[illegible]
10	79	74	75	77	55	59	59	35	43	41	29	39
20	222	218	205	214	164	153	154	103	104	99	86	92
30	478	503	434	455	377	302	304	238	192	181	198	167
50	1,760	2,163	1,529	1,641	1,622	914	923	1,025	498	459	854	[illegible]

[1] Total income wages, interest and dividends.

[2] Typical interest and dividend earnings for a taxpayer of the given total income (for those with any interest and dividends at all).

[3] Current top tax bracket of taxpayer, applicable to any added wages, interest, or dividend income.

[4] Lower top tax bracket of taxpayer on added interest and dividend income under H.R.6400.

[5] Effective top tax rate of taxpayer on added interest and dividend income under H.R.6375.

SUPPLEMENTAL TO STATEMENT OF PETER J. HART OF PRICE WATERHOUSE & CO.

TAX DEDUCTIONS FOR EMPLOYEE CONTRIBUTIONS TO RETIREMENT PLANS OR IRAs

Price Waterhouse strongly urges that any tax cut legislation include a provision which would permit employees who participate in tax qualified retirement plans to claim tax deductions for contributions they might make to either the retirement plan or to an Individual Retirement Account (IRA).

Under present law, no tax deduction is permitted for employee contributions to qualified plans, and an employee who is an active participant in such a plan is precluded from contributing to an IRA. The change we suggest would accomplish a number of important objectives.

Deductions would greatly enhance the ability of employees to save for retirement. That would be helpful in alleviating the much criticized lack of responsiveness of the private pension system to inflationary pressures on retired employees, since employees would have an incentive to put aside funds for retirement over and above the pensions their employers are able to provide. Moreover, the additional savings generated during working years would be counter inflationary. This change would also reduce the pressures which many employers presently encounter from employees, particularly young employees, who would like to opt out of participating in the employer-sponsored retirement plan so as to be eligible to establish IRAs. Those pressures have been responsible for some employer-sponsored plans being terminated.

Tax deductions for employee contributions would also make it possible for employers, particularly small businesses, to use employee contributions as a funding mechanism for improving the basic retirement benefits provided by the plan, or in some cases to preserve a plan which financial considerations might otherwise force an employer to terminate. At the present time, tax considerations make mandatory employee contributions a burdensome and

Price Waterhouse & Co.

inefficient manner of funding plan benefits. Providing deductibility would allow cooperative financing efforts by both employer and employees to maintain or improve benefits.

In summary we believe deductible employee contributions would significantly strengthen the private pension system, enhance savings and capital formation, and mitigate the inflationary effects which might otherwise be associated with tax reduction.

Michael F. Klein, Jr.
New York, New York
August 1, 1980

Price Waterhouse & Co.

STATEMENT OF M. LEE RICE, PRESIDENT,
OGDEN TRANSPORTATION CORPORATION, ON BEHALF OF
THE NATIONAL MARITIME COUNCIL,
THE SHIPBUILDER'S COUNCIL OF AMERICA,
THE U.S. MARITIME COMMITTEE, INC., AND THE
AMERICAN MARITIME ASSOCIATION

Mr. Chairman and members of the Committee, my name is Lee Rice. I am president of Ogden Transportation Corporation and Chief Executive Officer of Avondale Shipyards, companies engaged in the construction and operation of maritime vessels. I am also Chairman of the Executive Committee of the National Maritime Council; a Director and member of the Executive Committee of the Shipbuilder's Council of America; and Chairman of the U.S. Maritime Committee, Inc. This statement is submitted on behalf of the above companies and organizations. In addition, the American Maritime Association supports this statement. Together, the above organizations represent a substantial part of the U.S. flag independent shipping fleet and most of the domestic private shipbuilding capacity.

Introduction

My statement deals with an important element of capital cost recovery: the type of capital recovery needed by the shipping industry, including ship construction companies and companies engaged in national and international commerce in cargo carrying ships.

On March 19, 1980 I appeared before the House Ways and Means Committee in connection with the tax provisions of H.R. 4769, the Omnibus Maritime Regulatory and Revitalization Reform Bill. In marking up the tax provisions of H.R. 4769, the House Ways and Means Committee voted to delete Title IV, containing a series of tax provisions, pending more general consideration of capital cost recovery for the business community in general. The present hearings before the Senate Finance Committee (as well as simultaneous hearings now occurring before the Ways and Means Committee) now raise these broader issues of depreciation and other capital cost recovery proposals. We believe it is now appropriate for this Committee to consider tax proposals relating specifically to the operators of merchant marine vessels and, as a corollary, to the shipbuilding industry.

A key provision of Title IV of H.R. 4769 would permit five-year depreciation for the construction cost of domestically built U.S. flag merchant ships and ten-year depreciation for U.S. flag ships built outside the United States.

This provision, along with others in Title IV of the maritime reform bill, recognizes that the rebuilding of the U.S. flag merchant marine fleet requires positive incentives for the users of ocean transportation to change existing patterns of procurement of shipping services, both bulk and liner. At the present time these services are dominated by foreign-flag vessels. The incentive chosen is cost of service parity with foreign competitors, to be coupled with aggressive U.S. ownership operating style.

We need a major increase in U.S. flag and U.S. built vessels. To achieve this goal, we must recognize the key role which capital recovery plays in international ocean transportation. Under present accelerated depreciation rules, the shortest allowable useful life of a vessel under the asset depreciation range system ("ADR") is 14.5 years. This period is allowed regardless of where a ship is built; even foreign built ships owned by U.S. taxpayers are entitled to the same depreciation life as a U.S. built ship.

The depreciation provision that appears in the Maritime Reform Bill is not cast in stone. However, I urge that shipping be included in any accelerated cost recovery rules which the Committee adopts. Specifically, we believe that any new shipping depreciation rules should create a differential in favor of new ships built and registered in the United States, rather than abroad. I urge you to accept two basic policy propositions: First, shipping should receive faster cost recovery than is now provided by U.S. tax law. If owners of U.S. flag vessels are to be competitive in world shipping markets -- as present policy dictates as a priority national objective but does not implement -- parity in capital cost recovery is essential. Such parity does not now exist.

Second, a bias ought to be created in favor of U.S. built ships. We believe that U.S. flag shipping must be granted capital recovery incentives comparable to the five year vessel life proposed in H.R. 4769. We are also convinced that asset life is an effective method to bias an owner's choice of vessel origin, if capital cost recovery of a foreign built vessel is significantly longer than the depreciable life of a U.S. built vessel.

The Present Crisis in Maritime Policy

On March 19 I discussed before the Ways and Means Committee the precipitous decline in capacity within our U.S. flag shipping and domestic shipbuilding industries, and the need for legislative assistance. I pointed out that international shipping and ship construction are, at the present time, dominated by foreign built and foreign registered vessels.

Over the past three decades, our country has declined from its position as world leader in shipping and shipbuilding to reach a point, as we move into the 1980's, where as to both shipping and shipbuilding, we are heavily dependent on foreign vessels to carry the bulk of our own country's foreign trade.

This country's basic policy however, has long been that a merchant marine operating under the U.S. flag and manned by U.S. citizens -- and a U.S. shipbuilding industry with substantial capacity -- are essential to the nation's welfare. Further, these national assets should be provided through private ownership, fostered by government aids where necessary in order to make the private fleet internationally competitive.

The shipping industry -- companies which build ships and companies which operate ships in commerce -- competes on two fronts. It competes with shipbuilders and merchant marines of other countries. It also competes with other American companies for productive resources, including capital and labor. Many foreign governments, particularly our most intense competitors, subsidize their maritime industries through a variety of tax and nontax aids. Our government also assists the U.S. maritime industry through direct subsidy and tax assistance programs; however, these existing aids have not been adequate in helping our industry compete with the Soviet Union, with Japan and with other competitors on the international maritime scene. Because of this situation, the Omnibus Maritime Regulatory Reform bill currently under consideration by the House Merchant Marine and Fisheries Committee would make a number of improvements in existing operating-differential and construction-differential subsidy programs, and in existing tax incentives.

A. Shipping Companies

We must do more to enable the U.S. flag to recapture a fair share of international commerce -- as well as of our own foreign commerce -- in a market dominated increasingly by government-controlled fleets, international consortiums and cartels, and by a wide array of direct and indirect subsidies (including tax incentives).

At the end of World War II, more than half of the merchant shipping of the world was carried in

U.S. flag vessels. Today, however, the U.S. fleet carries only about 5 percent of our international trade by tonnage, as opposed to comparable carriage of over 65 percent by the Soviet Union, 44 percent for Japan, 34 percent for the United Kingdom, and 34 percent for France. The United States stands alone in tolerating, even encouraging, movement of its own trade in foreign-flag ships.

You do not need to be reminded of our dangerous dependence on foreign petroleum. You should also recognize that we must now import 68 of 71 critical raw materials such as manganese, cobalt, and nickel. At present, U.S. flag vessels transport less than 4 percent of our imported petroleum and virtually none of our dry bulk export or import cargoes. Nor does U.S. flag fleet capacity exist to meet this cargo demand. Our U.S. flag capability in scheduled liner international trades is higher, yet its share of export-import cargoes is in decline.

This situation exposes us to embargoes and to price cartels similar to OPEC. The national security implications of this fleet deterioration are brought into sharp focus by comparing the Russian and

U.S. fleets in 1950 and today. In 1950 we had over 3,500 ships totalling over 37 million deadweight tons. Today we have only 576 active and reserve oceangoing ships, of which 495 have direct military support capability and, in a national emergency, would be subject to control by the U.S. Navy. This would leave approximately 81 vessels to transport commodities essential for the functioning of our domestic economy. Since 1950 the Russian fleet has been increased from 437 ships and a carrying capacity of under 2 million deadweight tons to over 2,500 vessels totalling well over 20 million tons, of which 1,650 are modern ships suitable to support military forces. The remaining vessels are available for political purposes and to earn "hard" currencies.

Defense Department testimony before the House Merchant Marine Subcommittee has shown plainly that:

1. The U.S. does not have enough military sealift to provide combat support for U.S. forces already overseas.
2. The U.S. does not have enough sealift to reinforce U.S. forces in NATO under combat conditions.

3. The U.S. does not have enough sealift to transport U.S. forces to the Middle East and support them in combat.[1/]

4. U.S. airlift can provide less than 10 percent of the combat requirements, and only if sufficient airfields are available, adequately suplied with fuel and ground maintenance crews, and not under attack.

High ranking naval officers, led by Admiral Thomas H. Moorer, have emphasized that sealift is essential, and that this is an area where our country is in trouble:

> "There is no war plan, no contingency plan in the entire inventory in the Pentagon that does not assume at the outset that we are going to control the seas and have the ships necessary to support the air and army forces we put ashore."

This assumption rests on the availability to us of the NATO fleet in time of crisis or war. Recent events in the Middle East and the mixed reactions of our allies underscore the serious situation in which

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1/Statement of Vice Admiral Kent G. Carroll and Lt. General Arthur G. Gregg before the Merchant Marine Subcommittee, Merchant Marine and Fisheries Committee, U.S. House of Representatives, December 13, 1979.

prolonged neglect of our merchant marine has placed us. For me, as a citizen, it is chilling to reflect that President Carter's forebearance with Iran and repeated ruling out of military force may ultimately be motivated by an accurate perception of the military realities of our defense situation.

B. Ship Construction

Turning now to shipbuilding, elaborate testimony before the House Merchant Marine Subcommittee has shown that without new legislative initiatives to induce vessel owners to purchase ships in the United States, this country's shipbuilding capacity will fall substantially below the level needed for national security.

Without new inducements, shipyard employment will fall, during 1982-1984, to about 60 percent of the required shipyard mobilization base level. A recent article in the New York Times reported that the shipbuilding industry has 160,000 workers in all -- this is down from 180,000 in late 1977.[2]

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[2] New York Times, July 23, 1980, p. D1.

Within this total capability, the best estimates are that only about three-fourths of this total represents useful capability to support national security needs. If present trends continue, we are in danger of losing the minimum base of skilled manpower which is needed to serve in a short-term national emergency and which must be expanded if a more protracted crisis or war occurs. We are also in danger of losing the supplier base to our marine construction market, because it is perceived by many suppliers as a tiny market in danger of shrinking further because of the lack of a meaningful U.S. maritime policy.

TABLE 1 indicates projected future levels of shipyard employment within the mobilization base through 1986. These manning levels are compared to the "sustaining" employment level of 116,500 employees, which is a realistic required manning objective derived from testimony of both the Department of Defense and the Department of Commerce. Assuming that present Administration plans to increase the 5-year naval shipbuilding plan to 95 ships is implemented, the level of manpower utilization still falls far below the required level, as shown in TABLE 2. Clearly, we cannot allow the nation's security to be put in such jeopardy. In addition to the skilled shipyard workers who will be permanently lost to the industry, we will lose the engineering and management skills which form the heart of our expansion base if a national emergency should arise.

While the U.S. flag merchant fleet and our shipbuilding industry have been allowed to decline in capability, our economic and political competitors have moved aggressively to strengthen their maritime industries. Although different foreign countries have varying objectives and methods, including special tax incentives, to promote and maintain these capabilities, it is generally true that no other major industrial power has allowed itself to become so dependent on others for shipbuilding and shipping services as has the United States. The Russians have become a major shipping power. They operate their fleet for political purposes, as a naval auxiliary, and as an important -- and effective -- means to earn hard currency to finance their food and technology imports from the West.

Similar currency conversion goals motivate the Peoples Republic of China; their fleet has grown faster in the last five years than any other in the world. For Japan, shipping and shipbuilding are logical extensions of their fundamental national economic strategy: importing raw materials and processing and exporting finished products. By using their own shipping, they buy FOB and, hence, minimize the cost of imports and the demand for foreign exchange and, similarly, they sell CIF to maximize price and foreign earnings. The United States, which shares in all these shipping and shipbuilding industry needs, has no effective policy at all.

C. Summary

In summary:

(1) Our existing U.S. flag merchant fleet must be expanded by tax incentives and other means to serve the direct national security requirements I have described. The fleet must be large enough and flexible enough to serve the nation's international economic needs and to protect us against excessive

reliance on vessels of other countries for the water transport of our vital exports and imports.

(2) The decline in workload in this nation's shipbuilding and ship repair yards beyond 1980 must be stemmed. The capacity of this industry to met our vital defense requirements, as defined by the Departments of Defense and Commerce, must be improved greatly.

(3) The solution to these problems lies in stimulating a commmercial shipping and shipbuilding program through tax and other incentives. The tax proposal I am making to you reflects the specific circumstances and needs of our industry. It reflects the kind of capital cost recovery which will keep us competitive not only with the merchant marine of other countries but also with other American industries.

Before discussing tax depreciation rules in further detail, it will be useful, I believe, to outline briefly the basic structure of the international merchant marine industry.

Structure of International

Merchant Marine Industry

Vessels in the international merchant marine industry fly the "U.S. flag" or a "foreign flag." References to "flag" are to the one nation where a vessel is "registered" (in the same sense that an automobile is registered in one U.S. state). Usually, the country of registry ("flag country") requires that the vessel be nominally owned by a corporation incorporated in that country. However, the country of incorporation of the beneficial corporate owner of a vessel may be, and often is, different from the country where the ship is registered.

A. U.S. Flag Vessels

U.S. flag vessels must be owned by U.S. corporations or individuals,[3/] must use U.S. citizen crews[4/] and, in order to qualify for many governmental subsidies, must be built in

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3/ 46 U.S.C. §221.

4/ 46 U.S.C. §1132(a).

U.S. shipyards.[5] While U.S. operating and construction costs are substantially higher than foreign costs for the same services,[6] the merchant marine provisions of the U.S. Code reflect a policy aimed at making the U.S. shipbuilding industry and the U.S. flag fleet competitive in international ocean trade.[7] The maritime Administration carries out this policy through a number of programs.[8]

5/46 U.S.C. §1180. The crew requirement creates higher operating costs and is an important competitive disadvantage to registering vessels under the U.S. flag. U.S. operators can buy vessels overseas for U.S. registry if they intend not to apply for most federal subsidies. Furthermore, in the world market for vessels today, most foreign governments provide substantial subsidies to vessel purchases. See generally Maritime Administration, Maritime Subsidies (1978). The higher cost of building and operating U.S. built vessels thus produces a significant disadvantage.

6/Antitrust Division, Department of Justice, The Regulated Ocean Shipping Industry, 20, 48-51 (1977).

7/46 U.S.C. §1101.

8/These provide (a) operating subsidies, (b) construction subsidies, (c) guarantees for ship mortgages, (d) subsidized purchases of obsolete vessels, (e) reimbursement of construction costs for certain national defense features conforming to naval standards, (f) war risk insurance during wartime, and (g) enforcement programs which restrict coastwise trade and federal government cargoes to U.S. registered vessels. Maritime Subsidies, supra note 5, at 168-176.

The overall aim of these programs is to preserve a subsidized U.S. flag fleet which can compete in world trade. (Some nonsubsidized U.S. companies compete in foreign trade by using foreign built vessels and low cost vessels near the end of their useful operating lives.) The subsidized and nonsubsidized operators together form a U.S. fleet which today in only tenth in size in the world, having slipped from fifth place in 1966.[9]

B. Foreign Flag Vessels

In the case of industrialized foreign countries, much or most of the merchant marine capacity registered in each country is beneficially owned by citizens or residents of that country. Vessels registered in these countries are eligible for numerous government subsidy programs. Much or most of the merchant marine capacity of less developed countries is "internationally" owned -- that is, owned by residents of other countries. In both cases, these foreign flag vessels take advantage of low foreign construction costs, low wages and

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9/Maritime Administration, "Merchant Fleets of the World," 11 (September 1976); id. 18 (January 1979).

other low operating costs. Some foreign governments with aggessive maritime policies, especially communist countries, themselves own the major ship-operating companies within their countries. These companies serve foreign and military policy goals or serve as sources of hard currency; they are not subject to normal requirements to earn profits, and they are even more vigorous contenders for business in ocean trade than many privately-owned companies owning foreign flag vessels.[10/]

A large number of foreign flag vessels (registered in both developed and less developed countries) are owned by U.S. companies through their controlled foreign corporations ("CFCs"). The principal reason for the foreign registration of this U.S. owned fleet is that foreign registry enables these vessels to take advantage of low foreign construction and operating costs. However, in order to qualify for the Maritime Administration's War Risk Insurance Program,[11/]

10/Bulgaria, China (People's Republic), East Germany, Poland, Rumania, the U.S.S.R. and Yugoslavia have fleets in approximately the top third of the world's fleets.

11/46 U.S.C. §§1281 *et seq*.

the owners of many of these vessels -- especially vessels registered in Honduras, Liberia and Panama -- have agreed to make their vessels subject to age limitations, to prohibitions on long term charter agreements with certain foreign citizens, and to formal commitments to the Maritime Administration allowing their recall by the U.S. government during a national emergency. Although the reliability and availability of these vessels is less than that of U.S. flag vessels, we must presently rely on this CFC fleet to a major extent to support national emergency needs, since the U.S. flag fleet is insufficient in size to meet these needs. This CFC fleet makes up the major portion of what is called the "Effective U.S. Control Fleet."

Comparison With Other Countries' Capital Cost Recovery Policies

Since 1936 U.S. maritime policy has been based largely on the cost parity concept. The Merchant Marine Act of 1936 and the 1970 amendments focus on three areas of cost parity: capital cost, operating cost and financing cost. However, as I noted earlier, the different political, economic and national security perceptions of free world and communist bloc powers have led to policies which have seriously eroded the parity position of the U.S. flag fleet.

Essentially, other countries' policies have changed while ours have stood still.

We must recognize the pivotal role which capital recovery plays in the cost structure of international ocean transportation. As capital cost has become, and continues to be, a major cost element in shipping economics, we must extend parity to include equivalency of capital recovery.

The pivotal role of capital cost recovery has not escaped the policymakers among our free world competitors, most of whom have much faster depreciation schedules for maritime vessels than we have in the United States. TABLE 3 summarizes the capital recovery programs of the leading maritime nations in which depreciation is a factor in tax liability, and of several representative other countries. Included are the fleets of the top twenty maritime nations, other than the communist countries and countries (including Liberia, Greece, Panama and Singapore) which do not impose substantial income taxes on their maritime industries. Also included are fleets of developed and less developed countries, among which Brazil, South Korea and Taiwan have rapidly expanding maritime industries. TABLES 3 through 5 show that, among free world countries, the United States ranks 16th by depreciable life (see TABLE 4) and 15th by first year depreciation allowed (see TABLE 5).[12]

The attached tables show, in general, that the largest fleets in the world are registered in countries that impose the lowest tax obligations. All the developed countries except the United States use capital cost recovery policy as a powerful incentive to invest in domestic shipping. And most countries with major national flag maritime interests have a tax environment more conducive to shipping investment than that of the United States.

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[12] TABLE 4 was prepared by the Shipbuilders Council of America and appears in its publication, A New Direction For U.S. Maritime Policy (1979), pp. 21-26.

Recognizing the importance of the shipbuilding industry to their economies, a number of countries, including Canada, Brazil and South Korea, provide more attractive tax treatment of vessels built domestically than for those built abroad.[13]

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[13] In Canada the general depreciation rate for vessels is 15 percent of the undepreciated capital cost. Income Tax Act, Paragraph 20(1)(a); Regulations Pt. XI, Section 1100(1)(a)(vii); Regulations Pt. XI, Schedule II. A separate rule applies to vessels in the hands of the original owner if the vessels have been constructed and registered in Canada. Regulations, Pt. XI, Section 1101(2a). Depreciation on these vessels is allowed at the rate of 33-1/3 percent. Regs. Pt. XI, Section 1100(1)(v).

Brazil provides a general useful life of 20 years for ships. Depreciation is allowed at a rate of 5 percent of the cost of the ship per year. However, ships constructed and registered in Brazil (or approved by the Superintendent of Merchant Marine) may be depreciated over five years. In this latter case depreciation is allowed at a rate of 20 percent per year. To be eligible for the increased depreciation deduction, an amount equal to 15 percent of the cost of the ship must be invested for each of the five years in ships constructed in Brazil. Income Tax Regulations, Art. 194 et seq.; Portaria No. GB-163 of May 19, 1969.

In South Korea the general useful life for vessels is 12 years (chemical vessels), 15 years (tankers) and 18 years for other steel vessels. If a ship is built with machinery or equipment 60 percent or more of which was manufactured in South Korea, however, additional depreciation equal to 40 percent of the ordinary depreciation may be deducted annually. Ministry of Finance, Korean Taxation, p. 99 (1979).

Denmark, Norway, Sweden and West Germany allow depreciation of vessels to begin during the construction period (rather than commencing when the vessel is placed in service). See TABLE 3.

The average depreciation lifetime in the countries surveyed in TABLE 3, excluding the U.S., is 11.2 years. Every country but one with a fleet larger than that of the U.S. offers a <u>shorter</u> tax depreciation lifetime. Of the countries offering shorter depreciation lives than the U.S., all but two are developed countries. The United Kingdom allows an immediate one-year deduction for ship construction costs.

Nine countries also have first year "bonus" depreciation provisions. The nine include three of the five fleets larger than that of the U.S., and, with one exception, are developed nations. The U.S. provision is the least stimulative of the nine countries.

The above comparisons shed some light on the capital recovery environment in which the U.S. maritime industry operates. Most comparable countries provide capital recovery in ways which, overall, are more stimulative than those of the U.S.

Realistic U.S. Tax Policy for Shipping Industry

We believe that the above comparative data provides a base on which to build realistic and modern capital cost recovery provisions for the maritime industry.

A bias in favor of U.S. construction of U.S. flag vessels will provide a strong economic incentive to operators to buy vessels from U.S. shipbuilders. This differential will create more jobs for skilled employees in U.S. shipyards. It will attract and keep skilled workers in the ship construction industry. It will increase the number of modern U.S. ships able to serve both commercial and military needs. It will increase Defense Department access to U.S. ships in the event of a national emergency. And this policy will increase the capacity and readiness of U.S. shipyards to build military ships on short notice for the armed forces.

Many persuasive economic arguments can be made -- on the basis of Gross National Product, investment, balance of trade, employment and reduction in the federal deficit -- for building all of our ships in the U.S. However, it is possible that the number of ships which owners will want to have under U.S. flag will exceed the number that needs to be built in U.S. yards if the industry is supported by national policy and funding limitations as the minimum shipbuilding mobilization base. A major increase in actual numbers of U.S. flag vessels is highly desirable. For this reason, we believe that Congress ought to allow for certain conditions under which foreign built U.S. flag ships would be eligible for speedy cost recovery. However, an economic bias in favor of building in the U.S. is essential in order to assure that the nation's shipyard mobilization base is maintained.

Several precedents in existing U.S. tax law support the proposed distinction between U.S. and foreign built property. The investment credit-rules, for example, make the credit unavailable generally to property used predominantly outside the United States[14/]

14/Code section 48(a)(2). The investment credit for movie and television films is also available, generally, only for production costs allocable to the United States. I.R.C. §48(k)(5).

Accelerated depreciation on residential rental property is available generally only if the property is located within the United States[15/]

Conclusion

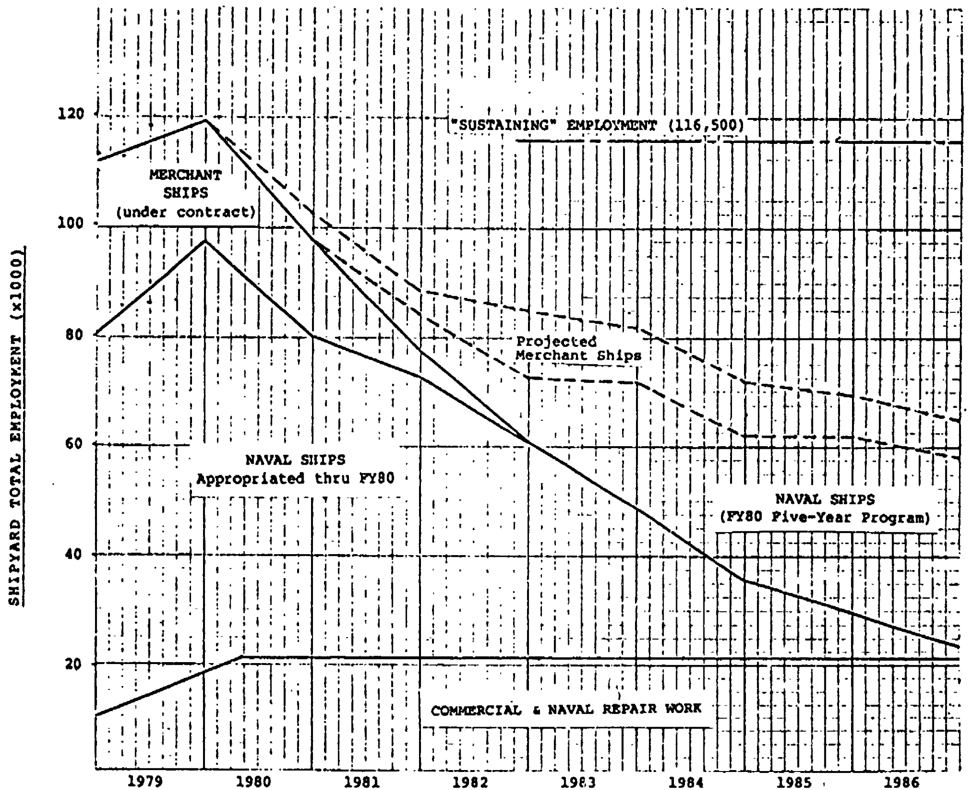
We must do more to enable the U.S. flag to recapture a fair share of our foreign commerce in a market dominated increasingly, as I have said, by state-controlled fleets and a wide array of direct and indirect subsidies.

We must also keep U.S. shipbuilding capacity in a state of readiness to support the needs of national defense when called on. By improving the attractiveness of U.S. flag shipping investment -- including investment by private capital sources within our country -- a realistic tax policy will induce new construction of vitally needed American ships, improve our continuing ship construction capacity, and update our defense readiness.

[15/] Code section 167(j)(2).

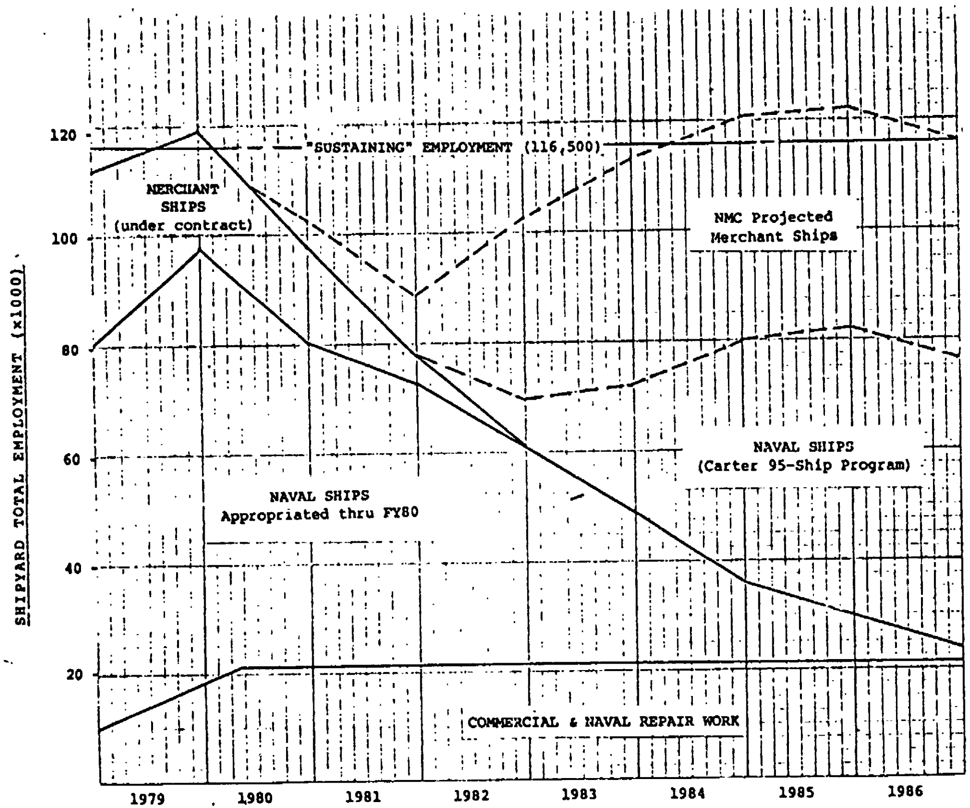
I urge you to include improved shipping depreciation in general cost recovery rules which you may adopt as a result of these hearings.

TABLE 1.



EMPLOYMENT TREND - U.S. SHIPBUILDING BASE

TABLE 2.



EMPLOYMENT TREND - U.S. SHIPBUILDING BASE

TABLE 3.

Capital Cost Recovery Summary

Country	Lifetime (years)	Normal Method	Extra First Year Allowance	Salvage Value Waived	Other	Corporation Tax Rate
Australia	16	150% DB	20%	yes	CG 1/	46%
Belgium	8	200% DB		yes	VAT exempt	48%
Brazil	20 2/	SL		yes		30%
Canada	7 3/	DB		yes		46-51%
Denmark	3	DB	30% 4/	yes	VAT exempt 5/	37%
Ecuador	10	SL		yes	15% ITC	22%
France	8	250% DB		yes	VAT exempt	50%
India	20	SL	25%	yes		55%, 60% 6/
Italy	10, 11	SL	15% 7/	yes	CG; VAT exempt	36%
Japan	13, 15	200% DB	45%	no	CG	42%, 54% 8/
Netherlands	20	200% DB		yes	VAT exempt; 15% ITC	48%
Norway	13 - 20	SL	25% 9/ 4/	yes	CG; VAT exempt	24%, 51% 8/
South Korea	15	200% DB 10/		no	8-10% ITC	27%, 40% 6/
Spain	9, 10	DB		yes	CG	33%
Sweden	3	DB	30% 4/	yes	CG; VAT exempt 5/	54%
Taiwan	3-5	SL		no		35%
United Kingdom	1			yes	VAT exempt	52%
United States	14.5	200% DB	$2,000	no	CG; 5, 10% ITC 5/	46%
Venezuela	10 - 20	SL		yes	15% ITC	55%
West Germany	12, 14	SL	40% 11/ 4/	no	CG	36%, 56% 8/ 12/

Abbreviations: DB - declining balance; SL - straight line; VAT - value added tax; ITC - investment tax credit; CG - capital gains (see n. 1).

1/ Indicates that tax on gain on the sale of a vessel is deferred if the gain is later reinvested.

2/ Five year life if built in Brazil or if approved by tax authorities.

3/ Three year life if built and registered in Canada.

4/ May be taken while vessel is under construction; limited to 15% per year in Denmark; limited to ratio down payment and progress payments bear to total cost for Germany.

5/ 25% (Denmark), 40% (Sweden), and 50% (United States) of net maritime income, as defined, may be eligible for deferral of tax. In the cases of Denmark and the United States, these amounts must be reinvested in maritime capacity.

6/ Rates on publicly held and privately held corporations.

7/ 15% extra allowance available in second and third years.

8/ Rates on distributed and undistributed income.

9/ Limited to 50% of related profits.

10/ 250% if built in South Korea.

11/ May be reduced for vessels constructed in 1979 or later. If not used, 250% declining balance method may be used.

12/ Income from German-registered ships taxed at 21.6%, 33.6% rates.

TABLE 4.

Ranking of Countries by Depreciable Life[1]

Country	Effective Depreciable Life[2]	Depreciation Method[3]	Maximum Corporate Tax Rate	Maximum Individual Tax Rate
United Kingdom	1	N/A	52%	83 %
Denmark	3	100% DB	36%[4]	66.6%
Sweden	3	100% DB/SL	54%	83 %
Canada	3	SL	51%	66.6%
Taiwan	2 or 5	See note 5	35%	60 %
Brazil	5	SL	30%	50 %
Italy	6	See note 6	36%	72 %
France	6	250% DB/SL	50%	60 %
Belgium	8	See note 7	48%	71.5%
Spain	9, 10	100% DB	33%	40 %
Ecuador	10	SL	22%	62.2%
Venezuela	10	SL	55%	45 %
Norway	11, 12	SL	51%[4]	70 %
Japan	13, 15	200% DB	54%	80 %
West Germany	12, 14	SL or 250% DB	56%[8]	55 %
United States	14.5	200% DB/SYD	46%	70 %
South Korea	15	200% DB[9]	27%	87.5%
India	15	SL	55%	69 %
Australia	16	150% DB/SL	46%	61.5%
Netherlands	20	200% DB	48%	72 %

1 Countries that do not tax shipping income under any condition are excluded: Liberia, Panama, Greece, Singapore.

2 Including allowable bonus depreciation and switchover of depreciation methods. In countries using declining balance methods for the life of the vessel, the life shown is the guideline life used to compute the declining balance fraction. Minimum depreciable lives are given in all cases where a range is specified under applicable law. Also, effective depreciable life is measured from the year of vessel delivery.

3 Abbreviations used:

SL: *Straight line depreciation:* A method of depreciation in which the annual depreciation deduction is determined by dividing the original cost of an asset by the number of years the property will remain in service.

DB: *Declining balance depreciation:* A method in which the annual depreciation deduction is determined as a percentage of the net tax basis of the assets; the percentage is equal to the reciprocal of the lifetime. If 150%, 200% or 250% declining balance depreciation is available, the result is multiplied by 1.5, 2.0, or 2.5, respectively, to compute the deduction.

SYD: *Sum of the year digits:* A method of depreciation whereby the annual depreciation is determined by multiplying the original cost of the asset by a fraction. The denominator is sum of the digits from 1 up to the depreciable life, e.g 1 + 2 + 3+ 4 for an asset with a 4 year life. The numerator is determined by counting backward starting with the asset's useful life. Hence, the fractions for an asset with a 4 year life would be 4//10, 3/10, 2/10, 1/10.

Two methods separated by a slash (/) indicates switchover permitted.

4 Denmark and Norway tax shipping income at ½ the normal corporate rate if revenue is derived from crosstrading.

5 Five (5) year depreciation if Owner takes five (5) year tax holiday; three (3) years otherwise.

6 Normally 25/25/25/10/10/5

7 Normally 20/15/15/10/10/10/10/10

8 Shipping company profits in Germany taxed at special rates: 33.6% if undistributed.

9 Additional 50% of normal depreciation allowed in first five (5) years.

TABLE 5.

Ranking of Countries by Total First Year Depreciation Allowed

Country	Total First Year Depreciation	Normal First Year Depreciation	Bonus Depreciation	Investment Tax Credit
United Kingdom	100%	100%	—%	—%
Japan	59.3	14.3	45	—
Sweden	51 [1]	21	30	—
Denmark	51 [2]	21	30	—
West Germany	45 [3]	5	40	—
India	37.5 [4]	5	25 + 7.5	—
Canada	33.3	33.3	—	—
Norway	33 [5]	8	25	—
France	31.3	31.3	—	—
Taiwan	25	25	—	—
Italy	25	10	15	—
Belgium	20	20	—	—
Brazil	20	20	—	—
South Korea	18	18	—	8–10
United States	13.8	—	—	10
Spain	10.5	10.5	—	—
Netherlands	10	10	—	15
Ecuador	10	10	—	15
Australia	9.4	9.4	—	—
Venezuela	7	7	—	15

1 Bonus depreciation in Sweden may be taken during construction period commencing with contract signing.

2 Bonus depreciation in Denmark limited to 15% per year for two (2) years may be taken commencing with contract signing.

3 An amount equal to progress payments may be claimed during construction period up to the total of the bonus depreciation allowance.

4 India permits a special capital deduction equal to 7.5% of the remaining asset basis for the first five (5) years. This special allowance does not itself reduce the tax basis.

5 Bonus depreciation in Norway may be taken during construction period.

THE SECRETARY OF THE TREASURY
WASHINGTON

AUG 9 1980

Dear Bill:

At the Finance Committee hearing on July 23, 1980, you asked for an estimate of the revenue consequences of enactment of tax proposals in the 1980 Republican platform. We have reviewed some 36 references to tax policy included in that platform.

A few of the platform proposals are specific enough to be susceptible to cost evaluation. They aggregate to reductions of $300 billion per year by 1985 when they are fully effective as indicated in Exhibit A.

The remainder of the items as listed in Exhibit B are nothing more than vague statements, expressing support for tax reductions for various special interests. Because of this lack of specificity in the remaining proposals, we cannot furnish a more detailed revenue cost estimate.

Best wishes.

Sincerely,

(Signed) Bill

G. William Miller

The Honorable
Bill Bradley
United States Senate
Washington, D.C. 20510

Enclosures

Exhibit A

Specific Tax Proposals Contained in the 1980 Republican Party Platform

($ billions)

Proposal	Calendar year 1985 cost
Across-the-board reductions in personal income tax rates, phased in over three years, with indexing thereafter	222.0
Elimination of the marriage tax penalty	20.9
Permit taxpayers to deduct charitable contributions whether they itemize or not	5.4
Simplify and accelerate tax depreciation schedules for facilities, structures, equipment, and vehicles (10-5-3 depreciation)	59.8
Offset to gross costs due to the interaction of reduced tax rates with other proposals	-7.3
Total	300.8

Office of the Secretary of the Treasury
Office of Tax Analysis

August 1, 1980

Exhibit B

Other Tax Policy Recommendations Contained in the 1980 Republican Party Platform

Support tax indexing (once rates are reduced) to protect taxpayers from the automatic tax increases caused when cost-of-living wage increases move them into higher tax brackets.

Remove disincentives for venture capital.

Support tax incentives for the removal of architectural and transportation barriers (that discriminate against the handicapped).

Reduction in estate tax burden.

Seek to ease (the estate) tax burden on all Americans and abolish excessive inheritance taxes to allow families to retain and pass on their small businesses and family farms.

Tax laws must be reformed to encourage rather than discourage family farming and ranching . . . and . . . . We support the use of lower, productively-based valuation when farms are transferred within the family . . . and . . . no spouse should pay estate taxes on farm property inherited from a husband or wife.

Support . . . a system of educational assistance based on tax credits that will in part compensate parents for their financial sacrifices in paying tuition at the elementary, secondary, and post-secondary level.

Propose to assist them (Americans) in so doing (making their own choices about health care protection) through tax and financial incentives . . . . By using tax incentives and reforming federal medical assistance programs, government and the private sector can jointly develop compassionate and innovative means to provide financial relief when it is most needed.

Only new tax exemptions and incentives can make it possible for many families to afford to care for their older members at home.

Expand the eligibility for individual retirement accounts to enable more persons to plan for their retirement years.

Targeted tax relief (to) make it possible for parents to keep (a handicapped) child at home without foregoing essential professional assistance. Similarly, tax incentives can assist those outside the home, in the neighborhood and the workplace, who undertake to train, hire or house the handicapped.

Support legislation which would remove tax advantages foreign investors realize on the sale of United States forests, farmland and other real estate.

Support of broader tax incentives for contributions to charitable and cultural organizations.

Advocate decontrol of the price at the wellhead of oil and gas . . . and . . . the so-called windfall profit tax (which is unrelated to profit), should be repealed as it applies to small volume royalty owners, new oil, stripper-wells, tertiary-recovery and heavy crude oil. The phase-out of the tax on old oil should be accelerated. This tax legislation should be amended to include a plowback provision.

Immediately and completely dismantle all remaining energy price controls and subsidies.

Support legislation designed to eliminate this (excessive taxation of Americans working abroad) inequity.

End limitations on social security earnings.

Transfer all welfare functions to the states along with the tax sources to finance them.

More extensive availability of the reverse annuity mortgage.

Reform those tax laws which make it more profitable to breakup a small business or merge it into a conglomerate, then to allow it to grow and develop as an independent business.

Create and apply new tax incentives for employees and employers alike to stimulate economic growth and reduce red-tape for business ventures.

Support financing and tax incentives to encourage the construction of rental housing as an essential addition to our housing inventory.

Implement a young family housing initiative which would include several elements such as . . . tax reforms and innovative alternative mortgage instruments to help meet monthly payment requirements.

Pledge to allow responsible use of mortgage revenue bonds . . . and . . . work to change the tax laws to encourage savings . . . .

Lower tax rates on savings . . . and oppose any attempt to end the income tax deductibility of mortgage interest and property taxes.

Reduce tax rates on individuals and businesses to increase incentives . . . .

Provide special incentives for savings by lowering the tax rates on saving and investment income.

Oppose Carter proposals to impose withholding on dividend and interest income.

Pursue specific tax and regulatory changes to revitalize America's troubled basic industries.

Urge a reduction of payroll tax rates, a youth differential for the minimum wage, and alleviation of other costs of employment until a young person can be a production employee.

Lower business and personal tax rates for small businessmen and women.

Enact a substantial increase in the surtax exemption

Office of the Secretary of the Treasury
Office of Tax Analysis

August 1, 1980

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