SAVINGS AND INVESTMENT INCENTIVES

HEARING

BEFORE THE

SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT POLICY

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

FIRST SESSION

ON

S. 75, S. 141, S. 142, S. 145, S. 155, S. 330, S. 457, S. 492, S. 819, and S. 936

MAY 4, 1981

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SAVINGS AND INVESTMENT INCENTIVES

MONDAY, MAY 4, 1981

U.S. SENATE, SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT POLICY OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 2221, Dirksen Senate Office Building, Hon. John H. Chafee (chairman) presiding.

Present: Senators Chafee, Danforth, and Durenberger.

[The press releases announcing this hearing; the bills S. 75, S. 141, S. 142, S. 145, S. 155, S. 330, S. 457, S. 492, S. 819, and S. 936; the joint committee print; and Senator Sam Nunn's prepared statement follow:]

Press Release No. 81-126

PRESS RELEASE

FOR IMMEDIATE RELEASE
April 22, 1981

COMMITTEE ON FINANCE
UNITED STATES SENATE
Subcommittee on Savings, Pensions, and Investment Policy
2227 Dirksen Senate Office Bldg.

FINANCE SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT POLICY SETS HEARING ON SAVINGS AND INVESTMENT INCENTIVE TAX BILLS

Senator Chafee, Chairman of the Subcommittee on Savings, Pensions, and Investment Policy of the Senate Committee on Finance announced today that the Subcommittee will hold a hearing on May 4, 1981 on a number of bills directed at reducing tax disincentives for savings and investment.

The hearing will begin at 9:30 a.m. on May 4, 1981, in Room 2221 of the Dirksen Senate Office Building.

The following legislative proposals will be considered at the hearing:

Capital Gains Reduction

S. 75 -- (Senators Wallop, Moynihan, Cranston, and others) Would increase the deduction for noncorporate taxpayers from 60 percent to 75 percent of long-term capital gains and would reduce the maximum rate on corporate capital gains to 17.5 percent.

S. 145 -- (Senator Moynihan) Would increase the deduction for noncorporate taxpayers from 60 percent to 70 percent and would reduce the maximum rate on corporate capital gains to 20 percent. Would also reduce the maximum rate for individual income taxes from 70 to 67 percent.

Separate Taxation of Investment Income

S. 936 -- (Senators Roth, Bentsen, and Kasten) Would permit any individual taxpayer, other than one with more than $10,000 of preference income, to compute a tax on personal service income alone, and on investment income alone, and then add the taxes on each of the two "stacks", thus permitting the first dollar of each type of income to start in the 14 percent tax bracket.

Dividend and Interest Exclusion

Percentage Exclusion

S. 155 -- (Senator Schmitt) Would increase the exclusion for certain interest and dividend income to $200 ($400 for joint returns) plus 25 percent of additional interest and dividends up to $50,000 (phased in over 5 years).

S. 819 -- (Senators Nunn and Huddleston) Would increase the exclusion to the greater of $200 ($400 for joint returns) or 30 percent of dividends and interest and make permanent the exclusion's application to certain interest income (phased in over 3 years).

Flat Amount Exclusion

S. 142 -- (Senator Bentsen) Would increase the exclusion to $1,000 ($2,000 for joint returns) and make permanent its application to certain interest income.

S. 330 -- (Senators Durenberger and Boren) Like S. 142, but would increase the exclusion to $1,250 ($2,500) over 5 years.

S. 492 -- (Senators D'Amato and others) Like S. 142, would increase the exclusion to $1,000 ($2,000 for joint returns).

Reinvestment Plans

S. 141 -- (Senators Bentsen and Leahy) Would defer tax, up to a maximum of $1,500 ($3,000 for joint returns) per year, on stock dividends under a qualified dividend reinvestment plan.

S. 457 -- (Senator Cranston) Would defer tax on capital gains from investments held in a rollover account and eliminate carryover basis at death for such investments.

Senator Chafee noted that Commerce Department data released Monday show that the personal savings rate, which has fallen steadily since the middle of last year, now stands at a near postwar low of 4.7 percent. "These figures underline the need to examine targeted proposals to provide incentives (or, more appropriately, to reduce disincentives) for capital formation." By airing a range of tax reduction proposals, Senator Chafee indicated that the Subcommittee hearings would augment the Finance Committee's consideration of the administration's tax reduction proposals without diverting attention from the rate reduction and accelerated cost recovery issues.

Requests to Testify.--Witnesses who desire to testify at the hearing must submit a written request to Robert E. Lighthizer, Chief Counsel, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510, to be received no later than noon on Wednesday, April 29, 1981. Witnesses will be notified as soon as practicable thereafter whether it has been possible to schedule them to present oral testimony. If for some reason a witness is unable to appear at the time scheduled, he may file a written statement for the record in lieu of the personal appearance. In such case a witness should notify the Committee of his inability to appear as soon as possible.

Consolidated Testimony.--Senator Chafee urges all witnesses who have a common position or who have the same general interest to consolidate their testimony and designate a single spokesman to present their common viewpoint orally to the Subcommittee. The procedure will enable the Subcommittee to receive a wider expression of views than it might otherwise obtain. Senator Chafee urges very strongly that all witnesses exert a maximum effort to consolidate and coordinate their statements.

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

Witnesses scheduled to testify should comply with the following rules:

(1) All witnesses must submit written statements of their testimony.

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

(3) The written statements must be typed on letter-size paper (not legal size) and at least 100 copies must be submitted by noon on Friday, May 1, 1981.

(4) Witnesses should not read their written statements to the Subcommittee, but ought instead to confine their oral presentations to a summary of the points included in the statement.

(5) Not more than five minutes will be allowed for the oral summary.

Written Statements.--Witnesses who are not scheduled to make an oral presentation, and others who desire to present their views to the Subcommittee, are urged to prepare a written statement for submission and inclusion in the printed record on the hearings. These written statements should be typewritten, not more than 25 double-spaced pages in length, and mailed with five (5) copies to Robert E. Lighthizer, Chief Counsel, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510, not later than Monday, May 18, 1981. On the first page of your written statement please indicate the date and subject of the hearing.

P.R. # 81-126

II

97TH CONGRESS
1ST SESSION

S. 75

To amend the Internal Revenue Code of 1954 to encourage capital investment by individuals and corporations.

IN THE SENATE OF THE UNITED STATES

JANUARY 6 (legislative day, JANUARY 5), 1981

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

A BILL

To amend the Internal Revenue Code of 1954 to encourage capital investment by individuals and corporations.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. INCREASE IN CAPITAL GAINS DEDUCTION.

(a) IN GENERAL.—Subsection (a) of section 1202 of the Internal Revenue Code of 1954 (relating to deduction for capital gains) is amended by striking out "60 percent" and inserting in lieu thereof "75 percent".

(b) CONFORMING AMENDMENTS.—

(1) Subsection (c) of section 1202 of such Code is amended to read as follows:

"(c) TAXABLE YEARS WHICH INCLUDE JANUARY 1, 1981.—If for any taxable year beginning before January 1, 1981, and ending after December 31, 1980, a taxpayer other than a corporation has a net capital gain, the deduction under subsection (a) shall be the sum of—

"(1) 75 percent of the lesser of—

"(A) the net capital gain for the taxable year, or

"(B) the net capital gain taking into account only gain or loss properly taken into account for the portion of the taxable year after December 31, 1980,

plus

"(2) 60 percent of the excess of—

"(A) the net capital gain for the taxable year, over

"(B) the amount of net capital gain taken into account under paragraph (1).".

(2) Subparagraph (B) of section 170(e)(1) of such Code (relating to charitable deductions for contributions of capital gain property) is amended by striking out "40 percent" and inserting in lieu thereof "25 percent".

(c) Reduction in Rate of Alternative Minimum Tax.—Subsection (a) of section 55 (relating to alternative minimum tax imposed) is amended to read as follows:

"(a) Alternative Minimum Tax Imposed.—In the case of a taxpayer other than a corporation, if—

"(1) an amount equal to the sum of—

"(A) 10 percent of so much of the alternative minimum taxable income as exceeds $20,000, but does not exceed $60,000, plus

"(B) 17.5 percent of so much of the alternative minimum taxable income as exceeds $60,000, exceeds

"(2) the regular tax for the taxable year,

then there is imposed (in addition to all other taxes imposed by this title) a tax equal to the amount of such excess.".

(d) Special Rule for Passthrough Entities.—

(1) In general.—In applying sections 1201(c)(2)(A)(ii) and 1202(c)(1)(B) of the Internal Revenue Code of 1954 with respect to any pass-through entity, the determination of the period for which gain or loss is properly taken into account shall be made at the entity level.

(2) Passthrough entity defined.—For purposes of paragraph (1), the term "pass-through entity" means—

(A) a regulated investment company,

(B) a real estate investment trust,

(C) an electing small business corporation,

(D) a partnership,

(E) an estate or trust, and

(F) a common trust fund.

(e) EFFECTIVE DATES.—

(1) The amendments made by subsections (a), (b)(1), and (d) shall apply to taxable years ending after December 31, 1980.

(2) The amendment made by subsection (b)(2) shall apply to contributions made after December 31, 1980.

(3) The amendments made by subsection (c) shall apply to taxable years beginning after December 31, 1980.

SEC. 2. REDUCTION OF ALTERNATIVE CAPITAL GAINS FOR CORPORATIONS.

(a) GENERAL RULE.—Paragraph (2) of section 1201(a) of the Internal Revenue Code of 1954 (relating to alternative tax for corporations) is amended by striking out "28 percent" and inserting in lieu thereof "17.5 percent".

(b) TRANSITIONAL RULE.—Subsection (c) of section 1201 is amended to read as follows:

"(c) TAXABLE YEARS WHICH INCLUDE JANUARY 1, 1981.—If for any taxable year beginning before January 1, 1981, and ending after December 31, 1980, a corporation has a net capital gain, then subsection (a) shall be applied by substituting for the language of paragraph (2) the following:

"(2)(A) a tax of 17.5 percent of the lesser of—

"(i) the net capital gain for the taxable year, or

"(ii) the net capital gain taking into account only gain or loss properly taken into account for the portion of the taxable year after December 31, 1980, plus

"(B) a tax of 28 percent of the excess of—

"(i) the net capital gains for the taxable year, over

"(ii) the amount of net capital gain taken into account under subparagraph (A).".

(c) CONFORMING AMENDMENTS.—

(1) Subsection (g)(2) of section 58 of such Code is amended by striking out "28 percent (30 percent if the exchange occurs before January 1, 1979)" and inserting in lieu thereof "17.5 percent".

(2) Subparagraph (B) of section 170(e)(1) of such Code (relating to charitable deduction for contributions

of capital gain property) is amended by striking out "28/46" and inserting in lieu thereof "17.5/46".

(3) Subparagraph (E) of section 593(b)(2) of such Code (relating to addition to reserves for bad debts) is amended by striking out "18/46" each place it appears and inserting in lieu thereof "28.5/46".

(4) Clause (iii) of section 852(b)(3)(D) of such Code (relating to treatment by shareholders of undistributed capital gains) is amended by striking out "72 percent" and inserting in lieu thereof "82.5 percent".

(d) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to taxable years ending after December 31, 1980.

(2) CHARITABLE CONTRIBUTIONS.—The amendment made by paragraph (2) of subsection (c) shall apply to gifts made after December 31, 1980.

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X

97TH CONGRESS
1ST SESSION

S. 141

Relating to tax treatment of qualified dividend reinvestment plans.

IN THE SENATE OF THE UNITED STATES

JANUARY 19 (legislative day, JANUARY 5), 1981

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

A BILL

Relating to tax treatment of qualified dividend reinvestment plans.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 305 (relating to distributions of stock and stock rights) is amended by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) the following new subsection:

"(e) QUALIFIED DIVIDEND REINVESTMENT PLANS.—

"(1) IN GENERAL.—Subject to the limitation under paragraph (2) if a shareholder makes an election under paragraph (7), a distribution of stock under a qualified dividend reinvestment plan shall be considered to be a distribution of stock of a corporation made by such corporation to its shareholders with respect to its stock under subsection (a), and subsection (b) shall not apply.

"(2) LIMITATION.—The amount of any distribution excluded from gross income by any taxpayer under subsection (a) by reason of paragraph (1) shall not exceed $1,500 per year ($3,000 in the case of a joint return under section 6013).

"(3) BASIS AND HOLDING PERIOD.—Notwithstanding any other provision of this title, the basis of stock received as a distribution pursuant to a qualified dividend reinvestment plan by a shareholder who makes an election under paragraph (7) shall be zero and the holding period of such stock shall commence on the date of such distribution.

"(4) DISPOSITIONS.—Under regulations prescribed by the Secretary, if a shareholder sells common stock of a corporation within 1 year following the receipt of stock described in paragraph (3) of the same corporation, the stock so sold shall be deemed to be the stock so described commencing with the first shares received during said 1-year period.

"(5) DEFINITION OF QUALIFIED DIVIDEND REINVESTMENT PLAN.—The term 'qualified dividend reinvestment plan' means a plan under which the common and/or preferred shareholders of a domestic corporation (other than a regulated investment company) who elect to participate in such plan recieve a distribution otherwise payable in property only in shares (including fractional shares) of authorized but unissued common stock of the corporation which common stock is pursuant to such plan (i) designated by the board of directors of the corporation as issued for purposes of this subsection and (ii) priced at not less than 95 per centum of fair market value during the period immediately before the distribution (determined under regulations prescribed by the Secretary).

"(6) PRESUMPTION.—If a corporation, or a member of its 'affiliated group' within the meaning of section 1504(a), has purchased or purchases its common stock within 1 year of making a distribution pursuant to a dividend reinvestment plan, such distribution shall be presumed not to have been made pursuant to a qualified dividend reinvestment plan. Under regulations prescribed by the Secretary the corporation may establish that it had a business purpose for purchasing such stock which is not inconsistent with the intent of this subsection, in which event the distribution will not be disqualified hereunder.

"(7) SHAREHOLDER ELECTION.—Pursuant to regulations prescribed by the Secretary, a shareholder may elect to have paragraph (1) apply to any distribution of stock described therein by making such election on the shareholder's Federal income tax return on which such distribution is reported.".

SEC. 2. EFFECTIVE DATE.—This amendment shall apply with respect to distributions made on or after January 1, 1982.

O

II

97TH CONGRESS
1ST SESSION

S. 142

To increase the amount of the exemption of certain interest and dividend income from taxation, and to make permanent the exemption of interest from taxation.

IN THE SENATE OF THE UNITED STATES

JANUARY 19 (legislative day, JANUARY 5), 1981

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

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A BILL

To increase the amount of the exemption of certain interest and dividend income from taxation, and to make permanent the exemption of interest from taxation.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. INCREASE IN THE MAXIMUM AMOUNT OF THE DIVIDEND AND INTEREST EXEMPTION.

(a) IN GENERAL.—Paragraph (1) of section 116(b) of the Internal Revenue Code of 1954 (relating to maximum dollar amount) is amended to read as follows:

"(1) MAXIMUM DOLLAR AMOUNT.—The aggregate amount excluded under subsection (a) for any taxable year shall not exceed $1,000 ($2,000 in the case of a joint return under section 6013).".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1980.

SEC. 2. PERMANENT EXTENSION OF PARTIAL EXCLUSION OF INTEREST.

Section 404(c) of the Crude Oil Windfall Profit Tax Act of 1980 is amended by striking out ", and before January 1, 1983".

O

II

97TH CONGRESS
1ST SESSION

S. 145

To amend the Internal Revenue Code of 1954 to provide a 67 per centum maximum tax rate for individual income taxes and to reduce capital gains tax rates for corporations and individuals.

IN THE SENATE OF THE UNITED STATES

JANUARY 19 (legislative day, JANUARY 5), 1981

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

---

A BILL

To amend the Internal Revenue Code of 1954 to provide a 67 per centum maximum tax rate for individual income taxes and to reduce capital gains tax rates for corporations and individuals.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Investment Incentive Act of 1981".

SECTION 2. MAXIMUM TAX RATE ON INVESTMENT INCOME.

(a) Section 1 of the Internal Revenue Code of 1954 (relating to tax imposed on individuals) is amended by adding at the end thereof the following new subsection:

"(f) 67-Percent Maximum Rate.—

"(1) In general.—The Secretary shall prescribe tables which shall apply in lieu of the tables contained in subsections (a), (b), (c), (d), and (e) with respect to taxable years beginning after 1980.

"(2) Method of prescribing tables.—The table which under paragraph (1) is to apply in lieu of the table contained in subsection (a), (b), (c), (d), or (e), as the case may be, shall be prescribed—

"(A) so that the highest rate of tax under such subsection does not exceed 67 percent, and

"(B) by reducing each other rate of tax that is lower than 67 percent by three percent.".

(b) Tax Withholding.—Subsection (a) of section 3402 of such Code (relating to the requirement for withholding) is amended by inserting after the second sentence the following new sentence: "The Secretary shall prescribe tables that shall apply in lieu of the tables prescribed above to wages paid during any calendar year after 1980 and that shall be based on the tables prescribed under section 1(f).".

(c) Effective Dates.—

(1) The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1980.

(2) The amendment made by subsection (b) shall apply to remuneration paid after the date of the enactment of this Act.

SECTION 3. CAPITAL GAINS TAX RATES.

(a) INCREASE IN CAPITAL GAINS DEDUCTION FOR INDIVIDUALS.—Subsection (a) of section 1202 of the Internal Revenue Code of 1954 (relating to the deduction for capital gains) is amended by striking out "60 percent" and inserting in lieu thereof "70 percent".

(b) REDUCTION IN CAPITAL GAINS TAX RATE FOR CORPORATIONS.—Paragraph 2 of section 1201(a) of the Internal Revenue Code of 1954 (relating to the alternative tax for corporations) is amended by striking out "28 percent" and inserting in lieu thereof "20 percent".

(c) CONFORMING AMENDMENTS.—

(1) SECTION 170.—Paragraph 1 of section 170(e) of the Internal Revenue Code of 1954 (relating to certain contributions of ordinary income and capital gain property) is amended by striking out "40 percent (28/46, in the case of a corporation)" and inserting in lieu thereof "30 percent (20/46, in the case of a corporation)".

(2) SECTION 593.—Subparagraph (E) of section 593(b)(2) of such Code (relating to the addition to reserves for bad debts) is amended by striking out "18/46" each place it appears and inserting in lieu thereof "10/46".

(3) SECTION 852.—Clause (iii) of section 852(b)(3)(D) of such Code (relating to the treatment by shareholders of undistributed capital gains) is amended by striking out "72 percent" and inserting in lieu thereof "80 percent".

(d) EFFECTIVE DATES.—The amendments made by subsections (a) and (b), and by paragraphs (2) and (3) of subsection (c), of this section shall apply with respect to taxable years beginning after December 31, 1980. The amendment made by subsection (c)(1) shall apply with respect to contributions made after December 31, 1980.

O

II

97TH CONGRESS
1ST SESSION

S. 155

To amend the Internal Revenue Code of 1954 to make additional interest from savings eligible for exclusion.

IN THE SENATE OF THE UNITED STATES

JANUARY 19 (legislative day, JANUARY 5), 1981

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

---

A BILL

To amend the Internal Revenue Code of 1954 to make additional interest from savings eligible for exclusion.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Savings and Investment Incentive Act of 1981".

SEC. 2. (a) Paragraph (1) of subsection (b) of section 116 of the Internal Revenue Code of 1954 (relating to partial exclusions of interest and dividends received by individuals) is amended to read as follows:

"(1) MAXIMUM AMOUNT.—

"(A) IN GENERAL.—The aggregate amount excluded under subsection (a) for any taxable year shall not exceed the sum of—

"(i) $200 ($400 in the case of a joint return under section 6013), plus

"(ii) 25 percent of so much of the amount of interest and dividends received during the taxable year which are not taken into account under clause (i) as does not exceed $50,000.

"(B) TRANSITIONAL RULE.—For purposes of applying subparagraph (A)(ii) for taxable years beginning before January 1, 1986, the following percentages shall be substituted for '25 percent' in the case of taxable years beginning in the calendar year to which such percentage applies:

"Calendar year	Percentage
1982	5
1983	10
1984	15
1985	20.".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply with respect to taxable years beginning after December 31, 1981.

O

II

97TH CONGRESS
1ST SESSION

S. 330

Entitled "Investment Income Incentive Act of 1981".

IN THE SENATE OF THE UNITED STATES

JANUARY 29 (legislative day, JANUARY 5), 1981

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

A BILL

Entitled "Investment Income Incentive Act of 1981".

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. INCREASE IN THE MAXIMUM AMOUNT OF THE DIVIDEND AND INTEREST EXCLUSION.

(a) DIVIDEND AND INTEREST EXCLUSION.—Subsection (b)(1) of section 116 of the Internal Revenue Code of 1954 (relating to partial exclusion of dividends and interest received by individuals) is amended by striking out everything after "exceed" and inserting in lieu thereof the following: "the amounts shown in the following table for the appropriate taxable years:

	Dividend exclusion:	Dividend exclusion for a married couple filing a joint return under section 6013:
"Year:		
1981	$250	$500
1982	500	1,000
1983	750	1,500
1984	1,000	2,000
1985	1,250	2,500."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 1980.

SEC. 2. PERMANENT EXTENSION OF PARTIAL EXCLUSION OF DIVIDENDS AND INTEREST.

Section 404(c) of the Crude Oil Windfall Profit Tax Act of 1980 is amended by striking out ", and before January 1, 1983".

O

II

97TH CONGRESS
1ST SESSION

S. 457

To amend the Internal Revenue Code of 1954 to provide for increased investment by individuals through a tax-deferred rollover account.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 6 (legislative day, JANUARY 5), 1981

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

---

A BILL

To amend the Internal Revenue Code of 1954 to provide for increased investment by individuals through a tax-deferred rollover account.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

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

(a) SHORT TITLE.— This Act may be cited as the "Capital Gains Rollover Account Act of 1981."

(b) TABLE OF CONTENTS.—

(c) 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.

SEC. 2. TAX-DEFERRED ROLLOVER ACCOUNT.

Subchapter F of chapter 1 of subtitle A of the Internal Revenue Code of 1954 is amended by adding at the end thereof part VIII to read as follows:

"PART VIII—ESTABLISHMENT OF TAX-DEFERRED ROLLOVER ACCOUNTS

"SEC. 529. TAX-DEFERRED ROLLOVER ACCOUNT.

"(a) TAX-DEFERRED ROLLOVER ACCOUNT.—For purposes of this section, the term "rollover account" means a trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries, but only if, the written governing instrument creating the trust meets the following requirements:

"(1) No contribution will be accepted unless it is made by the individual and is in cash, or consists of stock or securities of a domestic corporation.

"(2) The trustee is a bank of such other person who demonstrates to the satisfaction of the Secretary that the manner in which such other person will administer the trust will be consistent with the requirements of this section.

"(3) The trust funds will be invested in stock or securities of a domestic corporation or held in interest-bearing deposits in a bank.

"(4) The assets of the trust will not be commingled with other property.

"(5) The interest of the individual in the balance of his rollover account is nonforfeitable, and all or any portion of stocks, securities, or money in such account will be paid or distributed—

"(A) to the individual within 10 days after demand, or

"(B) in the case a payment or distribution is to be made to a beneficiary, in accordance with subsection (e).

"(6) The trust will adopt a taxable year which is the same as the taxable year of the individual.

"(7) The individual is permitted to elect, no more often than each taxable year, for the rollover account to be either—

"(A) a discretionary account in which case the investment and reinvestment of the trust funds will be determined by the trustee, or

"(B) a self-directed fund in which case the investment and reinvestment of the trust funds will be determined by the individual.

"(b) TAX TREATMENT OF ROLLOVER ACCOUNTS.—A rollover account is exempt from tax under this subtitle.

"(c) TAX TREATMENT OF PAYMENT OR DISTRIBUTION.—Any amount paid or distributed from the capital gain fund of a rollover account shall be included as a long term capital gain in the gross income of the recipient for the taxable year in which such payment or distribution is received.

"(d) TAX TREATMENT OF ORDINARY INCOME.—All ordinary income consisting of—

"(A) interest and dividends received, plus

"(B) net short term capital gain as defined in section 1222(5),

shall be distributed to the trustor and shall be included in the gross income of the trustor for the taxable year in which such ordinary income was received by the trust.

"(e) PAYMENT OR DISTRIBUTION TO BENEFICIARY.—If the individual dies prior to the time the balance in the rollover account has been paid or distributed in accordance with subsection (a)(5)(A), the balance shall be paid or distributed to his designated beneficiary or beneficiaries, or, if no beneficiary has been designated, to his estate.

"(f) Establishment of Separate Funds.—The trustee of a rollover account shall establish on its books, without the segregation of assets, a capital fund, and a capital gain fund.

"(1) Capital fund.—The capital fund shall consist of the amount of cash contributed to the rollover account, the basis in the hands of the individual of property contributed to the rollover account, and the amount of any gain realized upon the disposition of property in a transaction in which gain or loss is not recognized under this subtitle.

"(2) Capital gain fund.—The capital gain fund shall consist of net capital gain as defined in section 1222(11).

"(g) Payment or Distribution Treated as Made From Separate Fund.—Any payment or distribution from a rollover account shall be treated as made—

"(1) first, from the capital gain fund, and

"(2) second, from the capital fund.

Except as provided in subsection (i)(4), no payment or distribution shall be treated as made from a fund until the balance of any fund which precedes it in order of priority has been paid or distributed.

"(h) CHARACTER OF AMOUNTS IN HANDS OF RECIPIENT.—Any amount paid or distributed from a rollover account shall, for the purposes of this subtitle, have the same character in the hands of the recipient as the amounts included in the fund from which it is treated as having been distributed.

"(i) SPECIAL RULES RELATED TO ACCOUNT BALANCES, BASIS, AND LOSSES.—

"(1) DETERMINATION AS OF END OF TAXABLE YEAR.—The balance of a fund established in accordance with subsection (f) shall be determined as of the end of each taxable year, taking into account the total of all amounts included in the fund in all taxable years and the total of all amounts paid or distributed from the fund prior to the beginning of the taxable year.

"(2) BASIS OF PROPERTY.—The basis of property contributed by an individual to a rollover account shall, in the hands of the trustee, be the same as the basis in the hands of the individual, and the basis of property distributed from a rollover account shall, in the hands of the distributee, be the same as the basis in the hands of the trustee.

"(3) VALUATION OF DISTRIBUTIONS IN KIND.—If property is distributed from a rollover account, for the purposes of this section the amount of the distribution shall be the basis of the property distributed.

"(4) LOSSES REALIZED BY INDIVIDUAL OUTSIDE THE ROLLOVER ACCOUNT.—If for any taxable year, the individual has a net capital loss within the meaning of section 1222(10) (determined without regard to paragraph (5)), the lesser of—

"(A) the net capital loss, or

"(B) the amount in the capital gain fund,

shall be treated as having been distibuted in the taxable year to the individual from the capital gain fund. Any amount treated as distributed by application of the preceding sentence shall be added to the capital fund.

"(5) LOSS UPON TERMINATION OF ACCOUNT.—If upon payment or distribution of the balance of a rollover account in any taxable year, the total of all contributions to the account exceeds—

"(A) the balance paid or distributed in such taxable year, plus

"(B) the total of all amounts previously paid or distributed from the account,

such excess shall be a capital loss of the recipient for such taxable year.

"(j) OTHER SPECIAL RULES, LIMITATIONS, AND DEFINITIONS.—

"(1) EFFECT OF TRANSFER OR PLEDGE OF ACCOUNT AS SECURITY.—If, during any taxable year, the individual transfers or uses as security for a loan, the account or any portion thereof, the portion so transferred or used shall be treated as having been paid or distributed to the individual.

"(2) TRANSFER OF ACCOUNT INCIDENT TO DIVORCE.—The transfer of an individual's interest in a rollover account to his former spouse under a divorce decree or under a written instrument incident to such divorce is not to be considered a payment or distribution or a taxable transfer made by the individual notwithstanding any other provision of this subtitle, and such interest at the time of the transfer is to be treated as a rollover account of such spouse, and not of the individual. Thereafter the rollover account, for purposes of this subtitle is to be treated as maintained for the benefit of such spouse.

"(3) ONLY ONE ACCOUNT MAY BE MAINTAINED.—

"(A) No rollover account for an individual may be established until after the close of the taxable year in which the balance of any previously established rollover account is paid or distributed, and

"(B) No contributions to a rollover account may be made after the balance of such account has been paid or distributed and another rollover account for such individual has been established.

"(4) DEFINITIONS.—For the purposes of this section, the term "bank" has the same meaning as in section 581.

"SEC. 530. FILING OF INFORMATION RETURNS.

"The trustee of a rollover account shall keep such records, render under oath such statements, comply with such rules and regulations as the Secretary may from time to time prescribe, and file an annual return, stating specifically the items of gross income, receipts, disbursements, and such other information for the purposes of carrying out the internal revenue laws as the Secretary may by forms or regulations prescribe.".

SEC. 3. EFFECTIVE DATE.

The amendments made by this Act shall apply to a trust created or organized after October 1, 1981.

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II

97TH CONGRESS
1ST SESSION

S. 492

To increase the income tax exclusion of dividends and interest received by individuals.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 17 (legislative day, FEBRUARY 16), 1981

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

A BILL

To increase the income tax exclusion of dividends and interest received by individuals.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 116(b)(1) of the Internal Revenue Code of 1954, as amended, is amended to read as follows:

"(1) MAXIMUM DOLLAR AMOUNT.—The aggregate amount excluded under subsection (a) for any taxable year shall not exceed \$1,000 (\$2,000 in the case of a joint return under section 6013).".

O

II

97TH CONGRESS
1ST SESSION

S. 819

To amend the Internal Revenue Code of 1954 to stimulate investment by increasing the interest and dividend exclusion.

IN THE SENATE OF THE UNITED STATES

MARCH 27 (legislative day, FEBRUARY 16), 1981

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

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A BILL

To amend the Internal Revenue Code of 1954 to stimulate investment by increasing the interest and dividend exclusion.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) paragraph (1) of section 116(b) of the Internal Revenue Code of 1954 (relating to maximum dollar amount of interest and dividend exclusion) is amended to read as follows:

"(1) MAXIMUM DOLLAR AMOUNT.—

"(A) In general.—The aggregate amount excluded under subsection (a) for any taxable year shall not exceed the greater of—

"(i) $200 ($400 in the case of a joint return under section 6013), or

"(ii) an amount equal to the product of the sum determined under subsection (a) (for both the individual and spouse in the case of a joint return), multiplied by the applicable percentage.

"(B) Applicable percentage.—The applicable percentage shall be determined in accordance with the following table:

"If the taxable year begins in:	The applicable percentage is:
1982	10
1983	20
1984 and thereafter	30.".

(b) The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1980.

O

II

97TH CONGRESS
1ST SESSION

S. 936

Entitled "Savings Expansion Act of 1981".

IN THE SENATE OF THE UNITED STATES

APRIL 8 (legislative day, FEBRUARY 16), 1981

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

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A BILL

Entitled "Savings Expansion Act of 1981".

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. AMENDMENT OF 1954 CODE, ETC.

(a) 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.

(b) TECHNICAL AND CONFORMING AMENDMENTS.—The Secretary of the Treasury or his delegate shall, not later than ninety days after the date of the enactment of this Act, submit to the Committee on Ways and Means of the House of Representatives a draft of the technical and conforming amendments which are necessary to reflect throughout the Internal Revenue Code of 1954 the substantive amendments made by this Act.

SEC. 2. 50-PERCENT MAXIMUM RATE FOR INDIVIDUALS; SEPARATE COMPUTATION OF TAX.

(a) GENERAL RULE.—Section 1 (relating to tax imposed on individuals) is amended to read as follows:

"SECTION 1. TAX IMPOSED.

"(a) GENERAL RULE.—

"(1) INDIVIDUALS.—Except as provided in paragraph (2), there is hereby imposed on the income of every individual a tax equal to the sum of—.

"(A) the tax on personal service taxable income determined under the applicable rate schedule, plus

"(B) the tax on nonpersonal service taxable income determined under the applicable rate schedule.

"(2) CERTAIN INDIVIDUALS WITH ITEMS OF TAX PREFERENCE, ESTATES, AND TRUSTS.—There is hereby imposed on the income of—

"(A) every individual who has items of tax preference described in section 57(a) (other than paragraph (9) thereof) for the taxable year in excess of $10,000 ($5,000 in the case of a separate return by a married individual (as defined in section 143)), and

"(B) every estate or trust taxable under this section,

a tax equal to the tax on taxable income determined under the applicable rate schedule.

"(b) APPLICABLE RATE SCHEDULE FOR MARRIED INDIVIDUALS FILING JOINT RETURNS.—In the case of—

"(1) every married individual (as defined in section 143 who makes a single return jointly with his spouse under section 6013, and

"(2) every surviving spouse (as defined in section 2(a)),

the following is the applicable rate schedule:

"If the amount on which the tax is to be determined is:	The tax is:
Not over $2,100	14% of taxable income.
Over $2,100 but not over $4,200	$294, plus 16% of excess over $2,100.
Over $4,200 but not over $8,500	$630, plus 18% of excess over $4,200.
Over $8,500 but not over $12,600	$1,404, plus 21% of excess over $8,500.
Over $12,600 but not over $16,800	$2,265, plus 24% of excess over $12,600.

"If the amount on which the tax is to be determined is:	The tax is:
Over $16,800 but not over $21,200	$3,273, plus 28% of excess over $16,800.
Over $21,200 but not over $26,500	$4,505, plus 32% of excess over $21,200.
Over $26,500 but not over $31,800	$6,201, plus 37% of excess over $26,500.
Over $31,800 but not over $42,400	$8,162, plus 43% of excess over $31,800.
Over $42,400 but not over $56,600	$12,720, plus 49% of excess over $42,400.
Over $56,600	$19,678, plus 50% of excess over $56,600.

"(c) HEADS OF HOUSEHOLDS.—In the case of every individual who is the head of a household (as defined in section 2(b)), the following is the applicable rate schedule:

"If the amount on which the tax is to be determined is:	The tax is:
Not over $2,100	14% of taxable income.
Over $2,100 but not over $4,200	$294, plus 16% of excess over $2,100.
Over $4,200 but not over $6,400	$630, plus 18% of excess over $4,200.
Over $6,400 but not over $9,500	$1,026, plus 22% of excess over $6,400.
Over $9,500 but not over $12,700	$1,708, plus 24% of excess over $9,500.
Over $12,700 but not over $15,900	$2,476, plus 26% of excess over $12,700.
Over $15,900 but not over $21,200	$3,308, plus 31% of excess over $15,900.
Over $21,200 but not over $26,500	$4,951, plus 36% of excess over $21,200.
Over $26,500 but not over $31,800	$6,859, plus 42% of excess over $26,500.
Over $31,800 but not over $42,400	$9,085, plus 46% of excess over $31,800.
Over $42,400	$13,961, plus 50% of excess over $42,400.

"(d) UNMARRIED INDIVIDUALS (OTHER THAN SURVIVING SPOUSES AND HEADS OF HOUSEHOLDS).—In the case of every individual (other than a surviving spouse as defined in section 2(a) or the head of a household as defined in section 2(b)) who is not a married individual (as defined in section 143) the following is the applicable rate schedule:

"If the amount on which the tax is to be determined is:	The tax is:
Not over $1,100	14% of taxable income.
Over $1,100 but not over $2,100	$154, plus 16% of excess over $1,100.
Over $2,100 but not over $4,200	$314, plus 18% of excess over $2,100.
Over $4,200 but not over $6,200	$692, plus 19% of excess over $4,200.
Over $6,200 but not over $8,500	$1,072, plus 21% of excess over $6,200.
Over $8,500 but not over $10,600	$1,555, plus 24% of excess over $8,500.
Over $10,600 but not over $12,700	$2,059, plus 26% of excess over $10,600.
Over $12,700 but not over $15,900	$2,605, plus 30% of excess over $12,700.
Over $15,900 but not over $21,200	$3,565, plus 34% of excess over $15,900.
Over $21,200 but not over $26,500	$5,367, plus 39% of excess over $21,200.
Over $26,500 but not over $31,800	$7,434, plus 44% of excess over $26,500.
Over $31,800 but not over $39,200	$9,766, plus 49% of excess over $31,800.
Over $39,200	$13,392, plus 50% of excess over $39,200.

"(e) SEPARATE RETURNS BY MARRIED INDIVIDUALS; ESTATES AND TRUSTS.—In the case of—

"(1) every married individual (as defined in section 143) who does not make a single return jointly with his spouse under section 6013, and

"(2) every estate and trust taxable under this subsection,

the following is the applicable rate schedule:

"If the amount on which the tax is to be determined is:	The tax is:
Not over $1,050	14% of taxable income.
Over $1,050 but not over $2,100	$147, plus 16% of excess over $1,050.
Over $2,100 but not over $4,250	$315, plus 18% of excess over $2,100.
Over $4,250 but not over $6,300	$702, plus 21% of excess over $4,250.
Over $6,300 but not over $8,400	$1,132.50, plus 24% of excess over $6,300.

"If the amount on which the tax is to be determined is:	The tax is:
Over $8,400 but not over $10,600	$1,636.50, plus 28% of excess over $8,400.
Over $10,600 but not over $13,250	$2,252.50, plus 32% of excess over $10,600.
Over $13,250 but not over $15,900	$3,100.50, plus 37% of excess over $13,250.
Over $15,900 but not over $21,200	$4,081, plus 43% of excess over $15,900.
Over $21,200 but not over $28,300	$6,360, plus 49% of excess over $21,200.
Over $28,300	$9,839, plus 50% of excess over $28,300."

(b) DETERMINATION OF INCOME.—Section 63 (defining taxable income) is amended to read as follows:

"SEC. 63. TAXABLE INCOME DEFINED.

"(a) CORPORATIONS.—For purposes of this subtitle, in the case of a corporation, the term 'taxable income' means gross income minus the deductions allowed by this chapter.

"(b) INDIVIDUALS.—For purposes of this subtitle, in the case of an individual—

"(1) PERSONAL SERVICE TAXABLE INCOME.—The term 'personal service taxable income' means personal service income reduced by so much of the allowable deductions as the individual elects to allocate against such income.

"(2) NONPERSONAL SERVICE TAXABLE INCOME.—The term 'nonpersonal service taxable income' means gross income reduced by the sum of—

"(A) personal service income, plus

"(B) so much of the allowable deductions as are not allocated against personal service income under paragraph (1).

"(3) TAXABLE INCOME.—The term 'taxable income' means gross income minus the allowable deductions.

"(4) ALLOWABLE DEDUCTIONS.—The term 'allowable deductions' means—

"(A) in the case of an individual who elects to itemize his deductions, the deductions allowed by this chapter, or

"(B) in the case of any other individual, the sum of—

"(i) the deductions allowable in arriving at adjusted gross income,

"(ii) the deductions for personal exemptions provided by section 151, and

"(iii) the standard amount.

"(c) STANDARD AMOUNT.—For purposes of this subtitle—

"(1) IN GENERAL.—Except as provided in paragraph (2), the term 'standard amount' means—

"(A) $3,400 in the case of—

"(i) a joint return under section 6013, or

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"(ii) a surviving spouse (as defined in section 2(a)),

"(B) $2,300 in the case of an individual who is not married and who is not a surviving spouse (as so defined),

"(C) $1,700 in the case of a married individual filing a separate return, or

"(D) zero in any other case.

"(2) SPECIAL RULE FOR CERTAIN DEPENDENTS.—In the case of an individual with respect to whom a deduction under section 151(e) is allowable to another taxpayer for a taxable year beginning in the calendar year in which the individual's taxable year begins, the terms 'standard amount' shall not exceed such individual's earned income (as defined in section 911(b)) for such taxable year.

"(d) PERSONAL SERVICE INCOME.—For purposes of this section—

"(1) IN GENERAL.—The term 'personal service income' means any income which is earned income within the meaning of section 401(c)(2)(C) or section 911(b) or which is an amount received as a pension or annuity which arises from an employer-employee relationship or from tax-deductible contributions to a retirement plan. For purposes of this paragraph, section

911(b) shall be applied without regard to the phrase ', not in excess of 30 percent of his share of net profits of such trade or business,'.

"(2) EXCEPTIONS.—The term 'personal service income' does not include any amount—

"(A) to which section 72(m)(5), 402(a)(2), 402(e), 403(a)(2), 408(e)(2), 408(e)(3), 408(e)(4), 408(e)(5), 408(f), or 409(c) applies; or

"(B) which is includible in gross income under section 409(b) because of the redemption of a bond which was not tendered before the close of the taxable year in which the registered owner attained age 70½.

"(e) ITEMIZED DEDUCTIONS.—For purposes of this subtitle, the term 'itemized deductions' means the deductions allowable by this chapter other than—

"(1) the deductions allowable in arriving at adjusted gross income, and

"(2) the deductions for personal exemptions provided by section 151.

"(f) ELECTION TO ITEMIZE.—

"(1) IN GENERAL.—Unless an individual makes an election under this subsection for the taxable year, no itemized deduction shall be allowed for the taxable year. For purposes of this subtitle, the determination of whether a deduction is allowable under this chapter shall be made without regard to the preceding sentence.

"(2) WHO MAY ELECT.—Except as provided in paragraph (3), an individual may make an election under this subsection for the taxable year only if such individual's itemized deductions exceed the standard amount.

"(3) CERTAIN INDIVIDUALS TREATED AS ELECTING TO ITEMIZE.—The following individuals shall be treated as having made an election under this subsection for the taxable year:

"(A) a married individual filing a separate return where either spouse itemizes deductions,

"(B) a nonresident alien individual, and

"(C) a citizen of the United States entitled to the benefits of section 931 (relating to income from sources within possessions of the United States).

"(4) TIME AND MANNER OF ELECTION.—Any election under this subsection shall be made on the taxpayer's return, and the Secretary shall prescribe the manner of signifying such election on the return.

"(5) CHANGE OF TREATMENT.—Under regulations prescribed by the Secretary, a change of treatment with respect to the standard amount and itemized deductions for any taxable year may be made after the filing of the return for such year. If the spouse of the taxpayer filed a separate return for any taxable year corresponding to the taxable year of the taxpayer, the change shall not be allowed unless, in accordance with such regulations—

"(A) the spouse makes a change of treatment with respect to the standard amount and itemized deductions, for the taxable year covered in such separate return, consistent with the change of treatment sought by the taxpayer, and

"(B) the taxpayer and his spouse consent in writing to the assessment, within such period as may be agreed on with the Secretary, of any deficiency, to the extent attributable to such change of treatment, even though at the time of the filing of such consent the assessment of such deficiency would otherwise be prevented by the operation of any law or rule of law.

This paragraph shall not apply if the tax liability of the taxpayer's spouse, for the taxable year corresponding to the taxable year of the taxpayer, has been compromised under section 7122.

"(g) MARITAL STATUS.—For purposes of this section, marital status shall be determined under section 143."

(c) REPEAL OF MAXIMUM RATE ON PERSONAL SERVICE INCOME.—Part VI of subchapter Q of chapter 1 is hereby repealed.

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1980.

[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX BILLS

RELATING TO

INCENTIVES FOR SAVINGS AND INVESTMENT

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT POLICY

OF THE

COMMITTEE ON FINANCE

ON MAY 4, 1981

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

MAY 1, 1981

U.S. GOVERNMENT PRINTING OFFICE
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INTRODUCTION

The Subcommittee on Savings, Pensions, and Investment Policy of the Senate Committee on Finance has scheduled a hearing on May 4, 1981, on 10 bills relating to the tax treatment of certain income from savings and investment.

This pamphlet, prepared in connection with the hearing, contains four parts. The first part is a summary of the ten bills scheduled for the hearing. The second part describes the present law treatment of capital gains and three bills (S. 75, S. 145, and S. 457) which would reduce the tax on capital gains. The third part describes S. 936, which would provide for the separate computation of tax on savings and investment income. The fourth part describes the present law treatment of dividend and interest income and six bills (S. 141, S. 142, S. 155, S. 330, S. 492, and S. 619) that would reduce taxes on dividend or interest income.

I. SUMMARY OF BILLS

Taxation of capital gains

Present law allows a noncorporate taxpayer to deduct from gross income 60 percent of any net capital gain. Corporate net capital gains generally are subject to an alternative capital gains tax rate of 28 percent. Present law generally does not provide for tax-deferred investment accounts.

S. 75 (Senators Wallop, Moynihan, Cranston, and others) would increase the capital gains deduction for individuals from 60 percent to 75 percent and would reduce the maximum rate of the alternative minimum tax from 25 percent to 17.5 percent. The bill also would reduce the capital gains rate for corporations from 28 percent to 17.5 percent.

S. 145 (Senator Moynihan) would increase the capital gains deduction for individuals from 60 percent to 70 percent and would reduce the maximum rate of the alternative minimum tax from 25 percent to 20 percent. The maximum noncorporate income tax rate would be reduced from 70 percent to 67 percent. The bill also would reduce the capital gains rate for corporations from 28 percent to 20 percent.

S. 457 (Senator Cranston) would provide for tax-deferred investment accounts. Capital gains realized in the account would not be subject to tax until distributed.

Separate taxation of investment income

S. 936 (Senators Roth, Bentsen, and Kasten) would provide for the separate computation of tax on personal service income and other income and would reduce the maximum tax rate on income from any source to 50 percent.

Taxation of dividends and interest

Exclusion for interest and dividends

Present law (for 1981 and 1982) allows individuals to exclude from gross income up to $200 ($400 on a joint return) of combined dividend and interest income.

S. 155 (Senator Schmitt) would provide for a dividend and interest exclusion of $200 ($400 on a joint return) plus 25 percent of dividends and interest (up to $50,000) in excess of that amount. The percentage exclusion would be phased in at a rate of 5 percent per year, beginning in 1982 (fully phased in by 1986).

S. 819 (Senators Nunn and Huddleston) would provide a dividend and interest exclusion equal to the greater of $200 ($400 on a joint return) or 30 percent of dividends and interest income. The percentage exclusion would be phased in at a rate of 10 percent per year, beginning in 1982 (fully phased in for 1984 and subsequent years).

S. 142 (Senator Bentsen) would increase the dividend and interest exclusion to $1,000 ($2,000 on a joint return) and would make the exclusion permanent.

S. 330 (Senators Durenberger and Boren) would, when fully effective in 1985, provide individuals with a dividend and interest exclusion of $1,250 ($2,500 on a joint return). This exclusion would be permanent.

S. 492 (Senator D'Amato) would increase the present dividend and interest exclusion to $1,000 ($2,000 on a joint return).

Dividend reinvestment plans

S. 141 (Senators Bentsen and Baucus) would allow shareholders to exclude up to $1,500 ($3,000 on a joint return) of dividends received in original issue stock under a dividend reinvestment plan.

II. TAXATION OF CAPITAL GAINS

A. Description of S. 75 (Senators Wallop, Moynihan, Cranston, and others) and S. 145 (Senator Moynihan): Capital Gains Tax Rates

Present Law

Noncorporate taxpayers

Noncorporate taxpayers may deduct from gross income 60 percent of the amount of any net capital gain (the excess of net long-term capital gain over net short-term capital loss) for the taxable year. The remaining 40 percent of the net capital gain is included in gross income and taxed at the otherwise applicable regular income tax rates. As a result, the highest tax rate applicable to a taxpayer's entire net capital gain is 28 percent, i.e., 70 percent (the highest individual tax rate) times the 40 percent of the entire net capital gain includible in gross income.

Under present law, an alternative minimum tax is payable by noncorporate taxpayers to the extent that it exceeds their regular income tax, including the "add-on" minimum tax. The alternative minimum tax is based on the sum of the taxpayer's gross income, reduced by certain allowed deductions, and increased by two tax preference items: (1) "excess" itemized deductions and (2) the section 1202 capital gains deduction. The alternative minimum tax rate is 10 percent for amounts from $20,000 to $60,000; 20 percent for amounts from $60,000 to $100,000; and 25 percent for amounts over $100,000.

Corporations

An alternative tax rate of 28 percent applies to a corporation's net capital gain (the excess of net long-term capital gain over net short-term capital loss) if the tax computed using that rate is lower than the corporation's regular tax. (The highest regular corporate tax rate is 46 percent for taxable income over $100,000.) Present law also makes 18/46th of a corporation's net capital gain an item of tax preference, subject to the "add-on" minimum tax. The capital gains deduction does not apply to corporations.

Description of the Bills

1. S. 75 (Senators Wallop, Moynihan, Cranston, and others)

Explanation of provisions

Noncorporate taxpayers

The bill would provide that a noncorporate taxpayer may deduct from gross income 75 percent of the amount of any net capital gain for the taxable year. The remaining 25 percent of the net capital gain would be includible in gross income and subject to tax at the otherwise applicable rates. As a result, the highest tax rate applicable to a noncorporate taxpayer's entire net capital gain would be 17.5 percent, i.e., 70 percent (the highest individual tax rate) times the 25 percent of the entire net capital gain which would be included in gross income.

The bill would reduce the maximum rate of the alternative minimum tax from 25 percent to 17.5 percent.

Corporations

The bill also would reduce the corporate alternative tax rate from 28 percent to 17.5 percent.

Effective date

The provisions of S. 75 generally would apply to taxable years ending after December 31, 1980.

Revenue effect

It is estimated that this bill would reduce calendar year liability and fiscal year receipts as follows:

[Millions of dollars]

	1981	1982	1983	1984	1985	1986
Individual:						
Calendar	3, 683	3, 959	4, 256	4, 575	4, 919	5, 287
Fiscal		3, 683	3, 959	4, 256	4, 575	4, 919
Corporate:						
Calendar	557	612	674	741	816	897
Fiscal	279	585	643	708	779	857
Totals:						
Calendar	4, 240	4, 571	4, 930	5, 316	5, 735	6, 184
Fiscal	279	4, 268	4, 602	4, 964	5, 354	5, 776

Note: These estimates are of the direct revenue loss and do not attempt to take into account taxpayer response to the liberalized tax treatment of capital gains under the proposal. Allowing for this response would reduce the estimated revenue losses.

2. S. 145 (Senator Moynihan)

Explanation of provisions

Noncorporate taxpayers

The bill would provide that a noncorporate taxpayer may deduct from gross income 70 percent of the amount of any net capital gain for the taxable year. The remaining 30 percent of the net capital gain would be includible in gross income and subject to tax at the otherwise applicable rates. As a result, the highest tax rate applicable to a noncorporate taxpayer's entire net capital gain would be 20.1 percent, i.e., 67 percent (the highest individual tax rate under the bill) times the 30 percent of the entire net capital gain which would be included in gross income.

The bill would reduce the maximum rate of the alternative minimum tax from 25 percent to 20 percent.

The bill also would reduce the maximum noncorporate income tax rate from 70 percent to 67 percent.

Corporations

The bill would reduce the corporate alternative tax rate from 28 percent to 20 percent.

Effective date

The provisions of S. 145 would apply to taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this bill would reduce calendar year liability and fiscal year receipts as follows:

[Millions of dollars]

	1981	1982	1983	1984	1985	1986
Individual:						
Calendar	2, 752	3, 025	3, 335	3, 689	4, 096	4, 567
Fiscal	279	2, 822	3, 112	3, 444	3, 826	4, 266
Corporate:						
Calendar	423	466	512	563	620	631
Fiscal	212	445	490	538	592	651
Totals:						
Calendar	3, 175	3, 491	3, 847	4, 252	4, 716	5, 248
Fiscal	491	3, 267	3, 602	3, 982	4, 418	4, 917

Note: These estimates are of the direct revenue loss and do not attempt to take into account taxpayer response to the liberalized tax treatment of capital gains under the proposal. Allowing for this response would reduce the estimated revenue losses.

Prior Congressional action

H.R. 5829 (96th Congress), as reported by the Finance Committee, contained a provision similar to S. 145.

B. Description of S. 457 (Senator Cranston)

Tax-Deferred Investment Accounts

Present law

Present law generally does not provide for the creation of tax-deferred investment accounts.

Explanation of the bill

The bill would permit an individual to defer from income tax the gain realized from the sale of stocks and securities which have been contributed to a "tax-deferred rollover account." A tax-deferred rollover account would be a trust created or organized in the United States for the exclusive benefit of an individual (or the individual's beneficiaries), governed by a written instrument which meets specified statutory requirements. Only one account could be maintained by a taxpayer at any time, and an account generally could not be transferred or pledged as security.

The trust instrument for each account would have to provide that:

(1) Only cash or stock or securities of a domestic corporation may be accepted, and only when contributed by the individual;

(2) The trustee is to be a bank or a person who demonstrates to the Secretary's satisfaction that the trust's administration will be consistent with the bill's requirements;

(3) Investments may be made only in stock or securities of domestic corporations or held in interest-bearing bank deposits;

(4) Trust assets may not be commingled with other property;

(5) The individual's interest in the account's balance is nonforfeitable, and payable within 10 days of demand (or pursuant to special testamentary rules);

(6) The trust's taxable year is the same as the individual's; and

(7) The individual may elect, annually, for the account to be discretionary (with investments determined by the trustee), or self-directed (with investments determined by the individual).

The bill would require the account trustee to establish two unsegregated funds on its books. One fund, the "capital fund," would consist of (1) cash contributed to the account, (2) an amount equal to the individual's basis for contributed property, and (3) gain realized in nonrecognition transactions. The second fund, the "capital gain fund," would consist of net capital gain.

Payments and distributions from an account would be treated as being made first from the capital gain fund, and second from the capital fund. Generally, payments and distributions would not be treated as being made from the capital fund until other remaining account balances have been distributed or paid. Capital gain fund distributions would be included in the recipient's gross income as long-term capital gain for the taxable year of receipt. Ordinary income would be taxable to, and would be required to be distributed to, the taxpayer for the taxable year in which it was received by the trust.

Property contributed to, or distributed from, a rollover account would have a carryover basis. For purposes of rollover account computations, a distribution of property would be treated as a distribution of an amount equal to the basis of the property distributed.

Under the bill, an individual with a net capital loss outside of the rollover account would be treated as having been distributed out of the capital gain fund the lesser of the net capital loss or the amount in the capital gain fund. The amount deemed distributed would increase the capital fund. Thus, a capital loss outside of an account first would reduce capital gains, if any, outside of an account, then would reduce potential tax liability on account gains. An individual could realize a loss, however, on the termination of an account if the amounts contributed exceed all distributions.

The bill would require the trustee to comply with administrative rules prescribed by the Secretary.

Effective date

The provisions of the bill would be effective with respect to trusts created or organized after October 1, 1981.

Revenue effect

A revenue estimate for this bill is not available at this time.

III. SEPARATE TREATMENT OF INVESTMENT INCOME

Description of S. 936 (Senators Roth, Bentsen, and Kasten)

Present Law

In general

Under present law, an individual's taxable income is subject to tax under one of four separate progressive tax rate schedules; the particular schedule applicable to a taxpayer depends upon the taxpayer's filing status. There are different rate schedules for married couples filing jointly and surviving spouses, married couples filing separately, unmarried heads of households, and other unmarried persons. Taxable income consists of gross income reduced by allowable deductions.

There is no tax on taxable income within the initial tax bracket, referred to as the "zero bracket amount." This amount also serves as a floor under allowable itemized deductions, so that itemizers can deduct only expenses in excess of that amount.[1]

Maximum tax

Above the zero bracket amounts, the tax rates range from 14 percent to 70 percent.

Although the tax rates range up to 70 percent on taxable income in excess of $215,400 for joint returns and $108,300 for single returns, a maximum tax rate of 50 percent generally applies to personal service income (for example, salaries and wages). The maximum tax applies to single individuals with taxable earned income above $41,500 and married couples with taxable earned income above $60,000, since these are the levels at which present tax rates rise above 50 percent. The actual marginal tax rate on earned income may be greater than 50 percent even for those individuals whose tax liability is calculated using the maximum tax. This occurs for two reasons. First, the tax liability on unearned income is calculated by "stacking" it after earned income, so that each additional dollar of earned income may push a taxpayer's unearned income into higher brackets. Second, because itemized deductions are, in effect, allocated on a pro rata basis between earned income and other income, each dollar of earned income causes an additional amount of itemized deductions to be allocated to earned income. As a result, a larger portion of the deductions reduces income which would be taxed at a 50-percent rate rather than at the higher rates applicable to other income.

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[1] Prior to 1977, the law provided a standard deduction, which taxpayers could use if they did not elect to itemize their deductions. The Tax Reduction and Simplification Act of 1977 replaced the standard deduction with the present system, in which the standard deduction is, in effect, built into the rate schedule for all taxpayers and then is "taken back" from itemizers through the floor under itemized deductions.

Capital gains

Under present law, individual taxpayers may deduct from gross income 60 percent of the amount of any net capital gain for the taxable year. The remaining 40 percent of the net capital gain is included in gross income and taxed at the otherwise applicable regular income tax rates. As a result, the highest tax rate applicable to a taxpayer's net capital gain is 28 percent (70 percent top tax rate on the 40-percent includible capital gain).

Minimum tax

Present law imposes an add-on minimum tax on items of tax preference other than the capital gains deduction and adjusted itemized deductions. The tax applies at a rate of 15 percent on the sum of an individual's tax preferences in excess of one-half of regular income taxes paid or, if greater, $10,000. An alternative minimum tax is imposed on individuals to the extent that the tax on alternative minimum taxable income exceeds their regular income tax, including the "add-on" minimum tax.

In general, alternative minimum taxable income is based on the sum of the taxpayer's gross income reduced by allowed deductions, and increased by tax preference items (i.e., adjusted itemized deductions and the capital gains deduction). The minimum tax rate ranges from 10 percent on amounts over $20,000 to 25 percent on amounts over $100,000.

Description of the Bill

Explanation of provisions

The bill would provide for the separate computation of tax on personal service income and other income, and would reduce the maximum tax rate on income from any source to 50 percent.

Eligible individual taxpayers would separate their income into two classes: personal service income and non-personal service income. The tax on each category would be computed using rate schedules that would be revised to remove the zero bracket amount provided under present law and to limit the top marginal rate to 50 percent. A standard deduction would be provided to offset the effect of eliminating the zero bracket amount. The standard deduction, itemized deductions, adjustments to gross income, and personal exemptions could be allocated to either category of income in whatever manner the taxpayer elects. Since the zero bracket amount would be replaced by a standard deduction, there would not be a reduction in the amount of itemized deductions to reflect the zero bracket amount.

The bill would adopt the definition of personal service income used for purposes of the maximum tax provision of present law. Thus, personal service income generally would include income from personal services such as wages, salaries, professional fees, pensions and annuities arising from employment, and net earnings from self-employment.

Separate computation would not be available to individuals who have items of tax preference (other than capital gains) in excess of $10.000 ($5.000 in the case of married taxpayers filing separately).

The following example illustrates the effect of the proposed change relative to present law.

Assuming that a married couple has combined income from employment of $31,900 and does not itemize deductions, their tax would be $6,201. Under present law, if that couple earned an additional $5,000 of either personal service income or investment income, their tax liability would increase by $1,850. Under the bill, there would be no difference in the tax liability if all of the income is from personal services. However, if the additional $5,000 is not personal service income, then the taxpayers would make a separate computation of the tax on each category of income. If the taxpayers allocated their standard deduction and personal exemption to the personal service income, the tax on that income would be $6,201, as under present law. The tax on the additional $5,000 of nonpersonal service income would be $774 (instead of $1,850, as under present law). This result reflects the fact that nonpersonal service income would not be stacked on top of the personal service income but instead would be taxed separately at the lower rates that apply to reduced amounts of income.

Effective date

The bill would be effective for taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this bill would reduce calendar year liability and fiscal year receipts as follows:

[Millions of dollars]

	1981	1982	1983	1984	1985	1986
Calendar	15, 899	18, 697	23, 116	26, 170	30, 812	36, 075
Fiscal	11, 654	17, 950	21, 203	25, 089	29, 572	34, 670

IV. TAXATION OF DIVIDENDS AND INTEREST

A. Description of S. 155 (Senator Schmitt), S. 819 (Senators Nunn and Huddleston), S. 142 (Senator Bentsen), S. 330 (Senators Durenberger and Boren), and S. 492 (Senator D'Amato)

Increase in the Exclusion for Dividends and Interest Income

Present Law

Under present law, there is a partial exclusion for dividends and interest received by individuals (Code sec. 116). Effective for taxable years beginning after December 31, 1980, and before January 1, 1983, individuals may exclude from gross income up to $200 ($400 on a joint return) of dividends and interest income received from domestic sources. After 1982, this exclusion is to revert to prior law, under which the exclusion was limited to $100 of dividends received by an individual ($200 on a joint return, if each spouse had at least $100 of dividends).

Description of Bills

1. S. 155 (Senator Schmitt)

Explanation of provisions

When fully phased in (in 1986), the bill would provide an exclusion for dividends and interest of up to $200 ($400 on a joint return) plus 25 percent of dividends and interest in excess of that amount. The maximum amount of interest and dividends that would be taken into account for purposes of the percentage exclusion would be $50,000. Thus, the maximum exclusion for a married couple would be $12,900 (*i.e.*, $400 plus 25 percent of $50,000) and the maximum exclusion for a single person would be $12,700 (*i.e.*, $200 plus 25 percent of $50,000).

The percentage exclusion provided by the bill would be phased in at a rate of 5 percent per year beginning in 1982, in accordance with the following schedule:

Calendar year:	*Percentage*
1982	5
1983	10
1984	15
1985	20
1986 and thereafter	25

Effective date

The provisions of the bill would be effective for taxable years beginning after December 31, 1981.

Revenue effect

It is estimated that this bill would reduce calendar year liability and fiscal year receipts as follows:

[Millions of dollars]

	1981	1982	1983	1984	1985	1986
Calendar		2, 299	8, 255	12, 341	17, 535	24, 087
Fiscal		517	4, 259	10, 406	14, 289	19, 991

Note: These estimates are of the direct revenue loss and do not attempt to take into account taxpayer's response to the liberalized tax treatment of interest and dividends under the proposal.

2. S. 819 (Senators Nunn and Huddleston)

Explanation of provisions

Under the bill, when fully effective in 1984, the exclusion for dividends and interest income would be the greater of: (1) $200 ($400 on a joint return) or (2) 30 percent of an individual's (individual and spouse on a joint return) aggregate dividends and interest income.

The percentage exclusion under the bill would be phased in at a rate of 10 percent per year beginning in 1982, in accordance with the following table:

Taxable year beginning in:	*Percentage*
1982	10
1983	20
1984 and thereafter	30

Effective date

The provisions of the bill would be effective for taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this bill would reduce calendar year liability and fiscal year receipts as follows:

[Millions of dollars]

	1981	1982	1983	1984	1985	1986
Calendar		4, 233	13, 950	22, 946	26, 419	30, 428
Fiscal		952	7, 466	18, 370	24, 248	27, 923

Note: These estimates are of the direct revenue loss and do not attempt to take into account taxpayer's response to the liberalized tax treatment of interest and dividends under the proposal.

3. S. 142 (Senator Bentsen)

Explanation of provisions

The bill would increase the partial exclusion for dividends and interest to $1,000 ($2,000 on a joint return). In addition, the exclusion would be made permanent.

Effective date

The provisions of the bill would apply to taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this bill would reduce calendar year liability and fiscal year receipts as follows:

[Millions of dollars]

	1981	1982	1983	1984	1985	1986
Calendar	6, 803	7, 483	11, 278	12, 405	13, 645	15, 010
Fiscal	1, 020	7, 467	9, 183	12, 545	12, 870	14, 157

Note: These estimates are of the direct revenue loss and do not attempt to take into account taxpayer's response to the liberalized tax treatment of interest and dividends under the proposal.

4. S. 330 (Senators Durenberger and Boren)

Explanation of provisions

When fully phased in, in 1985, the bill would increase the exclusion for dividends and interest income to $1,250 ($2,500 on a joint return). This increased exclusion would be phased in over a five-year period, as follows: In 1981, the exclusion would be $250 ($500 on a joint return); in 1982, the exclusion would be $500 ($1,000 on a joint return); in 1983, the exclusion would be $750 ($1,500 on a joint return); in 1984, the exclusion would be $1,000 ($2,000 on a joint return); and in 1985, the exclusion would be $1,250 ($2,500 on a joint return). In addition, the bill would make the exclusion permanent.

Effective date

The provisions of the bill would be effective for taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this bill would reduce calendar year liability and fiscal year receipts as follows:

[Millions of dollars]

	1981	1982	1983	1984	1985	1986
Calendar	597	3, 429	9, 248	12, 405	16, 052	17, 658
Fiscal	90	1, 279	5, 432	11, 125	13, 773	16, 654

Note: These estimates are of the direct revenue loss and do not attempt to take into account taxpayer's response to the liberalized tax treatment of interest and dividends under the proposal.

5. S. 492 (Senator D'Amato)

Explanation of provision

The bill would increase the exclusion for dividends and interest income to $1,000 ($2,000 on a joint return).

Effective date

The bill would be effective upon enactment.

Revenue effect

It is estimated that this bill would reduce calendar year liability and fiscal year receipts as follows:

[Millions of dollars]

	1981	1982	1983	1984	1985	1986
Calendar		7,483	11,278	12,405	13,645	15,010
Fiscal		1,684	9,183	12,546	12,870	14,157

Note: These estimates are of the direct revenue loss and do not attempt to take into account taxpayer's response to the liberalized tax treatment of interest and dividends under the proposal. The estimates assume that the exclusion is effective on January 1, 1982, and is permanent.

B. Description of S. 141 (Senators Bentsen and Baucus)

Dividend Reinvestment Plans

Present Law

Under present law (sec. 305(a)), a pro rata stock dividend is not taxable to a shareholder at the time he or she receives it, but is taxable only when the taxpayer sells or otherwise disposes of the shares received as a dividend. Any gain on the sale is treated as a long-term capital gain if the underlying shares (on which the dividend was declared) were held for more than one year.

Stock dividends which are not pro rata, including stock dividends received pursuant to a shareholder's option to receive either stock or cash, are taxable at fair market value when the shares are initially received. The rationale for this different treatment is that with pro rata stock dividends no shareholder has gained any increased interest in the corporation since all shareholders receive a proportionately equal amount of additional stock. But with non-pro rata dividends those receiving the stock dividend do gain an additional interest in the corporation relative to those not receiving stock. Thus, shareholders receiving the stock have gained some value, which is taxed as a dividend. For 1981 and 1982, an individual taxpayer is allowed to exclude from gross income up to $200 ($400 in the case of a joint return) of combined dividends from domestic corporations and interest.

Description of the Bill

Explanation of provisions

Under S. 141, a domestic corporation would be allowed to establish a plan under which shareholders who choose to receive a dividend in the form of common stock rather than cash or other property may elect to exclude up to $1,500 per year ($3,000 in the case of a joint return) of the stock dividends from income.

To qualify, the stock would have to be newly issued common stock, designated by the corporation to qualify for this purpose. The number of shares to be issued would have to be determined by reference to a value not less than 95 percent of the stock's value during the period immediately before the distribution date. Generally, stock would not qualify where the corporation has repurchased any of its stock within one year before or after the distribution date.

Stock received as a qualified dividend would have a zero basis, so that when the stock is later sold the full amount of the sales proceeds would be taxable. In general, proceeds from the sale of such stock would be taxed as capital gains. However, where the stock is sold within one year after distribution, any gain would be treated as ordinary income. In addition, where shares of stock of the distributing corporation are sold by the taxpayer any time after the record date for the dividend and before a date one year after the dividend distribution date, the sale would be treated as a sale of the qualified dividend stock. These rules are designed to prevent the immediate resale of stock without the recognition of ordinary income which would have resulted in the case of a taxable dividend.

Effective date

The provisions of the bill would be effective for distributions made after December 31, 1981.

Revenue effect

It is estimated that this bill would reduce calendar year liability and fiscal year receipts as follows:

[Millions of dollars]

	1982	1983	1984	1985	1986
Calendar	725	932	1,133	1,118	1,123
Fiscal	272	803	1,007	1,127	1,120

STATEMENT OF SENATOR SAM NUNN

Mr. Chairman, I am pleased to have this opportunity to submit my views on S. 819, the Savings Incentive Act. With the exception of a slight increase last year, the level of savings in the United States has declined every year since 1975. That trend has become a problem of critical national concern. The effects of today's anemic savings rate are clear and obvious—soaring inflation, high interest rates, lagging investment, poor productivity performance, and sluggish economy growth. Increasing savings is the necessary first step to accumulating the capital essential for new home construction and for investment in new plant and equipment which will lead to increased productivity, lower inflation, and sustained real growth.

While Americans have been saving only 4 to 5 percent of their income, other major industrialized nations have done much better. The Canadian savings rate is greater than 10 percent. The West Germans save 13 to 15 percent of their income and the Japanese save more than 20 percent of their income. Government incentives to encourage savings in these nations far exceed those in the United States. Canada excludes from taxation the first $2,000 of interest and dividends on a joint return. In West Germany, the first $300 of interest on regular savings is excluded from taxation and there are additional benefits for long-term savings. And in Japan, interest earned on the first $32,000 of savings is exempt from taxation.

The benefits of these savings incentives are clear as our competitors are succeeding where we are failing. The average plant in the United States is 16 to 17 years old, while the equivalent in West Germany is 12 and in Japan less than 10. Investment in the United States hovers at about 10 percent of gross national product compared with 15 percent in Germany and 20 percent in Japan. And as a result, U.S. productivity is slipping while that of our competitors is increasing.

Mr. Chairman, the list of victims of America's poor savings record continues to grow. The housing industry, the savings and loan industry, small businesses and farmers are suffering nationwide from runaway inflation and high interest rates. Many small businessmen, automobile dealers, farmers and construction companies are fighting for their very survival.

The lack of savings is particularly having a devastating whipsaw effect on the housing and savings and loan industries. Our Nation's savings and loans are being squeezed by low savings, high interest rates, and mortgages yielding less than current interest being paid by the savings and loan.

Channeling money into productive savings is a key ingredient to lowering interest rates, increasing productivity, lowering inflation and strengthening the economy.

Unless the current climate of "buy now, save later" is turned around, inadequate savings will deprive our economy of the capital necessary for the needed increase in productivity critical to restoring the domestic and international competitiveness of U.S. industries.

The President has also recognized the necessity to increase savings and he has proposed a tax cut bill to address the problem. The President's plan would reduce all marginal tax rates by 30 percent over a 36-month period in the hope that this will stimulate new savings flow. While all of us agree that individual taxes are too high and should be reduced, this approach provides no direct incentive for the average middle-income American to save and invest in the resources essential to economic recovery.

Given the Administration's inflation projections and the adoption of its economic program, middle income taxpayers would see no real decline in their effective tax rates as inflation pushes them into higher brackets and payroll taxes increase. I am concerned that these Americans who are really receiving no tax break from the Administration's proposal and who are now saving $4 out of every $100 they earn, will continue to save at about that same rate and not substantially increase their savings. The Administration's proposal provides no reasonable assurance that the middle-income American will take his $200 to $300 tax cut and open or add to a savings account, or invest in securities. Commonsense says that without savings incentives in the tax code, the tax cut will result in increased spending and little additional savings.

Individual tax reductions should be enacted over the next few years. But in the immediate future, I believe we need to adopt a "rifle approach" to encourage increased savings rather than the "shotgun approach" suggested by the Administration. And, in future years, budget reduction beyond those adopted by the Senate this year should be precedent to individual income tax reductions.

The Savings Incentive Act which I introduced in March would help establish a reward for saving by making the temporary $200/$400 exclusion payment. My bill would also allow a taxpayer to exclude 10 percent of income from savings or dividends from taxation in 1982, 20 percent in 1983, and 30 percent in 1984 is such a percentage were greater than the $200/$400 exclusion. The net effect of this measure is to gradually reduce the maximum marginal tax on interest and dividends from 70 percent to 49 percent. Even more importantly, it will reduce the tax rate on savings and productive investments for middle-income Americans.

Mr. Chairman, the subcommittee has before it several other proposals which would help create additional savings by making the tax code neutral in its treatment of consumption and savings. All of them deserve serious consideration. The pros and cons of each proposal must be weighed and compared so that the best possible proposal can be enacted. I commend the subcommittee for holding this hearing and I hope the full Committee will adopt badly needed incentives as a part of any tax cut bill it reports to the full Senate.

Senator CHAFEE. This morning is the second hearing we have scheduled this year for analyzing individual savings and investment incentives.

The first hearing was held on February 24 and that focused on proposals to expand the eligibility requirements for individual retirement accounts and to increase the contribution limit and purposes for which an IRA can be used.

In today's hearings we will look at savings and investment incentives having a more general impact on individual savers.

One of the most widely heard and accepted criticisms of our economy is that we have a capital shortage. There isn't enough money available for investing in new machinery and equipment to make our industries more productive.

The home mortgage market is practically dried up. Interest rates are so high, no one is buying cars and the U.S. auto industry is having considerable trouble.

Part of the reason for the shortage of investment capital is that huge Federal deficits are causing the Government to borrow heavily from its citizens, shifting almost 30 percent of all loanable funds in the market this year.

Another basic reason for the shortage is seen in the economic behavior of U.S. taxpayers. Figures show that last year our savings rate dipped as low as 3.5 percent of personal income. That is down from 5.7 percent during the 1976–80 period and 8.1 in the first 5 years of the last decade.

Another widely heard and widely accepted criticism of our economy is that our tax system provides the wrong incentives, or at least a bad balance between incentives. Taxpayers are rewarded with tens of billions of dollars in tax breaks for their everyday habit of borrowing money rather than saving it. Interest payments to lenders are deductible, whether they are from charging a pair of shoes or buying a house. On the other hand, interest and dividends earned by savers are taxed at the highest marginal rates.

The questions before us are these: Should Congress act to change this balance by creating more effective savings and investment incentives? If so, when should we act and what should we do?

The President's economic package provides no specific tax incentives for individual savings and investment. It does, however, contain essential budget reductions, marginal tax rate cuts, and business investment stimulus. It provides a good foundation for America's economic renewal. We are told by the administration that a second tax proposal will be made containing a savings incentive, a remedy for the marriage tax penalty, and other tax-cutting measures.

While I understand the administration's legislative strategies, neither I nor many of my colleagues on the Finance Committee believe there will be two tax bills this year. We have only one chance to enact a savings incentive, and we believe we must not let it pass.

The study I have done and the testimony we have heard so far this year has persuaded me that expanding individual retirement accounts would give us the most effective incentive for increasing total savings; however, I remain open to the persuasive argument.

This morning's testimony will focus on four basic types of savings and investment incentives. First, reducing the capital gains tax rate. Second, taxing investment income separately from salary and wage income to give it the benefit of a lower marginal rate. Third, excluding large amounts or portions of interest and dividend income from taxation. Fourth, allowing tax deferrals for reinvestment of dividends or capital gains.

We will also hear from two gentlemen who will discuss savings and investment incentives used in other industrial nations.

To begin with we have two very distinguished U.S. Senators here who are going to make a contribution to our efforts today. I am delighted to welcome Harrison "Jack" Schmitt, Republican of New Mexico, who will be followed by the Honorable Alan Cranston, a Democrat from California.

Both of these gentlemen have had long interest in this area and have made very, very valuable contributions. Gentlemen, let me say, I appreciate your taking the time to come here, today, to present to the subcommittee your thoughts.

STATEMENT OF HON. HARRISON "JACK" SCHMITT, U.S. SENATOR

Senator SCHMITT. Well, thank you, Mr. Chairman; and by your remarks introducing this hearing, you clearly understand that our basic savings and investment rate in this country is far too little to support an economic revival that we all hope and believe must occur.

Frankly, in a highly inflationary economy, one in which the regulation of interest rates is artificial, there is no direct incentive to save and invest. As I have said frequently, anyone with a savings account or who invests at interest rates that are less than the inflation rate is a patriot and not a saver.

Mr. Chairman, it has become widely recognized that America must increase its rates of savings, investment, if we are to have the economic goals that we desire in the decade ahead.

A significant factor in the declining performance of the U.S. economy in the past decade has been falling rates of savings by the American public, as you have indicated, down to probably as low as 3.5 percent.

Personal savings as a percentage of disposable income, has undergone a steady decline from 7.7 percent in 1975 to the level that you mentioned in the first quarter of this year.

In every year since 1975, the amount of personal savings has fallen lower than the previous year. The overall reduction is in excess of 50 percent, Mr. Chairman.

It is generally recognized that savings is a source for investment and that investment is the generator of increased productivity, new employment, and therefore increased revenues to the Federal Government.

Investment means new plants and equipment and new jobs to build new production facilities and operate new machinery. If the critical element of personal savings is absent from this equation, then production and employment, obviously suffer.

To achieve the economic goals of full employment and price stability that are the express goals of our national economic policy, it is crucial that our economy generate increased investment through increased savings.

The legislation that I have introduced, along with others in the Senate, would permit taxpayers to exclude from taxation, 25 percent of combined interest and dividend income up to a maximum of $50,000.

A taxpayer at the maximum interest and dividend level of $50,000 could exempt 25 percent or $12,500 from taxation and then pay full tax on the remainder. The 25-percent exemption would be phased in at 5 percent a year over a period of 5 years beginning in 1981. Mr. Chairman, I picked the 25 percent as a sort of an arbitrary figure. Frankly, a theoretical argument cannot be made to justify any taxation of investment and savings income, I believe, but nevertheless, I think 25 percent is clearly a good place to start.

According to the Joint Committee on Taxation of the Congress, the saving to the taxpayer would be about $1 billion in the first fiscal year and $5 billion to $7 billion when fully operative.

Because the 25-percent exemption becomes gradually at 5 percent per year, it will minimize revenue loss in the early years, while maximizing the increase in savings and investment.

Dr. Martin Feldstein, professor of economics at Harvard University, recently wrote an op-ed piece for the Wall Street Journal which recommends an approach similar to the one I am proposing today and have proposed before.

Dr. Feldstein points out that the phased-in exemption of interest and dividend income would create a strong incentive for households to start saving now in order to take advantage of the lower tax rate when it becomes fully effective.

In a later op ed piece, Dr. Feldstein again recommended this approach and I would request that both these editorials be reprinted in your record at the conclusion of my remarks.

The 25-percent exclusion of additional interest and dividends income has the effect of reducing the tax rates on additional savings income by one-quarter. For example, an individual at the 28-percent tax bracket would see the effecting marginal rate on savings income fall to 21 percent.

The 40-percent bracket would effectively fall to 30 percent and the 70-percent bracket to 53 percent. This would result in a substantial increase in savings, a switch out of tax shelters, reduced interest rates and less pressure on the Federal Reserve to create money.

It is a progrowth, anti-inflationary step which I believe will have great effectiveness. Mr. Chairman, I would request that the remainder of my testimony be included in the record. I will summarize portions of it as we go through it.

Recent studies have shown a close correlation between the rates of growth and rates of savings and investment. It is therefore, no coincidence that the United States with the lowest rates of savings among major industrialized nations is also affected with stagnating economic growth.

The U.S. rate of savings as a percentage of national income in 1976 was only 4.9 percent compared to rates of 7.1 percent in England, 4.4 percent in France, 13 percent in Germany and 20.9 percent in Japan.

The anemic level of U.S. savings as compared to the leading industrialized nations of the world accounts in part, for the declining GNP growth rate and high inflation rate, internal inflation rate, of the United States as measured against those of other nations.

It is interesting to note that each of these countries offered considerably greater incentives to savings and investment activity, than does the United States. There is a table in my prepared testimony that illustrates some of these factors among the various industrialized nations.

Senator CHAFEE. I must say that figure about Japan is extraordinary.

Senator SCHMITT. It is, Mr. Chairman.

Senator CHAFEE. Do you know what Japan does about savings, interest, and dividends?

Senator SCHMITT. Mr. Chairman, we can supply that information for the record. Each of these countries has slightly different approach that one way or the other effectively reduces the marginal rate on income.

Frankly, at this point I don't remember the distinctions between the various countries, but they do have a basic incentive program.

Senator CHAFEE. I see we have two witnesses coming up who will testify on that. That will be most interesting. Those are startling statistics.

Senator SCHMITT. Mr. Chairman, it is also startling to look at and I used the term "internal inflation rate" a few moments ago. I think that is the key factor. All industrialized nations are affected by the inflation in energy prices on a worldwide basis, but it is important that we examine the internal inflation rate.

If I remember correctly, the internal inflation rate in Japan is about one-third that of this country, at this time. We can supply more information on that for the record.

Mr. Chairman, the key variable in achieving the economic goals of full employment and low inflation is the rate of investment. Low investment leads to poor productivity growth which results in high inflation and reduced GNP growth.

These effects combined with increased unemployment produce lower personal savings. A shortfall in personal savings means fewer funds for investment and the cycle repeats itself and unfortunately reenforces itself. This vicious circle, in fact, the downward spiral, must be broken and the most effective means of breaking it is to create new economic incentives that will encourage individuals to shift economic activity from consumption to savings and investment.

The administration's tax package currently before the Congress is a good one and I fully support it, but as the President noted in his speech last week, the personal income tax reductions in the bill do not really cut taxes below current levels. They reduce the size of the tax increase. I fail to see how an incentive to save and invest more will result from a small tax increase as opposed to a large one.

Along with the changes in tax rates, we need something that is specifically targeted to savings and investment so that there is a real incentive to invest at these unfortunately high inflation rates.

That is the purpose of S. 155 and I believe it will provide the kind of insurance necessary to make sure that what I believe will happen when we cut individual tax rates, in fact does happen, and that is increased savings and investment.

Mr. Chairman, this legislation will affect every American with savings accounts and investments. Over 44 million Americans will benefit from reduced taxes on interest and dividends. Low- and moderate-income people will benefit in two ways. First, from lower taxes, and second, from job production, real income growth and overall increases in economic prosperity that will result.

Older Americans on fixed incomes facing high inflation, will benefit through an improved rate of return on their savings. In short, all aspects of the economy and all segments of our population will benefit from this proposal and ones like it.

I urge you join me in this effort to improve the rate of return our people receive on their savings and investment for this is the key to economic growth in the decade ahead.

Thank you, Mr. Chairman. I'd be happy to try to answer any questions you might have.

Senator CHAFEE. Thank you very much, Senator. I noticed there a series of bills by Senators Huttleston, Durenberger, and Warren that are somewhat like yours. You and others have this excellent suggestion which we'll take up.

There are loss of revenue problems here, which Mr. Chapoton will be here following Senator Cranston, to discuss, in the description of the tax bills, the projected loss of revenue effect of your bill.

Senator SCHMITT. Mr. Chairman, if you could yield for a moment, I think clearly that when ones looks at a static loss of revenue and does the calculation, there will be a static loss. That may be even as much as $10 billion a year when the proposal would be fully implemented after 5 years.

But, on the other hand, there will be a dynamic increase in revenue. It is much more difficult for us to get a handle on what that is and we will supply for the record various analyses, but the one which we have put together based on New York Stock Exchange estimates indicates about $28 billion dynamic increase in revenue in about the same time frame.

Senator CHAFEE. Would you recommend this as a supplement or a substitute for the President's 10-10-10 proposal?

Senator SCHMITT. I think it has to be a supplement, Mr. Chairman. I believe that if you give people more income to use they are going to save a larger percentage of their income, but I would like to have some insurance. I see nothing wrong with providing insurance to make sure that is what happens.

We have to remember that in a highly inflationary economy at regulated savings interest rates, it just doesn't pay to save. What we are trying to do is make it pay to save.

Senator CHAFEE. The argument from the administration, particularly from Mr. Stockman, is that given this 10 percent cut per year, people will put it into savings. I don't subscribe to that view. I subscribe to more of a target approach. You would go with the Stockman or the President's cut at 10 percent and in addition have your targeted cut?

Senator SCHMITT. Yes, sir, because I think that makes sure that the predictions of Mr. Stockman will in fact come true. If people have an incentive to save, they will save more so than they will otherwise.

I believe that we are going to get an increase in saving because I believe people still feel that that is an appropriate thing to do with some proportion of their income. Even at interest rates of 5½ percent in a highly inflationary economy, people are still saving.

I save. I suspect that you have a savings account, but as I say with inflation running at a base rate of around 10 percent and the interest rates you can get on an ordinary savings account about half that, or a little more than half that, there is not any basic incentive to save from a purely objective monetary point of view.

Let's give an incentive. Let's provide some insurance to make sure that what Mr. Stockman and the President believe will happen, will in fact happen.

Senator CHAFEE. Well, thank you very much, Senator. That is very helpful. We now welcome Senator Cranston, a very distinguished Senator that we are delighted to see.

[The prepared statement of Senator Schmitt follows:]

STATEMENT OF SENATOR HARRISON SCHMITT

THE SAVINGS AND INVESTMENT INCENTIVES ACT OF 1980

Mr. Chairman, It has become widely recognized that America must increase its rates of savings and investment if we are to have economic growth in the decade ahead.

A significant factor in the declining performance of the U.S. economy in the past decade has been falling rates of saving by the American public. Personal savings as a percentage of disposable personnel income has undergone a steady decline from 7.7 percent in 1975 to 3.7 percent in the first quarter of this year. In every year since 1975, the amount of personal savings has fallen lower than the previous year. The overall reduction is in excess of 50 percent.

It is generally recognized that savings is the source for investment and that investment is the generator of increased productivity and employment. Investment means new plants and equipment and new jobs to build new production facilities and operate new machinery. If the critical element of personal savings is absent from this equation, then production and employment suffer. To achieve the economic goals of full employment and price stability that are the express goals of our National economic policy, it is crucial that our economy generate increased investment through increased savings.

The legislation I have introduced would permit taxpayers to exclude from taxation 25 percent of combined interest and dividend income up to a maximum of $50,000. A taxpayer at the maximum interest and dividend level of $50,000 could exempt 25 percent or $12,500 from taxation and then pay full tax on the remainder. The 25 percent exemption would be phased in at 5 percent a year over a period of five years beginning in fiscal year 1981. According to the Joint Committee on Taxation, the saving to the taxpayer would be about $1 billion in the first fiscal year and $5 billion to $7 billion when fully operative. Because the 25 percent exemption becomes effective gradually at 5 percent per year, it will minimize revenue loss in the early years while maximizing the increase in savings and investment.

Dr. Martin Feldstein, Professor of Economics at Harvard University, recently wrote an op-ed piece for the Wall Street Journal which recommends an approach similar to the one I am proposing today. Dr. Feldstein points out that the phased-in exemption of interest and dividend income would create a strong incentive for households to start saving now in order to take advantage of the lower tax rate when it becomes fully effective.

In a later op-ed piece Dr. Feldstein again recommended this approach and I would request that both of these editorials be reprinted in the record at the conclusion of my remarks.

The 25 percent exclusion of additional interest and dividends has the effect of reducing the tax rates on additional savings income by one-quarter. For example, an individual in the 28 percent tax bracket would see the effective marginal tax rate on savings income fall to 21 percent. The 40 percent bracket would effectively fall to 30 percent, and the 70 percent bracket to 53 percent. This would result in substantial increases in saving, a switch out of tax shelters, reduced interest rates and less pressure on the Federal Reserve to create money. It is a progrowth, anti-inflationary step of great effectiveness.

A larger exemption for income derived from interest and dividends is essential if the economy of the 1980's is to be one strong, real growth. Full employment and low inflation can only be achieved if there is sufficient captial to finance the investments required to make new discoveries, technologies and build new plants.

A complete view of the economy reveals an interdependency of all its components; components which interact with each other. It would be short-sighted to assume that one part of this system could be altered without impacting on the system as a whole. According to estimates made by the Joint Committee on Taxation and the Department of Treasury, Federal taxes paid by Americans will increase by at least $1.5 trillion over the next ten years as a result of upcoming social security, decontrol, windfall oil profits and inflation induced tax increases. Other estimates exceed $2 trillion. These will be the greatest tax increases in American history, as much as $200 billion per year! Those who contend that the economy can absorb these increases without creating dislocations are advocating a dangerous course. It is a course that may lead the United States down the road of indefinite, slow growth—or no growth at all.

This massive transfer of resources to the government is of crucial importance to the economy, particularly since it comes at a time when we are already experiencing declining productivity and negative growth in the economy. It is, therefore, essential that the Congress take action to offset the effect of these taxes; and more importantly to create new incentives for savings and investment.

Recent studies have shown a close correlation between rates of growth and the rates of savings and investment. It is, therefore, no coincidence that the United States, with the lowest rate of savings among major industrialized nations, is also affected with stagnating economic growth. The United States' rate of savings as a percentage of national income in 1976 was only 4.9 percent compared to rates of 7.1 percent in England; 12.4 percent in France; 13.0 percent in Germany; and 20.9 percent in Japan. The anemic level of U.S. savings as compared to the leading industrial nations of the world accounts, in part, for the declining GNP growth rate and high inflation rate of the U.S. as measured against these same nations. It is interesting to note that each of these countries offer considerably greater incentives to savings and investment than does the United States.

COMPARISON OF SAVINGS RATES, INFLATION RATES, FEDERAL DEFICIT, AND GNP GROWTH AMONG MAJOR INDUSTRIALIZED NATIONS

Year	United States	Japan	France	Germany	United Kingdom
Rate of consumer price inflation:					
1976	5.8	9.3	9.6	4.3	16.5
1977	6.5	8.1	9.4	3.6	15.9
1978	7.5	3.8	9.1	2.8	8.3
1979	11.3	3.6	10.7	4.1	13.4
Federal Government deficit as percentage of GNP:					
1976	3.3	2.0	.8	2.7	5.5
1977	2.7	6.1	.8	1.9	3.2
1978	2.1	6.5	.8	2.0	5.2
1979	1.2	5.3	NA	1.9	NA
Source—IMF: Savings as percentage of national income:					
1976	4.9	20.9	12.4	13.0	7.1
1977	5.7	20.3	12.8	12.9	8.4
1978	6.5	20.0	13.5	14.0	8.3
1979	NA	NA	NA	NA	NA
Source—OECD—GNP growth rate:					
1976	5.9	6.5	4.6	5.1	3.6
1977	5.3	5.4	3.0	2.6	1.4
1978	4.4	5.6	3.3	3.4	3.3
1979	2.3	6.0	NA	4.8	N/A

Source: U.S. Department of Commerce, International Economic Indicators, March 1980.

This chart shows the relationship between savings rates and the rates of inflation and GNP growth among several major industrialized nations. In 1978, for example, the rate of personal savings in Japan was 20 percent, more than three times that of the United States. At the same time, Japan's inflation rate was 3.8 percent, almost exactly half the U.S's inflation rate of 7.5 percent. In addition, the rate of economic growth in Japan as measured by GNP, was 26 percent higher than the United States. In other words, even while maintaining a deficit more than three times greater than the United States on a percentage basis, Japan was still able to hold inflation down and to enjoy high rates of growth. One explanation for this phenomenon is that the high rate of personal savings fueled by savings incentives provided by the Japanese Government, insures that there are adequate funds available for investment purposes even when the Central Government may need to borrow significant amounts to finance a deficit. In the United States, where pesonal savings has been lower than any other major industrialized country for several years, when the Treasury taps the capital markets to finance a deficit, the pressure generated on the market drives up interest rates—making it difficult for corporate borrowers to afford to borrow—and forces the Federal Reserve to inject funds into the system to maintain stable interest rates. The result is more inflation and a short-fall in investment which inevitably impact on overall economic growth. The alternative is to develop appropriate incentives for savings and investment to produce fresh inflows of funds into our financial institutions and capital markets that will act as a stabilizing force with regard to inflation, while spurring greater investment in the plant and equipment needed for future economic growth.

NEW YORK STOCK EXCHANGE STUDY ON INVESTMENT

The Office of Economic Research at the New York Stock Exchange (NYSE) recently published a study entitled "Building a Better Future—Economic Choices for the 1980's". This study, conducted with the assistance of Professor Lawrence Klein of Wharton Econometrics and Professor John W. Kendrick of George Washington University and drawing upon the expertise of a number of other economists, demonstrates in detail the need to stimulate investment in the economy in order to generate economic growth. I ask unanimous consent that the full text of this study be reprinted in full at the conclusion of my remarks. The NYSE study analyzes the impacts of three possible economic scenarios. The first of these alternatives assumes that the ratio of nonresidential fixed investment to GNP remains constant at its current level of 10.2 percent. (Non-residential fixed investment includes both personal and business investment for non-residential purposes.) The effects of these "base case" assumptions on the economy of the 1980's is as follows:

Base case scenario 1980–90

	Percent
Ratio of nonresidential fixed investment/GNP	10.2
Real growth in GNP (average per year)	2.4
Inflation rate (GNP deflator, average pier year)	7.7
Productivity growth (average per year)	1.1
Unemployment rate (average per year)	6.7

Under the second set of assumptions, the "pessimistic" scenario, the level of investment is assumed to fall to 9.6 percent. The effects of such a decline are significant. Unemployment would rise from 6.7 percent of 8.9 percent. Productivity growth would fall from 1.1 percent growth per year to 0.9 percent. The inflation rate, as measured by the GNP deflator, would rise from 7.7 percent to 8.9 percent. As the NYSE study states, "The pessimistic model underscores the direct relationship between low investment in plant and equipment and the one-two punch of fewer new employment opportunities and high rates of inflation.

Low growth scenario, 1980–90

	Percent
Nonresidential Fixed Investment/GNP	9.6
Real growth in GNP (average per year)	2.0
Inflation rate (GNP deflator, average per year)	8.9
Productivity growth (average per year)	.9
Unemployment rate (average per year)	8.9

The third scenario analyzed by the NYSE study contains the same assumptions as the "base case" and the "pessimistic" simulations with regard to: oil prices; Federal government defense expenditures; and monetary policy.

However, this scenario assumes that tax policies are implemented that would increase the investment/GNP ratio to 12.1 percent. In addition, it was assumed that government regulation was eased somewhat such that productivity growth would increase by one-half percent over the period 1980-1990. The impact of these policy changes is powerful. The following chart shows the effect of an improvement in the investment/GNP ratio on inflation, productivity, unemployment and economic growth:

High growth scenario, 1980–90

	Percent
Nonresidential fixed Investment/GNP	12.1
Real growth in GNP (average per year)	3.4
Inflation rate (GNP deflator, average per year)	6.7
Productivity growth (average per year)	2.0
Unemployment rate (average per year)	5.8

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The result is a full percentage point increase in GNP growth over the base case scenario, accompanied by improvements in productivity, reduced inflation and an unemployment level of 5.8 percent, a level considered to be very near "full employment" by many economists. The following chart compares the economic impact of three different levels of investment over the coming decade:

THREE SCENARIOS, 1980-90

[In percent]

	Pessimistic	Base case	Optimistic
Investment to GNP	9.6	10.3	12.1
Real growth in GNP	2.0	2.4	3.4
Inflation (GNP deflator)	9.5	7.7	6.4
Unemployment rate	8.9	6.7	5.8

Clearly, the levels of economic growth, unemployment, productivity and price stability achieved through the higher ratio of investment to GNP represent the most desirable outcome for the future.

Mr. Chairman, the key variable in achieving the economic goals of full employment and low inflation is the rate of investment. Low investment leads to poor productivity growth, which results in high inflation and reduced GNP growth. These effects combined with increased unemployment produce lower personal savings. A shortfall in personal savings means fewer funds for investment, and the cycle repeats itself. This vicious circle must be broken and the most effective means of breaking it is to create new economic incentives that will encourage individuals to shift economic activity from consumption to savings and investment.

The Administration's tax package currently before the Congress is a good one that I fully support. But as the President noted in his speech last week, the personal income tax reductions in the bill do not really cut taxes below current levels, they reduce the size of the tax increase. I fail to see how an incentive to save and invest more will result from a small tax increase as opposed to a large one. Along with the changes in tax rates we need something that is specifically targeted to savings so that a real incentive is created. That is the purpose of S. 155.

This legislation will affect every American with a savings account and investments. Over 44 million American will benefit from reduced taxes on interest and dividends. Low and moderate income people will benefit in two ways. First, from lower taxes; and second, from the job production, real income growth and overall increase in economic prosperity that will result. Older Americans on fixed incomes, facing high inflation, will benefit through an improved rate of return on their savings. In short, all aspects of the economy and all segments of our population will benefit from this proposal.

I urge you to join me in this effort to improve the rate of return our people receive on their savings and investment, for this is the key to economic growth in the decade ahead.

[From the Wall Street Journal, July 25, 1980]

TAX INCENTIVES WITHOUT DEFICITS

(By Martin Feldstein)[1]

Despite the best efforts of the Carter administration, the tax cut debate has fortunately moved from "whether" to "what kind." There is of course the danger of a quick-fix election year tax cut aimed at stimulating employment and camouflaging next year's Social Security tax rise. But what is really needed ia a multi-year program of tax cuts that will reduce some of the existing strong disincentives to capital formation and production. And if it is done in the right way, a multi-year tax cut could bring immediate increases in investment, saving and individual effort without any increases in the government deficit now or in the future.

The most important thing to consider in a tax-cut strategy is that all important economic decisions are based on expectations. What matters for *current* actions—investment, saving, the choice of jobs—is not the current tax rates but the rates that are *expected.*

[1] Mr. Feldstein is professor of economics at Harvard University, president of the National Bureau of Economic Research, and a member of the Journal's Board of Contributors.

Congress can therefore improve current incentives without any increase in the current deficit by enacting *now* a schedule of *future* tax cuts. These precommitted tax cuts can be financed as they occur out of the automatic revenue increases produced by inflation and out of the savings that could result from a slowdown in the growth of government spending. The commitment to a schedule of future tax cuts would give Congress and the government agencies time to shape their spending plans to the lower level of available revenue. Thus, while an immediate tax cut generally means an increased deficit, precommitted future tax cuts can change incentives without any deficits.

STIMULATING SAVING

Consider the problem of stimulating individuals to save more. Today the combination of inflation and high tax rates makes the real after-tax return negative for many individuals. To stimulate saving, the key requirement is to raise the real after-tax return that savers can *expect* to receive in the future on additions to their assets. One simple and direct way to achieve this would be to treat interest and dividends like capital gains—i.e., exclude 60 percent of all interest and dividends from taxable income. Of course, if this 60 percent exclusion were allowed all at once in 1981, the revenue loss would probably exceed the increased saving. The government's borrowing to finance this revenue loss would then absorb more than all of the increased saving—and the amount available for investment in plant and equipment would actually be reduced.

But what if the 60 percent exclusion were enacted now with its effective date postponed until 1985? The government would clearly lose no revenue in the next four years. But households would have a strong incentive to start saving more immediately in order to have more assets on which to take fuller advantage of the lower tax rate when it becomes effective. Starting with a small exclusion in 1981 and allowing it to rise to 60 percent by 1985 would make the prospect of the full future exclusion more credible without changing the fundamental point that the immediate increase in saving can be substantially greater than the concurrent increase in the deficit.

The same idea of a precommitted tax cut can work to stimulate investment. Consider the effect of a major cut in the corporate tax rate—say from 46 percent to 36 percent—that is enacted now with an effective date in 1985. Although there would be no change in tax rates from 1981 through 1984, firms would have a substantial incentive to increase their investment spending immediately. Investments made during the next four years would benefit from depreciation at high tax rates while the subsequent profits would be subject to lower tax rates. Again, a gradual phase-in of the tax rate reduction would increase the credibility and visibility of the future rate reductions.

There are other ways to stimulate investment with little or no decrease in tax revenue. Replacing the existing historic cost decpreciation method with an indexed depreciation system for all future investment would immediately raise the after-tax yield on all prospective projects. Indeed, at the current high rate of inflation, indexed depreciation would offer a greater stimulus to investment than the Conable-Jones 10-5-3 plan for accelerated depreciation. Indexed depreciation would involve no immediate revenue loss, and the future revenue losses would rise only slowly as the eligible capital stock grew.

For personal rate cuts, a slow but certain phasing in would also achieve most of the benefits of a large immediate rate cut without the large revenue loss. An individual who is deciding whether to change jobs, to relocate, to "invest" in more schooling or training, or just to work harder in the hope of better promotions will look at these future tax rates. Because a gradual phase-in could be financed by the automatic inflation tax windfalls and by a gradual reduction in the growth of government spending, tax rates could be reduced by 30 percent over a few years without any deficits.

Because of the progressivity of the tax schedule, a 10 percent rise in total personal income raises individual income tax collections by about 16 percent—and thus permits a 6 percent "tax cut" without any reduction in the ratio of taxes to personal income. Over four years, the cumulative tax "reduction" would be nearly 25 percent. Pruning the share of personal income that goes in federal personal taxes back to the ratio of 20 years ago would permit an additional real tax cut of 13 percent. The total real tax cut—combining inflation givebacks and real reductions—can be between 30 percent and 40 percent over the next four years. This provides a unique opportunity for a series of tax changes that combine across-the-board reductions in personal rates with specific incentives for saving and investment.

The supply side tax-cut goal of increasing incentives without budget deficits can be achieved in this way without depending on a miraculous response of labor supply or productivity. And to the extent that increases in individual effort and in capital accumulation raise national income over time, there will be greater tax revenues with which to finance either government spending or further tax reductions.

OLD-FASHIONED TAX CUT

Although this is a uniquely good time to begin a series of percommitted tax cuts focused on strengthening incentives, much of the talk in Washington is about an old-fashioned countercyclical tax cut. The advocates of such a policy seem to have forgotten that economist and forecasters just don't know enough to use tax cuts to attenuate the business cycle.

For a tax cut to reduce the current rise in unemployment, it owuld have to have been passed last year, long before the beginning of the recession was clearly in sight. A tax cut now would probably have its impact in 1981 and 1982 when the recession is past and the economy is expanding. Of course, the recession may potentially be worse than it now looks and output may continue to fall well into 1981. We know too little about just where the economy is going—and about the magnitude and timing of the impact of a tax cut—to recommend a countercyclical reduction in taxes.

The experience of the past 30 years shows that attempts at countercyclical fiscal policy have actually worsened the business cycle—expansionary policies overstimulating the economy and fiscal contractions deepening the recessions. The lesson of this experience is that attempts at fiscal stablization should be avoided in the short swings of the business cycle and saved as the ultimate economic weapon to be unleashed only if the economy falls into a deep and protracted depression. That is not a reason to avoid a tax cut now but it does imply that the current tax cut should be aimed at long-run goals rather than at the current recession.

Our nation's economic survival and success in the 1980's will depend on the type of tax system we have. Now is the time to begin a serious restructuring that will restore incentives for saving, investment and individual effort. A firm legislative commitment to a gradual phasing-in of these tax changes can provide a major stimulus to current capital formation and individual productivity without any unwanted increase in the government deficit.

[From the Wall Street Journal, Mar. 17, 1981]

STRUCTURING THE PERSONAL TAX CUT

(By Martin Feldstein)[1]

The personal income tax is a prodigious generator of revenue for the federal government. As incomes rise, individuals move into higher brackets and the government gets an ever larger share of national income. And when there is rapid inflation of the current sort, revenue grows with alarming speed.

If there is no tax cut, inflation and rising real incomes will double income tax collections between 1980 and 1985. Even after adjusting for inflation, real tax revenue will rise more than 30 percent and the government will take a much larger share of personal income.

Everyone agrees that this should not happen and that personal tax rates should be cut. The only question is how.

The administration has proposed a 30 percent across-the-board reduction in all tax rates phased in over the next four years. The idea of a legislated precommitment to a series of cuts is very appealing. The knowledge that marginal tax rates will be lower in the future gives individuals an immediate incentive to save more and to prepare for and seek jobs with higher pay. A precommitment to reduce tax rates also puts Congress on notice that revenue will not automatically be rising rapidly and, therefore, that future spending commitments must be restrained.

ECONOMISTS LACK DATA

Spreading the tax cut over four years reduces substantially its impact on aggregate demand. Much of the tax cut just offsets the higher taxes that would otherwise be paid as inflation and rising incomes push individuals into higher brackets. The administration's plan for a major reduction in government spending further reduces aggregate demand. And the tax incetives to increase industrial capacity and output

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[1] Mr. Feldstein is professor of economics at Harvard University, preside' ' of the National Bureau of Economic Research, and a member of the Journal's Board of Contributors.

also diminish the risk of increased inflation. Economists don't know enough about where the economy s headed or about the precise impact of spending cuts and tax cuts to say whether, on balance, the proposed size of the tax cut is too large or too small to achieve the best level of demand.

Reducing marginal tax rates will unambiguously lead to a more efficient use of resources and will provide incentives for increased work effort and saving. Bringing the top rate down from 70 percent to 50 percent is particularly important in this regard since the distortions created by high tax rates grow increasingly serious at such levels.

Indeed, it would be worthwhile to accelerate this reduction and bring the top rate down to 50 percent in 1982. Even if there were no behavioral response to such a rate cut, the total cost to the Treasury would only be about $6 billion. But cutting the top rates would induce a significant increase in taxable income—by discouraging the use of tax sheltes, by stimulating the realization of capital gains and by providing the incentive to earn higher incomes. Tax rates over 50 percent are not an efficient source of revenue but only a way of punishing those whose good fortune and hard work have led to high incomes.

Although the administration's emphasis on reducing marginal tax rates is to be applauded, it is unfortunate that a significant portion of the overall tax reduction wasn't devoted specifically to stimulating private saving. Of course, the uniform 30 percent reduction in all tax rates may be the best form of the tax cut that is politically feasible. Any deviation from this extremely simply formula may lead to a tax reduction that abandons the general goal of lower marginal tax rates in favor of a tax cut aimed at income redistribution or at "offsetting" the increase in the Social Security payroll tax (by transferring the tax burden through the income tax to higher income individuals).

But that view may be too pessimistic. It may be possible to improve the administration's original proposal and still have a politically viable piece of legislation. It is clear that several influential members of Congress will try to do just that.

The current tax reduction provides a unique opportunity for restructuring our tax rules to encourage a higher level of saving. Limiting the across-the-board rate reduction to 20 percent over the next four years instead of 30 percent would leave $30 billion of tax reduction that could be targeted at stimulating saving. Indeed, since a tax cut that stimulates saving adds less to aggregate demand than a general rate cut, the tax cut aimed at savings could exceed $30 billion.

The administration's proposal does of course provide some additional incentive to save, especially for higher-income individuals. Since the maximum tax rate on interest and dividends would be reduced from 70 percent to 50 percent, the net reward for saving would be significantly increased; for someone who is now paying the 70 percent tax rate, the tax cut would raise the after-tax share of interest and dividends from 30 percent to 50 percent, an increase of two-thirds.

But the marginal rate reductions for the vast majority of middle-income taxpayers would be relatively small and would offer little additional reason to save. An individual who now pays a 35 percent marginal tax rate might see it fall to 30 percent after four years as the result of the tax-rate reduction and the inflation-generated bracket creep. His net-of-tax share of interest and dividends would therefore rise only slightly from 65 percent to 70 percent, an increase of less than one-tenth; the extra incentive to save would be quite small.

There are two basic ways in which the tax law might be modified to provide significant saving incentives for middle-income families. The simplest of these would be to permit individuals to exclude a substantial fraction of all interest and dividends from taxable income.

While the current interest and dividend exclusion of $400 for a joint return may provide an incentive for some low-income savers, most taxpayers with any interest and dividend income already have more than $400. For them, the $400 exclusion is a reward for past virtue but not an effective incentive for additional saving. In contrast, a partial exclusion without a ceiling would provide everyone with a higher reward for increased saving while limiting the exclusion to a fraction of interest and dividend income would keep down the revenue loss.

An unlimited exclusion of 50 percent of interest and dividend income in 1982 would probably cost less than $20 billion. Phasing such an exclusion in over the next four or five years would further reduce the revenue loss while having a much smaller effect on the immediate incentive to save. And, over time, the extra saving that flows into new corporate investment would raise corporate tax collections.

Opportunity for Taxpayers

The second method of stimulating saving would be to extend to all taxpayers the opportunity to make tax-deductible contributions to special savings accounts in which the interest and dividend income also accumulates untaxed. The current law permits this in Keogh Accounts for the self-employed and in Individual Retirement Accounts for employes who do not participate in a company pension plan. Extending the IRA option to all employes would reach a group whose incomes and ages should make them quite responsive to such a saving incentive.

Under the current law, funds can be withdrawn from IRA and Keogh accounts without penalty only when the individual reaches age 59. For many potential savers, the illiquidity of these plans outweighs the extra return. This conflict could be resolved by allowing individuals the choice of withdrawing funds after four years or postponing the tax by committing the funds for another four years. In practice, most individuals would probably continually roll over the account balance until they reach retirement. But the availability of the funds on relatively short notice would greatly strengthen the appeal of these accounts and therefore the incentive to save.

Although both plans raise the net return to savers, each has special features that make it appeal to different individuals. It is therefore likely that the best way to stimulate saving with any given amount of revenue is to use a combination of both plans rather than either one alone.

There is of course no guarantee that these saving incentives would be successful. But little is lost if they fail and, if they succeed, our national rate of saving and investment could rise significantly. Not trying at this time would be wasting a unique opportunity.

STATEMENT OF HON. ALAN CRANSTON, A U.S. SENATOR FROM CALIFORNIA

Senator CRANSTON. Thank you, Mr. Chairman. I appreciate very much the opportunity to appear before you. I know of your very active efforts, your own efforts, to reduce disincentives for savings and investment, Mr. Chairman. I commend you heartily for that.

I will abbreviate my testimony, but ask that the full text appear.

Much has been said and will be said, for and against President Reagan's tax program. But on a vital key point I think there really is no disagreement. We need to reverse the trend in our tax system which discourages savings and investment.

There are honest differences over how to promote the objective of encouraging savings by American families. Today we are discussing the merits of a number of specific proposals which can be called "competitive" with the President's program, only in the sense of timing and order of action by Congress.

It is in that spirit that I am pleased to be associated with your colleagues Senators Wallop and Moynihan as the cosponsors of S. 75 which would reduce the maximum rate on capital gains to 17.5 percent.

I am also the sponsor of another measure which I will get to shortly, about rollover accounts.

I have endorsed also proposals to increase the exclusion of interest and dividend income and I strongly believe that every American should have the opportunity to establish individual retirement accounts under liberal rules for amounts invested and purposes for which such trust accounts can be established.

Senator CHAFEE. That would be regardless of whether there is a qualified pension plan.

Senator CRANSTON. Yes.

Senator CHAFEE. Yes, I subscribe to that. Do you have a target figure for what would be deductible per year?

Senator CRANSTON. No, I don't have such a target figure.

Senator CHAFEE. One of the figures in legislation I submitted, provided for $2,000 annual reduction.

Senator CRANSTON. I think whatever is workable and you and the committee should be able to figure that out.

Senator CHAFEE. Thank you.

Senator CRANSTON. I want to focus today on a bill I have introduced, S. 457, the Capital Gains Rollover Account Act. Its basic purpose is to help individuals make long-term commitments of capital and savings to productive investments without suffering adverse tax consequences when they move assets from nonproductive to productive investments.

As the tax law now stands, when an individual realizes a gain upon the transfer of assets from one investment situation to another, the gain is taxable in the same way as it would be if the individual used his gain as income for the purposes of consumption. Thus, there is no incentive for reinvestment of the realized gain.

Not all such transfers in which gains are realized, are treated as a taxable event however.

The best known instance, of course, is the deferral of capital gains taxes allowed when an individual reinvests the proceeds realized from the sale of his personal residence into another personal residence.

My bill proposes to apply the same tax deferral treatment to reinvestments of capital gains. That is, deferral of taxes due on a rollover of capital gains, into other investments.

The deferral of taxes will help individuals make long-term commitments of substantial amounts of capital into a series of investments, such as stocks, bonds, enterprises, and the like.

Under my proposal only realized gains will be deferred. Interest and dividends received will be treated as ordinary income of the investor in the tax year received just as it would under normal investment circumstances.

The purpose of this bill is to help meet the enormous need of our economy for substantial commitments of capital for long-term periods. It is estimated that our economy will require about a $5.3 trillion in capital investment in the next 10 years.

Where is this capital to come from?

A significant source of capital today is frozen in investments made many years ago. The holders of those investments, in some cases, literally are waiting to die in order to avoid heavy taxation if they should realize their gains today.

Some prefer to accept their return in the form of dividends. Many other investors, however, must make prudent decisions based upon the potential return of a new investment against remaining locked in an old one and accepting dividend income instead of gains.

The tax deferred rollover account would offer such investors very substantial incentives to move their capital into new dynamic investments with a greater potential for profit.

I think our general economy would benefit greatly from movement of capital from older, less productive enterprises into newer ones.

Under my proposal, the economy and the Treasury will benefit so long as the investor retains his capital in the rollover account.

The economy benefits directly from the investment in business and other enterprises and indirectly from the lessened purchasing power of the investor who no longer has surplus dollars available to bid up prices on goods and consumables, thus fueling inflation.

I want to emphasize that my proposal is tax revenue positive. A dollar invested in equities in a company—these are very interesting statistics, Mr. Chairman. A dollar invested in equities in a company returns about 28 cents to the Treasury in new tax revenues each year the original dollar remains invested.

Dr. William Ballhaus, president of Beckman Instruments, has calculated that for each year a dollar is invested in his company, the return in new revenues to the Treasury is 28.7 cents—year after year after year.

The tax on $1 of capital gain at the maximum rate is about 28 cents for one time only.

I ask my colleagues to compare the value to the Treasury of $1 of capital invested for 10 years with the value of one dollar of capital gains taxed once. The invested dollar is worth 10 times, $2.87, what the taxed dollar, 28 cents, is worth to the Treasury.

Dr. Ballhaus did studies of other companies, with similar and sometimes better results.

Throughout the life of the rollover account, the Treasury would receive taxes on interest and dividends paid on stocks and bonds held by the account. I want to emphasize that these taxes will not be at a sheltered rate, but at the individual investor's ordinary income tax rate.

When the rollover account is liquidated, the Treasury will receive taxes on gains realized at the capital gains tax rates.

Death of the trustor will not result in avoidance of capital gains taxes. Under this bill, the capital gains accrued in the trust account will be taxed immediately.

I have discussed the rollover concept largely in terms of substantial investors. I want to point out that modest investors can benefit substantially, as well. By setting the capital gains rollover account, a relatively modest sum can be built up through sound investments in growth stocks.

When the investor wishes to realize income, he or she can rollover into income producing securities, without paying any capital gains taxes and draw the income as ordinary income.

The adverse effect of the preference tax on corporate capital gains income has not been addressed. Companies should be encouraged to sell nonproductive assets in order to realize new capital for investment.

Our tax laws now compel exchanges and complex transactions designed to reduce the tax consequences of such sales. It is ironic that a record-breaking loss company, such as Chrysler, would have to pay taxes on gains realized from the sale of assets instead of reinvesting the proceeds to strengthen the company.

I am convinced that the principle of my bill, Mr. Chairman, let me say in closing, is correct and represents a necessary trend of the future. I urge the committee and you to hasten the day.

I thank you very much.

Senator CHAFEE. Thank you, Senator Cranston.

As you know, Senator Nelson had bills dealing with this in relation to so-called small businesses. However, yours would not be limited to small businesses.

Senator CRANSTON. That is correct. Mine would be——

Senator CHAFEE. In dealing with all of this, our problem is how can we get the maximum encouragement for new investment from each lost tax dollar. We have a series of proposals. You heard Senator Schmitt's proposal and this one of yours is a most interesting one.

I suppose if we get to substantially reducing the capital gains tax, the problem you mentioned will be solved to a considerable degree.

Senator CRANSTON. It would be greatly reduced. It would not be solved unless we totally eliminate capital gains.

I would like to make one point, in response to what you said. I don't think there is any loss of taxes in doing this. I believe there would be an increase in tax received.

Senator CHAFEE. Thank you very much for your able testimony, Senator Cranston.

Senator CRANSTON. Thank you a great, great deal.

[The prepared statement of Senator Cranston follows:]

SUMMARY STATEMENT OF SENATOR ALAN CRANSTON

Mr. Chairman: Good morning. I appreciate the opportunity to appear.

I know of your active efforts to reduce disincentives for savings and investment, Mr. Chairman, and I commend you heartily.

Much has been said and will be said for and against President Reagan's tax program. But on a vital key point I think there really is no disagreement. We need to reverse the trend in our tax system which discourages savings and investment. There are honest differences over how to promote the objective of encouraging savings by American families. But today we are discussing the merits of a number of specific proposals which can be called "competitive" with the President's program only in the sense of timing and order of action by Congress.

It is in that spirit that I am pleased to be associated with your colleagues Senators Wallop and Moynihan as a cosponsor of S. 75 which would reduce the maximum rate on capital gains to 17.5 percent.

I am also the sponsor of S. 457 which defers tax on capital gains held in rollover account.

I have endorsed also proposals to increase the exclusion of interest and dividend income and I strongly believe that every American should have the opportunity to establish Individual Retirement Accounts under liberal rules for amounts invested and purposes for which such trust accounts can be established.

I want to focus today on a bill I've introduced, S. 457, the Capital Gains Rollover Account Act. Its basic purpose is to help individuals make long-term commitments of capital and savings to productive investments without suffering adverse tax consequences when they move assets from nonproductive to productive investments.

As the tax law now stands, when an individual realizes a gain upon the transfer of assets from one investment situation to another the gain is taxable in the same way as it would be if the individual used his gain as income for the purposes of consumption. Thus, there is no incentive for reinvestment of the realized gain.

Not all such transfers in which gains are realized are treated as a taxable event however. The best known instance, of course, is the deferral of capital gains taxes allowed when an individual reinvests the proceeds realized from the sale of his personal residence into another personal residence.

My bill proposes to apply the same tax deferral treatment to reinvestments of capital gains, that is deferral of taxes due on a rollover of capital gains, into other investments.

The deferral of taxes will help individuals make long-term commitments of substantial amounts of capital into a series of investments such as stocks, bonds, enterprises and the like.

Under my proposal only realized gains will be deferred. Interest and dividends received will be treated as ordinary income of the investor in the tax year received just as it would under normal investment circumstances.

The purpose of this bill is to help meet the enormous need of our economy for substantial commitments of capital for long-term periods. It is estimated that our economy will require about $5.3 trillion in capital investment in the next ten years to replace worn out equipment, expand plant capacity and promote research and development to sustain even a modest level of economic growth.

Where is this capital to come from?

A significant source of capital today is frozen in investments made many years ago. The holders of those investments, in some cases, literally are waiting to die in order to avoid heavy taxation if they should realize their gains today. Some prefer to accept their return in the form of dividends. Many other investors, however, must make prudent decisions based upon the potential return of a new investment against remaining locked in an old one and accepting dividend income instead of gains. The tax-deferred rollover account would offer such investors very substantial incentives to move their capital into new dynamic investments with a greater potential for profit. I think our general economy would benefit greatly from movement of capital from older, less productive enterprises into newer ones. Under my proposal the economy and the Treasury will benefit so long as the investor retains his capital in the rollover account.

The economy benefits directly from the investments in business and other enterprises and indirectly from the lessened purchasing power of the investor who no longer has surplus dollars available to bid up prices on goods and consumables, thus fueling inflation.

I want to emphasize that my proposal is tax revenue positive. A dollar invested in equities in a company returns about 28 cents to the Treasury in new tax revenues each year the original dollar remains invested.

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Throughout the life of the rollover account, the Treasury would receive taxes on interest and dividends paid on stocks and bonds held by the account—I wish to emphasize that these taxes will not be at a sheltered rate but at the individual investor's ordinary income tax rate.

When the rollover account is liquidated the Treasury will receive taxes on gains realized at the capital gains tax rate.

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I have discussed the rollover concept largely in terms of substantial investors. I wish to point out that modest investors can benefit substantially as well.

By setting up a capital gains rollover account, a relatively modest sum can be built up through sound investments in growth stocks. When the investor wishes to realize income, he or she can rollover into income-producing securities without paying any capital gains taxes and draw the income as ordinary income.

The adverse effect of the preference tax on corporate capital gains income has not been addressed. Companies should be encouraged to sell nonproductive assets in order to realize new capital for investment. Our tax laws now compel exchanges and complex transactions designed to reduce the tax consequences of such sales. It is ironic that a record-breaking loss company, such as Chrysler, would have to pay taxes on gains realized from the sale of assets instead of reinvesting the proceeds to strengthen the company.

I am convinced that the principle of my bill is correct and represents a necessary trend of the future. I urge the committee to hasten the day.

Thank you.

Senator CHAFEE. Will Mr. Chapoton come forward? We will be seeing a lot of Mr. Chapoton before this committee and we welcome you once again.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. CHAPOTON. Thank you, Mr. Chairman. The statement, I would request, be submitted as a part of the record. I will attempt to summarize it, but I will go through most of it.

I am pleased to be here today to discuss the general subject of savings and investment incentives as well as comment on the specific proposals in which the subcommittee has expressed an interest.

THE PRESIDENT'S PROPOSALS

The President has submitted to the Congress a program for economic recovery which will, if adopted, expand national prosperity, enlarge national incomes, and increase opportunities for all Americans.

The tax program proposed as part of the economic recovery package is specifically designed to increase savings and investment in the economy by lowering the marginal rate of tax on income and by allowing faster recovery of capital costs.

We think that the proposed reduction in marginal rates of tax is, per dollar of cost, the best savings incentive that Congress could adopt.

A reduction in marginal tax rates increases the after-tax rate of return from additional capital investment. In an economy with an inflation rate of 10 percent, a family of four with income twice the median level and a marginal rate of tax of 49 percent—the marginal rate which would apply to such family's income by 1984 without enactment of the President's program—would need to receive a before-tax interest rate of 19.6 percent just to break even, that is, to avoid a decrease in the real value of its savings.

If the marginal rate for that same family were reduced to 36 percent, as proposed by the President, the family would break even if the interest rate were 15.6 percent, or 4 percentage points lower.

If inflation also falls from 10 percent to 6 percent—a result which would be partly attributable to the increased savings and investment resulting from lower marginal tax rates—the family's break-even interest rate would fall even further to 9.4 percent, just about half the rate needed in a world with higher tax and inflation rates.

Thus, by providing substantial increases in real rates of return to savings, marginal tax rate reductions lessen substantially the disincentive to save which is inherent in current income tax law.

Reducing marginal tax rates will also increase savings in a more subtle way. Under current law, many high income taxpayers seek tax shelters to reduce their tax liability. An element common to many of these shelters is debt the allowance of interest as a deduction against ordinary income reduces taxable income and therefore reduces taxes.

By lowering marginal tax rates, the President's program reduces the tax benefit of the interest deduction. This reduction in the incentive to borrow should not be discounted as of minor importance. Some current studies conclude that recent decline in the net rate of savings by individuals is a result of an increase in their gross rate of borrowing rather than a decline in their gross rate of savings. Thus, a reduction in marginal rates of tax has a double-barreled effect on net savings: it raises the incentive to save at the same time that it reduces the incentive to borrow.

Reducing marginal rates has yet another advantage as a means of providing a savings incentive. Lower marginal rates increase the incentive to save without requiring a further reduction in the tax base. When the tax base is eroded, the tax rates on remaining amounts of taxable income are often kept high to compensate for the loss of revenue on the excluded amounts of income. The President has proposed a means of increasing the incentive to save without reducing the tax base to accomplish that result.

EVALUATION OF SAVINGS INCENTIVES

In comparing the effect of marginal rate cuts with both existing and proposed savings incentive proposals, the following three basic issues must be considered.

First, is there any incentive for savings at the margin? Many taxpayers would benefit from certain of the proposals pending before the subcommittee without any increase in savings or reduction in debt. For example, a taxpayer who already has more than $200 in interest and dividend income has no incentive to save more if $200 of interest and dividend income is excluded.

Second, will the tax benefits go to taxpayers who simply switch assets from one form of savings to another?

Third, do the proposals deal with the question of borrowing? If a taxpayer can borrow and deduct all the interest on the borrowing while investing in an asset yielding untaxed income, then taxes are reduced without any additional savings on the taxpayer's part.

INTENT OF THE LEGISLATIVE PROPOSALS

The bills before you today, Mr. Chairman, attempt to address a fundamental problem of our current tax system: its bias against savings. They also attempt to deal with the plain fact that in a period of high inflation, the effective tax rate on realized capital income may be onerously high, if not confiscatory. This is especially true for interest receipts and certain realized capital gains. The low rate of savings in the United States must be increased, and the administration is quite sympathetic with the stated objective of these proposals to increase savings.

SPECIFIC PROPOSALS

The bills before you fall into four categories: (1) reductions in capital gains tax rates; (2) separate taxation of investment income; (3) dividend and interest exclusions; and (4) reinvestment or rollover plans.

CAPITAL GAINS TAX RATES

A number of the bills would increase, from 60 to 70 percent or even 75 percent, the portion of long-term capital gains allowed as an exclusion noncorporate taxpayers, and would make corresponding changes in the effective maximum rate on corporate capital gains.

Reducing the rate of tax on capital gains would have a number of advantages. Individuals would be encouraged to invest in new ventures which generally entail greater risks, and would be less "locked-in" to their current assets. Moreover, because lock-in is reduced, the revenue losses from reduced tax rates are partly offset by the increased volume of transactions.

However, there are inherent limitations in attempting to provide a savings incentive through capital gains tax reductions. Since capital gains do not comprise all income from capital, a reduction in capital gains taxes does not have the same efficiency results as a reduction in taxes on all capital income. For example, reduction in taxes on capital gains may encourage taxpayers who wish to hold bonds or interest bearing instruments to invest instead in land or stock and thereby deny loans to other investors. A reduction in taxes on all capital income would not have this result. Additionally, a more uniform reduction on capital income would not increase the disparity between the portion of capital gain receipts included in taxable income and the reduction in taxable income from deductible interest payments.

The President's proposal would make a substantial reduction on the rate of tax on all capital income, including realized capital gains.

Under the President's program, the maximum rate of tax on capital gains will be reduced from 28 percent to 20 percent. In general, by 1984, taxpayers will pay 30 percent less on capital gains than they would be paying in the absence of the President's program. Additionally, a lessening of the inflation rate will reduce substantially this rate of tax by simply lowering the amount of inflationary gains from capital assets.

We believe that the President's program provides an adequate reduction in the rate of tax on capital gains. Reductions should be made across the board to all taxpayers, not just those receiving capital gains.

SEPARATE TAXATION OF INVESTMENT INCOME

One approach to lowering the rate of taxation on capital income is to compute taxes on capital income separately from taxes on wage income and then to add together the tax on these two stacks, thus permitting the first dollar of taxable income for each type of income to start in the lowest tax bracket. The advantage of this approach is that it lowers substantially the average rate of taxation on capital income, offering a positive incentive both to save and to invest. Moreover, by providing equal treatment to all the capital income of a taxpayer, the so-called two-stack approach limits the extent to which a taxpayer can generate tax savings by simply reallocating savings to tax-preferred assets without actually increasing economic savings.

While this approach offers many conceptual advantages, implementation would raise some difficult problems that, while generally technical, are difficult to overcome.

First, the allocation of deductions, and in particular the interest deduction, is somewhat troublesome. We question whether it is desirable to allow a taxpayer to deduct interest paid at, say, a 50-percent rate, but include interest income at a 14-percent rate.

Second, at any given level of income, the "two-stack" approach causes the greatest amount of taxes to be paid by those individuals with all income from either capital or wages, and the least amount of taxes to be paid by those individuals whose income is half capital and half wages. For example, a taxpayer with $20,000 of capital income would pay substantially higher taxes than would a taxpayer with $10,000 of wages and $10,000 of capital income.

Third, it is quite difficult in many cases to distinguish between capital income and wage income, especially in the case of self-employed individuals.

We are, however, continuing to study and evaluate this two stack approach.

INTEREST AND DIVIDEND EXCLUSIONS

Of all the types of capital income received by taxpayers, interest bears perhaps, the highest rates of tax. This is because the interest rate includes an inflationary component which is entirely recognized when the interest is paid. Unlike most other assets, interest bearing assets do not offer a taxpayer the option of postponing or deferring recognition of this inflationary component. Thus, we are especially sympathetic with the need to lower the rate of tax on interest income.

In the case of income from dividend-paying assets, the rate of tax is also quite high, although for different reasons. On the one hand, some types of dividend-paying stock, such as preferred stock, are quite similar to interest-bearing assets and, therefore, contain a large inflationary element which is taxed as if it were real income. On the other hand, most companies do not pay out all their income as dividends, and while inflation may distort the nominal value of a stock, it does not necessarily distort the dividend rate. If the gains are recognized rather than deferred, the tax on income from these assets may also be quite high, although technically it is not because of the tax paid on the dividends, but rather the capital gains tax on inflationary increases in the value of the stock. [Time expires.]

Senator CHAFEE. Now, Mr. Chapoton, since you are probably the sole voice that will be heard against these bills today, I will give you an extra minute.

We recognize, of course, that you'll have your day in court as we go through the deliberations in this. As you know, the Treasury will be represented at any markups. In order to give some semblance of balance to the proceedings, I will give you 2 minutes more.

I think what would be important to me, is if you get into your counterarguments on each of these.

Mr. CHAPOTON. OK, I'll try to go to the problems we do have with some of these proposals.

Unfortunately, most mechanisms for lowering the amount of interest and dividends includible in income are not efficient. The existing interest and dividend exclusion does not provide much of an incentive for saving because it does not affect most savings done on the margin. It does provide a certain amount of simplification by eliminating the tax on interest and dividends for those taxpayers with low amounts of interest and dividends. However, it is clear that the existing exclusion does not constitute a meaningful savings incentive.

A number of bills before you today, Mr. Chairman, attempt to increase the savings impact of the exclusion by providing for increases in the amount of the exclusion, in some cases to $1,000 or $1,250 for each taxpayer. For the reasons described above, we do not believe that this is a significant savings incentive. Much savings is still not affected at the margin even though the tax cost of the proposal is large. Therefore, the Treasury Department is opposed to increases in the flat dollar amount of the exclusion.

Senator CHAFEE. Does the Treasury oppose going to the permanency of the $200 to $400?

Mr. CHAPOTON. We have not included an extension of the $200 to $400 in the budget, Mr. Chairman.

Senator CHAFEE. You have not included it?

Mr. CHAPOTON. We have not included it, so we would not support going forward with it at this time—at least as a savings incentive.

Senator CHAFEE. You would have it lapse back?

Mr. CHAPOTON. Yes sir, or perhaps turn to an alternative approach which attempts to solve the problem.

Senator CHAFEE. What was it before—$100 to $200?

Mr. CHAPOTON. $100 to $200.

One alternative approach attempts to solve this problem by excluding a percentage of interest and dividends received. In terms of its incentive effect, this type of approach is preferable to a flat dollar exclusion. At least as far as interest income is concerned, this approach can be considered as one means of eliminating the tax on the inflationary component.

If an exclusion is provided for a portion of interest income, however, it is also necessary to deal with interest deductions. Ideally, a similar portion of the interest deduction should be disallowed.

Finally, we would not support the rollover provisions, basically because they affect only the tax on one type of capital income, that is capital gains. We would prefer the direct approach followed in the administration's proposal, that is, reducing the tax on all income which would have significant reduction in the tax on capital gains.

Senator CHAFEE. I think you recognize the concern of this committee, and I think of Congress as a whole, that the flat individual tax cut is not going to produce the investment that the country needs. I know you have confidence that that will be done. Obviously, the President and Mr. Stockman do.

I notice that Under Secretary Ture suggested that the two-stack approach, would be the best alternative if Congress wishes to substitute some targeted savings incentive. I take it you would not subscribe to that.

Mr. CHAPOTON. Well, as I said in the statement, it conceptually is a very sound idea. It does significantly lower the tax on capital income and it does so on all types of capital income. It has a significant incentive effect at the margin.

There are some technical problems when you get into it; for example, allocating the deductions between the two stacks.

Senator CHAFEE. Between the amounts?

Mr. CHAPOTON. Yes, between the amounts of wage and capital income.

In addition, the two-stack approach raises what might be called an equity problem of taxing most favorably someone who has both capital and wage income, and less favorably one who has only capital income.

Senator CHAFEE. The Treasury did not testify on the expansion of the IRA's when we had the hearing on February 24. Do you have a statement on that that you might submit?

Mr. CHAPOTON. Yes, sir, we do have a statement and it will be submitted this week. I apologize to the committee for our delay in getting that here.

Senator CHAFEE. Senator Bentsen was unable to be here so we are going to have one other hearing of this subcommittee.

Thank you, Mr. Chapoton.

Mr. CHAPOTON. Thank you, Mr. Chairman.

[The prepared statement of Hon. John E. Chapoton follows:]

For Release Upon Delivery
Expected at 9:30 A.M. EDT
May 4, 1981

STATEMENT OF
THE HONORABLE JOHN E. CHAPOTON
ASSISTANT SECRETARY (TAX POLICY)
BEFORE THE SUBCOMMITTEE ON SAVINGS, PENSIONS
AND INVESTMENT POLICY
OF THE COMMITTEE ON FINANCE

Mr. Chairman and members of this Subcommittee:

I am pleased to be here today to discuss the general subject of savings and investment incentives, as well as to comment on specific proposals in which this Subcommittee has expressed an interest.

The President's Proposals

The President has submitted to the Congress a program for economic recovery which will, if adopted, expand national prosperity, enlarge national incomes and increase opportunities for all Americans. The tax program proposed as part of the economic recovery package is specifically designed to increase savings and investment in the economy by lowering the marginal rate of tax on income and by allowing faster recovery of capital costs. We think that the proposed reduction in marginal rates of tax is, per dollar of cost, the best savings incentive that Congress could adopt.

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A reduction in marginal tax rates increases the after-tax rate of return from additional capital investment. In an economy with an inflation rate of 10 percent, a family of four with income twice the median level and a marginal rate of tax of 49 percent -- the marginal rate which would apply to such family's income by 1984 without enactment of the President's program -- would need to receive a before-tax interest rate of 19.6 percent just to break even, that is, to avoid a decrease in the real value of its savings. If the marginal rate for that same family were reduced to 36 percent, as proposed by the President, the family would break even if interest were 15.6 percent, or 4.0 percentage points lower. If inflation also falls from 10.0 percent to 6.0 percent -- a result which would be partly attributable to the increased savings and investment resulting from lower marginal tax rates -- the family's break-even interest rate would fall even further to 9.4 percent, just about half the rate needed in a world with higher tax and inflation rates. Thus, by providing substantial increases in real rates of return to savings, marginal tax rate reductions lessen substantially the disincentive to save which is inherent in current income tax law.

Reducing marginal tax rates also will increase savings in a more subtle way. Under current law, many high income taxpayers seek tax shelters to reduce their tax liability. An element common to many of these shelters is debt; the allowance of interest as a deduction against ordinary income reduces taxable income and therefore reduces taxes. This analysis applies without regard to whether the debt was incurred for personal, investment or business purposes, since money is fungible. By lowering marginal tax rates, the President's program reduces the tax benefit of the interest deduction. This reduction in the incentive to borrow should not be discounted as of minor importance. Some current studies conclude that the recent decline in the net rate of savings by individuals is a result of an increase in their gross rate of borrowing rather than a decline in their gross rate of savings. Thus, a reduction in marginal rates of tax has a double-barreled effect on net savings: it raises the incentive to save at the same time that it reduces the incentive to borrow. Yet it does this in a manner that provides a tax reduction for everyone with no new, complicated rules to be added to the Internal Revenue Code.

Reducing marginal rates has yet another advantage as a means of providing a savings incentive. Lower marginal rates increase the incentive to save without requiring a further reduction in the tax base. When the tax base is eroded, the tax rates on remaining amounts of taxable income are often kept high to compensate for the loss of revenue on the excluded amounts of income. The President has proposed a means of increasing the incentive to save without reducing the tax base to accomplish that objective.

Evaluation of Savings Incentives

In comparing the effect of marginal rate cuts with both existing and proposed savings incentive proposals, the following three basic issues must be considered. First, is there any incentive for savings at the margin? Many taxpayers would benefit from certain of these proposals without any increase in savings or reduction in debt. For example, a taxpayer who already has more than $200 in interest and dividend income has no incentive to save more if $200 of interest and dividend income is excluded. Second, will the tax benefits go to taxpayers who simply switch assets from one form of savings to another? These taxpayers would achieve a tax reduction without increasing their economic savings. Third, do the proposals deal with the question of borrowing? If a taxpayer can borrow and deduct all the interest on the borrowing while investing in an asset yielding untaxed income, then taxes are reduced without any additional savings on the taxpayer's part.

Intent of the Legislative Proposals

The bills before you today attempt to address a fundamental problem of our current tax system: its bias against savings. They also attempt to deal with the plain fact that in a period of high inflation, the effective tax rate on realized capital income may be onerously high, if not confiscatory. This is especially true for interest receipts and certain realized capital gains. The low rate of savings in the United States must be increased, and the Administration is quite sympathetic with the stated objective of these proposals: to increase savings.

Specific Proposals

The bills before you today fall into four categories: 1) reductions in capital gains tax rates; 2) separate, taxation of investment income; 3) dividend and interest exclusions; 4) reinvestment or rollover plans.

Capital Gains Tax Rates

A number of bills would increase, from 60 percent to 70 or 75 percent, the portion of long-term capital gains allowed as an exclusion to noncorporate taxpayers, and would make corresponding changes in the effective maximum rate on corporate capital gains.

Reducing the rate of tax on capital gains would have a number of advantages. Individuals would be encouraged to invest in new ventures which generally entail greater risk, and would be less "locked-in" to their current assets. Moreover, because lock-in is reduced, the revenue losses from reduced tax rates are partly offset by an increased volume of transactions.

However, there are inherent limitations in attempting to provide a savings incentive through capital gains tax reductions. Since capital gains do not comprise all income from capital, a reduction in capital gains taxes does not have the same efficiency results as a reduction in taxes on all capital income. For example, reduction in taxes on capital gains may encourage taxpayers who may wish to hold bonds or interest-bearing instruments to invest instead in land or stock and thereby deny loans to other investors. A reduction in taxes on all capital income would not have this result. Additionally, a more uniform reduction on capital income would not increase the disparity between the portion of capital gain receipts included in taxable income and the reduction in taxable income from deductible interest payments. An extreme example of the type of problem that can arise with exclusions only for gains on capital assets is the so-called "cash and carry transaction" in commodities where an ordinary deduction is allowed for interest and other carrying costs for assets that will yield capital gains when sold. The problem extends well beyond these commodities transactions, however.

The President's proposals would make a substantial reduction in the rate of tax on all capital income, including realized capital gains. Under the President's program, the maximum rate of tax on capital gains will be reduced from 28 percent to 20 percent. In general, by 1984, taxpayers will pay 30 percent less on their capital gains than they would be paying in the absence of the President's program. Additionally, a lessening of the inflation rate will reduce substantially this rate of tax by simply lowering the amount of inflationary gains from capital assets.

We believe that the President's program provides an adequate reduction in the rate of tax on capital gains. Reductions should be made across the board to all taxpayers, not just those receiving capital gains.

Separate Taxation of Investment Income

One approach to lowering the rate of taxation on capital income is to compute taxes on capital income separately from taxes on wage income and then to add together the two "stacks", thus permitting the first dollar of taxable income for each type of income to start in the lowest tax bracket. The advantage of this approach is that it lowers substantially the average rate of taxation on capital income, offering a positive incentive both to save and to invest. Moreover, by providing equal treatment to all the capital income of a taxpayer, the "two-stack" approach limits the extent to which a taxpayer can generate tax savings by simply reallocating savings to tax-preferred assets without actually increasing economic savings.

While this approach offers many conceptual advantages, implementation would raise some problems that, while generally technical, are difficult to overcome. First, the allocation of deductions, and in particular the interest deduction, is somewhat troublesome. We question whether it is desirable to allow a taxpayer to deduct interest paid at, say, a 50 percent rate, but include interest income at a 14 percent rate. Second, at any given income level the "two-stack" approach causes the greatest amount of taxes to be paid by those individuals with all income from either capital or wages, and the least amount of taxes to be paid by those individuals whose income is half capital and half wages. For instance, a taxpayer with $20,000 of capital income would pay substantially higher taxes than would a taxpayer with $10,000 of wages and $10,000 of capital income. Third, it is quite difficult in many cases to distinguish between capital income and wage income, especially in the case of self-employed individuals. However, we are continuing to study and evaluate this approach.

Interest and Dividend Exclusions

Of all the types of capital income received by taxpayers, interest bears perhaps the highest rates of tax. This is because the interest rate includes an inflationary component which is entirely recognized when the interest is paid. Unlike most other assets, interest-bearing assets do not offer a taxpayer the option of postponing or deferring recognition of this inflationary component. Thus, we are especially sympathetic with the need to lower the rate of tax on interest income.

In the case of income from dividend-paying assets, the rate of tax is also quite high, although for different reasons. On one hand, some dividend paying stocks, such as preferred stock, are quite similar to interest-bearing assets and, therefore, contain a large inflationary element which is taxed as if it were real income. On the other hand, most companies do not pay out all of their income as dividends, and while inflation may distort the nominal value of a stock, it does not necessarily distort the dividend rate. If the gains are recognized rather than deferred, the tax on income from these assets may also be quite high, although technically it is not because of the tax paid on the dividends but rather the capital gains tax on inflationary increases in the value of the stock. The combination of a corporate tax and an individual tax on dividends and capital gains results in a double taxation of taxpayers who receive dividends from a corporation. For these reasons, we are also quite sympathetic to the need to lower the rate of tax on dividend-paying stock, although not necessarily in the same manner that taxes should be lowered on interest-bearing assets.

Unfortunately, most mechanisms for lowering the amount of interest and dividends includable in income are not efficient. The existing interest and dividend exclusion does not provide much of an incentive for savings because it does not affect most savings done on the margin. It does provide a certain amount of simplification by eliminating tax on interest and dividends for those taxpayers with low amounts of interest or dividends. Many of these taxpayers are probably receiving such low rates of interest that their effective, real interest rate is negative anyway. However, it is clear that the existing exclusion is not a savings incentive.

A number of bills before you today attempt to increase the savings impact of the exclusion by providing for increases in the amount of the exclusion. One approach simply increases the cap or the maximum amount of exclusion from $200 per taxpayer to some higher flat amount, e.g., $1,000 or $1,250. For the reasons described above, we do not believe that this is a significant savings incentive. Much savings is still not affected at the margin, even though the tax cost of the proposal is large. Therefore, the Treasury Department is opposed to increases in the flat dollar amount of the exclusion.

An alternative approach attempts to solve this problem by excluding a percentage of interest and dividends received. In terms of its incentive effect, this type of approach is preferable to a flat dollar exclusion. At least as far as interest income is concerned, this approach can be considered as one means of eliminating the tax on the inflationary component.

If an exclusion is provided for a portion of interest income, however, it also is necessary for the reasons noted above to deal with interest deductions. Ideally, a similar portion of the interest deduction should be disallowed. To provide a taxpayer with a full deduction for interest payments and at the same time allow only a fraction of receipts to be included in income distorts the incentive effect: the taxpayer merely borrows on existing assets, invests the proceeds in interest-bearing accounts and generates tax savings through deductible interest even though there has been no change in net savings or net economic income. Moreover, consideration should be given to applying the same set of rules to all sectors of the economy so as to avoid substantial shifts of assets or debts to sectors receiving more preferential treatment.

The President's tax proposals provide an effective solution to these problems. If tax rates are reduced by 30 percent, the rate of tax on interest and dividend income would be reduced. At the same time, across-the-board rate reductions decrease the tax savings that result from the deduction of interest payments. The taxpayer will simply be in a lower bracket for both savings and borrowing. Thus, the President's individual rate reductions provide a sound yet workable approach to reducing the rate of tax on interest and dividends, and one which avoids some of the complications of interest and dividend exclusions. Moreover, the President's proposal for accelerated cost recovery will lower the corporate tax paid on dividend-paying stock, although not directly on the dividends themselves. Combined with lower marginal tax rates, accelerated cost recovery offers the best approach at this time for lowering the amount of tax paid, whether directly or indirectly, by owners of dividend-paying stock.

Reinvestment Plans

Another approach to savings incentives would allow taxpayers to "roll over" certain receipts of income without paying a tax on that income. Tax would be paid only when there was a withdrawal, either through sale of stock or withdrawal from an account.

Dividend Reinvestment Plans. One bill before you today would allow dividends reinvested through dividend reinvestment plans to obtain approximately the tax treatment accorded retained earnings of corporations. That is, reinvested dividends would be treated after 12 months as if the income had not been received by the taxpayer, but simply represented an increase in the value of the stock.

As described above, owners of dividend-paying stock often pay high rates of tax, primarily because of the double taxation of corporate income. Nonetheless, it is not clear that tax-favored treatment for dividend-reinvestment plans would solve this problem in the most direct way, nor that these plans would provide adequate encouragement to increased savings. Because the proposed incentive would apply only to a portion of capital income (dividend paying stock), much of the cost of the proposal is incurred for taxpayers who merely maintain their current behavior and do not actually increase their savings.

In addition, tax-motivated borrowing would be encouraged in certain cases. For example, a taxpayer could borrow on the margin to purchase the shares of a public utility while deducting interest on the margin account. Further, because the investor could reallocate portfolio assets to receive this tax break, it would not be necessary to increase savings in order to receive the benefits of the proposal.

While a dividend reinvestment proposal attempts to relieve the problem of double taxation of corporate dividends, it has some effects which are quite different from proposals for integration of the corporate and individual income taxes. For example, dividend reinvestment proposals would discourage a taxpayer from shifting assets within his or her portfolio when better investment opportunities exist elsewhere. This would not be the result if corporate and individual taxes were integrated. In addition, tax-favored treatment of dividend reinvestment plans would increase the lock-in effect of the current law rather than decrease it. Treasury therefore opposes this type of approach to reducing taxes on dividend income.

Capital Gains Rollovers. A more general approach to rollovers would allow assets to be commingled in a trust in such a manner that lock-in is avoided. Under S. 457, for example, taxes on capital gains would be deferred if held in a rollover account rather than distributed. Thus, taxes which otherwise would be paid on the realization of capital gains from the sale of stock or securities of a domestic corporation would be deferred and in some cases eliminated altogether.

While this bill does have the advantage of tending to eliminate "lock-in" effects, it too is limited by the fact that only capital income received in the form of capital gains is given the tax break, while interest and dividend income are ignored. It also does not deal with the problem of borrowing to make tax-preferred investments. Moreover, the requirement of a segregated fund for capital gains and detailed distribution rules would be complex for the small investor and difficult to administer. Finally, the bill would be especially beneficial to active traders, as opposed to long-term investors. For these reasons, Treasury opposes this limited approach to lowering the rate of tax on capital income.

Conclusion

In conclusion, current law often imposes especially high rates on tax of the realization of capital income. Interest income is taxed heavily because the inflationary component of income is always realized, while dividend income is taxed heavily because of the double taxation of corporate dividends. The President has presented Congress with a savings incentive proposal which would lower substantially the rate of tax on all capital income, first through a reduction in individual tax rates on all income, and second through an accelerated cost recovery plan which would lower the total amount of taxes paid by owners of dividend-paying stock. In addition, the President's proposal has a number of advantages over other types of proposals. It discourages tax-motivated borrowing while providing a tax reduction for all taxpayers. It provides savings incentives without reducing the tax base. It provides incentives at the margin for individuals to save and invest. By applying to all capital income, it does not generate tax savings to those individuals who switch their savings from one asset or account to another. Finally, it avoids the problem of encouraging tax-deductible borrowing for the purpose of making investments in tax-preferred assets.

We urge you to support the President's program and to recognize that it provides one of the best, simplest and most efficient savings and investment incentives that the Congress could adopt.

o 0 o

Senator CHAFEE. We are now going to have a two-person panel. Dr. Hoefs of Arthur Andersen and Mr. O'Brien of the Securities Industry Association.

Mr. HOEFS. Thank you, Senator.

STATEMENT OF RICHARD A. HOEFS, DIRECTOR OF INTERNATIONAL TAX POLICY, ARTHUR ANDERSEN & CO.

Mr. HOEFS. We have performed a study for the Securities Industry Association the details of which Mr. O'Brien will be covering, but I wanted to highlight some parts of it in our testimony.

The level of taxation of investment income in the United States, as demonstrated in that study, generally exceeds the level of taxation of investment income in 10 other countries.

It is our view that a country's level of taxation has a powerful influence on the personal savings habits of its residents.

We made a comparison of the taxation of investment income in 11 countries with the rate of savings of individuals in those particular countries. The level of savings appears as appendix A in our written testimony and represents the percentage of gross domestic product involved in personal savings for those countries for a 5-year period between 1974 and 1978.

As the exhibit demonstrates, the United States has the lowest savings rate of any of the 11 countries.

Senator CHAFEE. I am not sure I know what gross domestic product is.

Mr. HOEFS. Gross domestic product basically is gross national product after eliminating the impact of exports and imports. There are different ways that such a savings calculation can be made and we chose gross domestic product because of the availability of statistical data on that base.

Senator CHAFEE. So, you are comparing apples to apples throughout here?

Mr. HOEFS. Right. As the exhibit also demonstrates, Italy and Japan are among the thriftiest countries.

Senator CHAFEE. In Japan are there savings banks on every street corner? Where do they save their money?

Mr. HOEFS. As is shown in the SIA study, there are a lot of incentives offered in the interest-bearing investment area. The detail is in their statement which is submitted for the record.

Senator CHAFEE. But, where is the Japanese that works for Mitsubishi putting his paycheck? Where does he save? What does he do with his money? Does he go to a bank?

Mr. HOEFS. Well, Senator, I'd like to submit something to you on that for the record. We did a study a few years ago of overall investment incentives in a number of countries. I don't happen to have that with me today, but it included for Japan, probably 12 to 15 incentive factors in the areas of pensions, insurance policies, real estate, and so forth.

Senator CHAFEE. You take Italy here as the second highest. I am astonished by it. If you could tell me what the worker for Fiat does, I thought he went home and put it under the mattress.

Mr. HOEFS. Well, I suspect to some degree, he does.

Senator CHAFEE. Well, obviously, these statistics indicate that he has it working somewhere.

Mr. HOEFS. What I am getting at is that some of the money that he gets, when I say under the mattress, that is probably the wrong terminology to use, represents money that is earned in their version of the underground economy. Some of it represents income which is not taxed and then effectively is saved in some way.

As is also indicated, Australia and Belgium have a high savings rate compared to the United States. All the countries, other than Sweden, have rates in excess of 7 percent.

Many things influence savings patterns, including inflation, cultural tradition and taxation of investment income.

Exhibit B in our written statement presents a simplified summary of the tax policies of these countries on investment income and the savings patterns of the 11 countries.

As can be seen, overall the U.S. tax position is the most negative toward investment income and the personal savings rates reflect that. Undoubtedly, however, other factors also influence the relationship.

As a supplement to exhibit B, in 1977 Germany reduced dividend taxation. I know some people are interested in what the impact might have been from that change.

Investment indicators prepared by the IMF showed that positive changes in direct investment occurred in Germany in the immediately following 2 years.

Again, I am sure factors other than the tax law change influenced that investment pattern change.

Senator CHAFEE. Are you saying that in Germany the dividends are not taxed twice.

Mr. HOEFS. No; that is not completely true. They are taxed twice but only partially.

Senator CHAFEE. I see.

Mr. HOEFS. They are not fully taxed twice by giving the shareholder a partial relief from his individual taxation for the tax that has been paid at the corporate level. In addition the corporation tax rate is reduced for profits paid out as a dividend.

Senator WALLOP. So he is lesser taxed?

Mr. HOEFS. He is lesser taxed, right. We do the same here to the extent of the $200 exclusion, but it is a very modest relief.

On January 1, 1979, France imposed a capital gains tax of 15 percent on large gains. The change was made in order to expand income tax revenue and to get a more complete reporting of revenue.

It also enacted an incentive for small investors called the Monory Law which is a deduction similar to our Keogh or IRA plans.

In 1980, the second year after the change, stock exchange transactions increased 17 percent. The increase, undoubtedly, was influenced heavily by the Monory change. In conflict with that apparent positive change in the stock exchange transactions, however, French bankers, who traditionally handle stock securities transactions in France, contend that the new capital gains tax has caused investors to defer selling rather than selling as they have in the past. Such a result is a very logical one to occur.

It has been mentioned here, today, several times that we have capital accumulation needs. Taxation of dividends, interest, and capital gains presently encourage present consumption because U.S. tax policy significantly lowers the return available to investors through savings.

Inflation further exacerbates the impact of taxation because income taxes are imposed on nominal gains rather than real gains to the economy.

Senator CHAFEE. Thank you very much. Senator Wallop, do you have any questions of Mr. Hoefs?

Senator WALLOP. Mr. Chairman. No; I regret that I was not here when the testimony began. I would ask that an opening statement be placed in the appropriate place in the record.

Senator CHAFEE. Definitely. Mr. O'Brien?

[The opening statement of Senator Wallop and Dr. Ture's letter and tables follow:]

Opening Statement
Senator Malcolm Wallop
Hearing on Savings and Investment Incentives
Senate Committee on Finance

Mr. Chairman, I want to commend you for holding these hearings on tax incentives to encourage savings and investment. In the past our tax policies have given inadequate consideration to the effects that excessive levels of taxation create on an individual's willingness to save and invest. Unfortunately such tax policies have combined with inflation to encourage consumption over savings, resulting in the U.S. having one of the lowest rates of personal investment and savings in the industrialized world.

One bright spot in the recent tax policy as it relates to investment incentives is the Revenue Act of 1978, in which Congress reduced the maximum effective capital gains tax on individuals and corporations from 49 percent to 28 percent. The results of the cuts in capital gains taxes have been extremely impressive and they include higher equity values, more seed money for new companies, and a much higher level of total stock offerings in 1979-1980. The economic activity generated by the 1978 tax cut has provided an additional source of revenue for the Treasury and helped to provide new jobs and innovative technology during these difficult economic times.

Clearly the most impressive aspect of the 1978 capital gains tax reduction is that it stimulated new investment and generated a wide array of economic activity with very little revenue impact on the U.S. Treasury. I recently requested updated information from the Department of the Treasury on the revenue effects of the 1978 capital gains tax cut. The Under Secretary of the Treasury for Tax Policy, Dr. Norman Ture, provided statistics in response to my letter which indicates how powerful those tax cuts were in unlocking old investments and generating increased realizations. If I could, Mr. Chairman, I would like to quote from Dr. Ture's letter:

> "The net revenue loss in 1979 from capital gains tax reductions contained in the Revenue Act of 1978 was originally estimated by Treasury to be $1.7 billion. The static revenue loss was estimated at $2.6 billion, offset by $0.9 billion of tax liability generated by induced capital gains realizations.
>
> The preliminary statistics from tax returns filed for 1979 indicate, however, that the net revenue loss was only about $0.1 billion. Higher than estimated induced realizations increased receipts by $2.5 billion rather than the $0.9 billion originally estimated."

Mr. Chairman, I request unanimous consent that Dr. Ture's letter and accompanying tables be included in the Hearing Record. I think that the Treasury's analysis demonstrates that the 1978 capital gains tax cut was effective in stimulating new investments, and it suggests that an additional reduction in capital gains taxes will be equally effective.

THE UNDER SECRETARY OF THE TREASURY - designate
WASHINGTON, D.C.

MAR 26 1981

Dear Senator Wallop:

This is in reply to your letter of March 9, 1981, in which you requested data on capital gains, the taxes paid on capital gains and an analysis of the effect of the 1978 capital gain tax reductions on realizations. While the data for 1979 are preliminary, I am happy to provide you with this information.

In response to your first request, Table 1 shows the current estimates of total capital gains and the taxes paid on gains from 1955 to 1979. Data on capital gains in 1979 are preliminary at this time and subject to change, but historically the final data have not differed by more than about four percent from the preliminary data.

The net revenue loss in 1979 from capital gains tax reductions contained in the Revenue Act of 1978 was originally estimated by Treasury to be \$1.7 billion. The static revenue loss was estimated at \$2.6 billion, offset by \$0.9 billion of tax liability generated by induced capital gains realizations.

The preliminary statistics from tax returns filed for 1979 indicate, however, that the net revenue loss was only about \$0.1 billion. Higher than estimated induced realizations increased receipts by \$2.5 billion rather than the \$0.9 billion originally estimated.

Table 2 shows the distribution of net capital gains in 1978 and 1979. Net capital gains in adjusted gross income increased from \$23.2 billion in 1978 to \$26.8 billion in 1979. The largest increase was for taxpayers with adjusted gross income in excess of \$100,000. The percent of capital gains reported in this class increased from about 29 percent in 1978 to nearly 41 percent in 1979.

The alternative minimum tax enacted in the Revenue Act of 1978 raised \$0.7 billion in 1979. This amount is included in the taxes paid on capital gain income shown on Table 1.

I hope this information will be useful to you in your efforts to elucidate the effectiveness of the 1978 legislation. We'll keep you advised of any new analysis and data we develop.

Your support for the President's tax program is greatly appreciated. We look forward to working closely with you on it.

Cordially,

Norman B. Ture

The Honorable
Malcolm Wallop
United States Senate
Washington, D.C. 20510

Enclosures - 2

Table 1

Total Capital Gains and the Effective Tax Rate
on Capital Gains for Returns with Net Capital Gains Only

(Individual Only)

(1955-1979)

Year	Total gains 1/	Taxes paid on capital gain income	Effective tax rate
	(........... $ billions	............)	(.... percent ....)
1955	$ 9.9	$1.2	12.0%
1956	9.7	1.1	11.8
1957	8.1	0.9	11.1
1958	9.4	1.1	11.1
1959	13.1	1.6	11.8
1960	11.7	1.4	11.6
1961	16.3	2.0	12.4
1962	13.5	1.6	11.8
1963	14.6	1.7	11.9
1964	17.4	2.2	12.7
1965	21.5	2.8	13.1
1966	21.3	2.7	12.8
1967	27.5	3.9	14.0
1968	35.6	5.2	14.5
1969	31.4	4.4	14.1
1970	20.8	3.0	14.6
1971	28.3	4.3	15.2
1972	35.9	5.6	15.7
1973	35.8	5.3	14.9
1974	30.2	4.3	14.3
1975	30.9	4.5	14.4
1976	39.0	6.2	15.9
1977	45.9	7.3	15.8
1978	51.5	8.3	16.1
1979 2/	72.1	10.1	14.0

Office of the Secretary of the Treasury
Office of Tax Analysis

March 20, 1981

1/ Net long-term gain in excess of short-term loss
plus short-term capital gain.

2/ Estimate.

84-080 O—81——8

Table 2

Distribution of Net Capital Gains Included in Adjusted Gross Income, by Adjusted Gross Income Class, 1978 and 1979

Adjusted gross income class	Net capital gain included in adjusted gross income			
	1978		1979	
	Amount	Percent	Amount	Percent
($000)	($ millions)	(..... % .....)	($ millions)	(..... % .....)
Under 2	$ 1,180	5.1%	1,068	4.0%
2 - 4	200	0.9	201	0.7
4 - 6	276	1.2	224	0.8
6 - 8	324	1.4	356	1.3
8 - 10	524	2.3	425	1.6
10 - 12	528	2.3	429	1.6
12 - 14	539	2.3	468	1.7
14 - 16	610	2.6	468	1.7
16 - 18	587	2.5	681	2.5
18 - 20	648	2.8	416	1.6
20 - 25	1,562	6.7	1,281	4.8
25 - 30	1,575	6.8	1,395	5.2
30 - 50	4,052	17.4	4,082	15.2
50 - 100	3,984	17.1	4,341	16.2
100 - 200	2,675	11.5	3,143	11.7
200 - 500	2,035	8.8	2,813	10.5
500 -1000	858	3.7	1,587	5.9
1000 and over	1,076	4.6	3,426	12.8
Total	$23,231	100.0%	$26,803	100.0%

Office of the Secretary of the Treasury
Office of Tax Analysis

March 20, 1981

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

Mr. O'BRIEN. Good morning, Mr. Chairman. I am Edward I. O'Brien, president of the Securities Industry Association. It has over 500 members, serves 30 million investors and thousands of companies, both large and small, as well as units of government.

As Senator Schmitt noted earlier, the low rates of savings and investment in the United States are major factors in the loss of international competitiveness and we have just had the reference made to the Authur Andersen study which lays out the comparison of taxes between our country and others.

The bills which are the subject of this hearing are among the many legislative proposals aimed at stimulating savings and investment. In 1978 the Congress took a very bold step in that direction by cutting the capital gains tax rate from 49 to 28 percent and that has been even more successful than we could have projected at that time.

Increased taxes on investment enacted in 1969 were followed by an 18 percent decrease in the number of shareholders and 99 percent of operation of equity capital which was raised by small companies and the reduction in the Federal revenues from capital gains taxes.

Those trends were reversed when capital gains taxes were reduced in 1978. Capital raised through initial public offerings increased sharply in late 1978. They doubled in 1979 and tripled in 1980. Hundreds of thousands of investors returned to the market, stock prices rose despite rising inflation and interest rates.

Realization of capital gains also increased and Federal tax receipts from capital gains did not decline as forecast by the Treasury, but in fact increased by $2 billion in 1979.

S. 75 would build on the success of the 1978 legislation by further reducing capital gains taxes. SIA asked data resources to modify its econometric model by incorporating the most recent historical data and eliminating the need to make assumptions.

Using that version of the model, DRI estimates that increasing capital gains exclusion would have very positive effects on the economy.

Over the period from 1981 through 1983, real GNP would increase by nearly $5 billion—$800 million of increased investment would be made and savings would increase $1.3 billion.

Reducing the max tax on investment income from 70 to 50 percent, a provision contained in S. 936, would improve real GNP by $7.6 billion, investment by $1.4 billion, and savings by $6.5 billion over that same period.

Increasing the exclusion for dividends and interest to $1,000 and to $2,000 for joint returns, would boost real GNP by $51 billion, investment by $9 billion and savings by $9.6 billion.

Senator CHAFEE. Now, these projections, where are you getting them from?

Mr. O'BRIEN. They come out from the model of the DRI. They are referred to on page 15 of the written statement under table No. 6.

Senator CHAFEE. I see.

Mr. O'BRIEN. I am comparing all of them. These proposals, of course, have widely different magnitudes. Increasing the capital gains exclusion, for example, would reduce Federal tax revenues by $500 million over the period. Lowering the max tax would cost $1.8 billion and increasing the dividend and interest would cut tax revenues $33 billion.

In order to compare tax proposals of such different sizes, SIA has constructed an efficacy ratio which expresses the impact on economic activity per dollar of revenue loss.

The chart on page 17 of the written statement summarizes the comparison of these proposals. For every dollar of revenue lost, the capital gains exclusion would increase GNP by $14.13, boost investment by $1.25 and result in $3.88 in increased savings.

Reducing capital gains taxes is far more successful than the other two proposals, but there are also other considerations. The discriminatory nature of the current maximum tax on investment income creates a strong disincentive to investment, and in fact, requests for tax shelters among those in the upper brackets and small savers will derive the greatest benefit from an increase in dividend and interest exclusion.

SIA supports further reductions of capital gains taxes and the elimination of the distinction between earned and unearned income which really inhibits investment.

We also urge the committee to allow the small saver the widest possible choice of investment and savings vehicles in any adjustments to the exclusion by continuing to apply it to a broad range of sources and dividends.

We hope to provide this panel and the full Finance Committee with additional econometric simulations in the weeks to come. We believe that the results of the 1978 tax cuts have demonstrated the success that carefully designed tax policy can have in stimulating savings and investment in our economy.

Thank you, Mr. Chairman.

Senator CHAFEE. Does the Treasury dispute the statistics on the 1978 capital gains cut?

Mr. O'BRIEN. I don't think they do any longer, Mr. Chairman. They did in the early stages, in fact, took a different position, but I believe that they now realize that it has basically worked successfully.

Senator WALLOP. Actually, I believe that the Treasury's own figures are used to justify and be the banker.

Mr. O'BRIEN. Exactly.

So it is no longer a dispute although it certainly was a dispute, not only in 1978 as to what would happen. It was even a dispute in 1980 as to what the effect would be. Now that has pretty much cleared up. So they admit that it has worked.

Senator CHAFEE. Well, if a little bit does quite a bit of good, why doesn't a lot do a lot more good? Why not just eliminate the capital gains tax?

Mr. O'BRIEN. Well, I guess I would not argue too forcefully against that, Mr. Chairman. It may be that your judgment would be to take a gradualist approach and you will have to balance that against many other considerations.

Suffice it to say that what was done in 1978 has worked and it would argue very forcefully that more of the same would do better. Where you draw the line is a question, which I realize is difficult for you to make.

Senator CHAFEE. What does that bring the maximum capital gains rate down to?

Mr. O'BRIEN. It is about 17.5 percent. It increases. The one we are talking about here in the model would increase the exclusion to 75 percent from 60 and it brings it down to about 17.5 percent.

Senator CHAFEE. That's with the maximum rate staying at 70?

Mr. O'BRIEN. Yes.

Senator CHAFEE. You would do the same thing if you took the maximum rate down to 50.

Mr. O'BRIEN. No; You wouldn't quite go to there, you would bring it down to about 20, as I recall. Of course, under the administration proposal that would take place over a series of years, period of years, as distinguished from what we are talking about here which would go promptly.

Senator CHAFEE. Senator Wallop?

Senator WALLOP. Thank you, Mr. Chairman. I just would ask either of you if you would comment on the comparison between the U.S. favored taxation of capital gains and the rest of the industrial world—Germany, Japan, and France?

Mr. O'BRIEN. I am going to ask my associate from Arthur Andersen to look first because he is the expert. Looking at the study of Arthur Andersen on page 2 of the study, we have compared the different countries.

The maximum short term capital gains rate in the United States is 70 percent and it goes down to Australia, 60, 22 in Canada, France, 15, et cetera. A number of countries are simply exempt—Japan, Netherlands, etc.

The long-term rate is, at present, 28 percent in the United States, and in Canada, for example, it is 22 percent. It is exempt in Australia, Belgium, Italy, Japan, and the Netherlands, et cetera. In the United Kingdom it is 30 percent, which is hardly a group to emulate.

That, Senator Wallop, is the comparison.

Senator WALLOP. Thank you. I wonder if anybody has ever done a comparison of how different capital gains tax rates affect investment flows.

Do they have any estimation as to the effect of their tax rates? Is there a conversation that is ongoing in these countries?

Mr. O'BRIEN. I can't answer for Canada, but in France, of course, they had the program which was put into effect a couple of years ago which provided genuine incentives for people. It was overwhelmingly successful.

What it has done in terms of revenues and budget estimates, of course, I cannot tell you. It has been a major success.

Senator WALLOP. Thank you.

Senator CHAFEE. Thank you, very much, gentlemen. I appreciate your coming.

Mr. HOEFS. Mr. Chairman.

Senator CHAFEE. Yes.

Mr. HOEFS. With your permission, I would like to collect some information on this question of where the Japanese and where the Italians make their savings investments.

Senator CHAFEE. I wonder if in taking into account, the so-called savings and investment statistics of the United States vis-a-vis the rest of the world, whether you are taking into account the enormous investment in home mortgages that individuals have in this country.

Mr. HOEFS. Yes, it is and as far as I know our statistics would include that information.

Senator CHAFEE. They would include that.

Mr. HOEFS. Yes.

Senator CHAFEE. Well, thank you very much.

Mr. HOEFS. One thought has occurred to me in considering why Japanese might save. As you know, I am sure, employees are well taken care of by Japanese companies. They don't need to provide certain things that employees here must provide in terms of current consumption.

This, presumably, would leave them with more ability to save since their employer is providing some costs that American employees must meet on their own.

Senator CHAFEE. Yes, I appreciate that, but somehow we think in the United States we have the vastest banking system which applies to the individual.

Mr. HOEFS. I can assure you that many large banks, in fact, the largest banks in the world, are no longer American banks.

Senator CHAFEE. Yes, but are they made up of thousands and millions of individual savings in those banks? Apparently they are.

Mr. HOEFS. We will get you information on that.

Senator CHAFEE. Thank you.

Mr. HOEFS. Do you have a particular member of the staff you would like us to provide that to?

Senator CHAFEE. Bob Forman.

Mr. HOEFS. All right.

[The prepared statements of the preceding panel follow:]

ARTHUR ANDERSEN & CO.

Statement on

THE TAXATION OF INVESTMENT INCOME
IN OTHER COUNTRIES

Before the

SUBCOMMITTEE ON SAVINGS,
PENSIONS, AND INVESTMENT POLICY,
COMMITTEE ON FINANCE
of the
UNITED STATES SENATE

My name is Richard A. Hoefs. I am the Director of International Tax Policy of Arthur Andersen & Co., an international accounting firm. Our firm has more than 100 offices around the world and in our practice we observe the operation of tax systems in many foreign countries. We appreciate the invitation to participate in today's hearings.

We have observed that a country's tax rates on investment income have a powerful influence on the personal saving habits of its residents. At the request of the Securities Industry Association (SIA), we have conducted a study of the tax rates applied to dividends, interest and capital gains in ten major commercial countries as well as the United States. This study is available from the SIA and is presented separately as an attachment to their own testimony. In addition, we have analyzed the national savings rates of these same eleven countries. Our savings rate analysis appears as Appendix A.

A comparison of the level of taxation of investment income in eleven countries with each country's rate of saving shows that countries which tax investment income the least tend to have higher rates of saving. Although many factors such as inflation, and cultural tradition influence an investor's decision to save, it is reasonable to conclude that a country's tax burden on investment income has an important bearing on the national rate of saving.

Any taxation of investment income, such as dividends, interest and capital gains, discourages saving and encourages present consumption because it lowers the returns available to investors through saving. The larger the rate of taxation, the greater is the disincentive to save. Inflation further exacerbates the disincentive effects of taxation because income taxes are imposed on nominal gains rather than on real economic returns. The high levels of taxation and inflation we have experienced in recent years have discouraged new capital investment, particularly in equity securities and high-risk ventures.

The need for capital in the United States in the 1980's has been well documented, frequently reported and widely discussed. Studies of capital accumulation indicate a very substantial "capital gap" for most of the next ten years. At a time when there are concerns about our capital requirements and our need to encourage investment in equity securities with the risks that are inherent in them, it seems highly appropriate to take steps to decrease taxes on investment income in order to reduce disincentives to savings.

Taxes are an important determinant of an economy's productivity and long-run growth. Tax cuts aimed at increasing savings and fostering capital formation must have a high priority among the tax cuts presently under consideration.

COMPARISON OF SAVINGS RATES IN ELEVEN COUNTRIES

Appendix A lists the savings rates of eleven countries in the five-year period between 1974 and 1978. This list shows that none of the other countries has a rate of savings that is as low as the United States. Italy and Japan at savings rates approaching 20 percent are the thriftiest countries studied, closely followed by Australia and Belgium, in the 11 to 13 percent savings range. Three of the remaining four countries (excluding Sweden) fall in the six to ten percent savings range, tending to average around seven percent. Sweden's rate of savings is nearly as low as the United States, but does not show the ominous downward trend indicated in the five-year pattern of the United States.

COMPARISON OF INDIVIDUAL TAXATION OF INCOME FROM INVESTMENTS IN ELEVEN COUNTRIES

Investment income, including capital gains, dividends and interest income, is generally taxed more heavily in the United States than in the ten foreign countries studied. In particular, none of the countries have capital gains taxes as high as the United States. In fact, five countries do not tax capital gains at all.

The majority of the countries grant the same tax treatment to both long and short-term capital gains. In terms of the minimum holding period to qualify for long-term capital gain treatment, only Sweden requires a longer holding period than the United States. Sweden requires two years, the United States and Australia require one year and Germany requires six months. All the remaining countries studied tax long and short-term capital gains the same.

The Netherlands is the only one of the eleven countries reviewed in the SIA study which has a higher maximum effective tax rate on dividends than the United States. Japan has a maximum marginal tax rate of 70 percent, the same as the United States. However, many Japanese residents are subject to much lower tax rates on dividend income since shareholders owning stock and receiving dividends within certain limits can avail themselves of taxation at sources rules which tax dividends at rates as low as 20 percent. The other eight countries have marginal rates between 20 and 64 percent.

Seven of the countries have adopted some kind of integration system to reduce the burden of double taxation of corporate earnings at both the corporate and shareholder level. Both Germany and Japan provide lower overall taxation of profits paid out as dividends. The SIA study includes a table which summarizes this and several other features of dividend taxation in the eleven countries.

In considering the taxation of four major categories of interest income, the SIA study revealed that Belgium, the

Netherlands and the United Kingdom all have maximum marginal tax rates slightly exceeding the U.S. rate of 70 percent. The remaining seven countries have maximum marginal rates on interest that are substantially lower than the 70 percent rate found in the United States. Nine of the eleven countries, including the United States, have special exclusions, allowances, rates, etc. which reduce the effect of the maximum marginal rate.

The method and rates of taxation of investment income in the eleven countries have generally not changed over the five-year period in which the savings rates were reviewed. However, in France prior to January 1, 1979, gain on the sale of portfolio stock investments was exempt from tax. Now such securities are subject to a flat 15% capital gains tax rate. Also, Germany, in 1977, replaced its classical system of taxing corporate profits twice, once at the corporate level and again at the shareholder level. The effective maximum tax rate on dividends was 56 percent before 1977. Currently, the effective rate after considering the credit for corporate taxes paid is 20 percent.

CONCLUSION

The results of our study as shown in Appendix B indicate a strong relationship between the taxation of investment income and national savings rates. Countries with little or no tax burden on investment income tend to save more than countries with a heavy tax on such income.

The United States clearly saves far less than the other countries we analyzed. Since savings and capital formation are vital to the economic health of our nation, we would support measures that would reduce the tax on investment income and encourage the accumulation of capital.

There are many different ways of changing our present system for taxing income from investments to make it less burdensome. Any approach adopted by the Congress that would reduce the impact of taxation on investment income, would help meet our capital needs.

APPENDIX A

PERSONAL SAVINGS AS A PERCENT OF
GROSS DOMESTIC PRODUCT

Country Name	1974	1975	1976	1977	1978
United States	5.5	5.9	4.5	3.9	3.8
Australia	13.1	11.5	11.9	11.2	*
Belgium	12.2	12.4	12.9	12.0	11.8
Canada	6.7	7.2	6.7	6.6	6.9
France	10.0	11.1	9.1	10.0	10.7
Germany	9.3	10.0	8.7	8.7	*
Italy	15.3	20.3	18.5	20.0	*
Japan	17.0	16.7	16.7	15.5	14.7
Netherlands	11.0	7.1	9.9	6.7	8.7
Sweden	4.7	5.4	4.3	6.2	5.8
United Kingdom	6.5	7.2	6.9	6.6	7.7

*Complete data not available

Source: Yearbook of National Accounts Statistics 1979 Volume I, United Nations, New York, N.Y., 1980.

APPENDIX B

HOW THE UNITED STATES SAVINGS RATE AND TAX POLICY REGARDING INVESTMENT INCOME COMPARES WITH TEN FOREIGN COUNTRIES

	Taxation Policies Compared to Those of the United States				
Country	Long-Term Capital Gain+	Dividends+	Is There an Integration System**	Interest+	Savings Rate 1977
Italy	Lower	Lower	Yes	Lower	20.0
Japan	Lower	Equal	Yes	Lower	15.5
Belgium	Lower	Lower	Yes	Higher	12.0
Australia	Lower	Lower	No	Lower	11.2
France	Lower	Lower	Yes	Lower	10.0
Germany	Lower	Lower	Yes	Lower	8.7
Netherlands	Lower	Higher	No	Higher	6.7
Canada	Lower	Lower	Yes	Lower	6.6
United Kingdom	Higher*	Lower	Yes	Higher	6.6
Sweden	Lower	Lower	No	Lower	6.2
United States	28%	70%	No	70%	3.9

\+ Income tax rates relative to the U.S. tax rates.

* The United Kingdom taxes short-term capital gains at a lower rate than the United States.

** Most tax systems tax corporate income twice, once through corporate tax and again through a tax on shareholders. Integration is designed to reduce the double taxation of dividends, often through reduced taxes on the shareholder.

STATEMENT OF THE

SECURITIES INDUSTRY ASSOCIATION

BEFORE THE

SUBCOMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT POLICY

UNITED STATES SENATE

MAY 4, 1981

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 changes to stimulate savings and investment.

SIA represents over 500 leading investment banking and brokerage firms headquartered throughout the United States which collectively account for approximately 90% of the securities transactions conducted in this country. The activities of SIA members include retail brokerage conducted on behalf of 30 million individual shareholders, institutional brokerage, over-the-counter market making, various exchange floor functons 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 recent deterioration of the nation's economic health has spawned a consensus that new tax policies are imperative to ensure vigorous and stable future growth. U.S. economic activity has been on a downtrend, averaging almost 5% in the 1960s but sliding to about 3.7% in the 1970s. Moreover, the years characterized by negative growth are becoming more frequent. The decade of the '70s was marked with two recessions, cumulating in three years of negative real economic growth.

In 1980, with the beginning of a new decade, the nation's economic ills were underscored by one of the sharpest quarterly drops on record -- 9.9%. Despite the acuteness of this decline, inflationary pressures have proven intractable. Inflation set a 12.4% annual pace in 1980, less than 1% below the unprecedented 1979 rate. These two consecutive years of double-digit inflation marked the first time in history in which inflation in the U.S. was higher than the average of all industrial countries.

Labor productivity declined precipitously in the '70s. The increase in average annual productivity, more than 3% in the 1947-65 period, slowed to slightly over 2% between 1965-73, dropped to under 2% in 1974-77, and has been <u>negative</u> for the past three years. Among the factors determining productivity is the quality of physical capital. The percentage of plant and equipment considered outmoded at year-end 1980 by America's key industries reached as high as 42% for railroads, 34% for rubber manufacturers, and 28% for the automobile industry (see Table 1).

Table 1

Percent of Plant and Equipment
Industries Considered Outmoded

Industry	Outmoded as of Year-End: 1980	1978
Iron & Steel	26%	26%
Electrical Machinery	10	11
Autos, Trucks & Parts	28	17
Rubber	34	25
Petroleum	10	4
Railroads	42	10
Electric Utilities	3	10

Source: McGraw-Hill

Trends in the average annual growth rates of real non-residential investment offer much of the explanation for the antiquation of our industrial base. This rate was over 4% in the 1949-73 period and has fallen sharply to only 2.4% in the 1974-79 period. Any increase in investment must be accompanied by an increase in savings, for it is savings that provides the wherewithal for the updating of plant and equipment and the implementation of new, advanced technologies. The reduced level of savings and inadequate level of capital investment in the U.S. are closely intertwined and have been major factors in the decline of productivity and loss of international competitiveness. Savings as a percentage of disposable income has dwindled from 8.0% in 1970 to 5.7% in 1980. Recently released statistics show that savings in early 1981 continued at a depressed rate.

International Comparisons

The loss of our once-preeminent international competitive position has cost dearly in terms of lost production, lost jobs,

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and costly imports. In international comparisions of key indicators of economic progress, the U.S. does not fare well. The U.S. ranks last by far in terms of productivity growth.

Table 2

	1979 Manufacturing Productivity Gain Percent Increase	Percent Change in Annual GNP Growth Per Employee 1973-1979
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

The U.S. last-place showing in terms of productivity gains, is echoed in terms of savings and investment. Personal savings is an essential link to corporate capital formation; a low level of savings precludes a high level of capital investment and severely limits productivity gains.

Table 3

	Real Investment as % of Real National Output 1/	Savings as % of Disposable Personal Income 2/
Japan	23.8%	20.1%
Canada	17.4	10.5
France	16.2	16.7
United Kingdom	15.4	13.8
West Germany	15.2	14.2
Italy	14.9	23.8
United States	10.6	5.7

Source: OECD and U.S. Department of Commerce.

1/ Data is 1974-78 for Italy, U.S., West Germany, United Kingdom; 1974-77 for Canada, France and Japan.

2/ Data is 1980 for U.S.; 1979 for France, West Germany, United Kingdom and Canada; 1978 for Italy and Japan.

The savings rate of the above six major countries far exceeds the U.S. rate of only 5.7%. (See Table 3.) Both the U.S. and Germany experienced a decline in the savings rate in the '70s, the U.S. rate dropped by a considerable 35% while the West German rate dipped only 2.7%. Moreover, real investment as a percentage of total output in these countries is impressively higher than that of the U.S.

Savings and Investment Incentives

This nation's depressed level of savings and investment is one of the most urgent problems to be addressed by policy makers. There are numerous tax proposals specifically designed to stimulate savings and investment and correct this national economic problem. Selective measures aimed at removing tax disincentives can effectively and efficiently foster savings and investment. One such measure has met with considerable success.

The improvement in the investment atmosphere following the capital gains tax cut in 1978 is a prime example of the beneficial impact of direct targeting. To stimulate our sagging savings and investment rates, we believe that further cuts in capital gains taxes and a reduction in the maximum tax on investment income from 70% to 50% deserve strong support from policy makers.

Results of the 1978 Capital Gains Tax Cut

Of the many tax measures proposed to encourage savings and investment, the recent documented track record of the 1978 capital gains tax cut is encouraging. The Revenue Act of 1978 reduced the maximum effective capital gains tax rate for individuals from about 49% to 28%. That tax cut was both effective and efficient. The effectiveness can be found in the overall improvement in the investment climate since passage of the Act, despite adverse economic conditions that would tend to negate such improvement. As for efficiency, original projections of large revenue losses have been revised downward several times and the current estimates show that additional capital gains tax revenues were generated in 1979.

Revenue Effect

The inhibiting effect of capital gains taxation on the investment process is most pronounced in the 34% decline in total gains reported in the 1969-70 period which followed a substantial increase in the capital gains tax. The amount of capital gains reported inched up at an average annual pace of 5.8% in the 1969-77 period, in part reflecting illusory gains due to inflation. In striking contrast, reported gains soared 40% from $51.5 billion to $72.1 billion from 1978 to 1979 when the capital gains tax cut became effective. (See Table 4.)

Recent evidence of the offsetting effects of increased capital gains realizations on revenue loss is startling. The Treasury Department's original "static" loss estimate from the 1978 capital gains tax reduction was about $2.5 billion. This estimate was not based on actual data but on past trends prior to the capital gains tax cut in 1978. However, the initial analysis of the Treasury of tax returns actually filed for 1979 indicated that capital gains tax receipts were down only $100 million from that projected for 1979 before the capital gains tax cut in 1978 was enacted. More importantly, the most current data available to Treasury indicates that actual revenues generated from capital gains taxes are up $2.0 billion in 1979 over 1978 and are about $1.7 billion more than projected before the 1978 tax cut. Thus, the 1978 capital gains tax cut actually generated tax revenues in 1979.

Table 4

Taxes Paid on Capital Gains Income
(Individuals Only, $ Billions)

Year	Total 1/ Gains	Taxes Paid on Capital Gain Income
1969	$31.4	$4.4
1970	20.8	3.0
1971	28.3	4.3
1972	35.9	5.6
1973	35.8	5.3
1974	30.2	4.3
1975	30.9	4.5
1976	39.0	6.2
1977	45.9	7.3
1978 2/	51.5	8.1
1979 2/	72.1	10.1

Office of the Secretary of the Treasury
Office of Tax Analysis

1/ Net long-term gain in excess of short term loss plus short-term capital gain.

2/ Based on Preliminary Data.

Shareownership

Individual shareownership, reported in the New York Stock Exchange Survey, has risen and fallen in concert with tax policy changes on investment income over recent years. While no one factor accounts for the investment behavior of individuals, the after-tax return on investment is a prime consideration. Between 1970 and 1975, shareownership dropped 18%, coinciding with increased taxes and reduced returns that resulted from 1969 and 1976 tax policy changes. However, between 1975 and 1980, individual shareownership shot up to 29.8 million, almost completely recovering the loss of the prior 5 years. Moreover, the average individual investor is younger, less affluent and holds less stock than in prior years.

The number of new investors is striking compared with prior periods. Between 1965-70, 5.3 million new investors were reported and in the 1970-75 period, only 2.2 million. However, between 1975-80, a significant 6.5 million individuals became shareholders for the first time, an increase of almost 200% over the 1970-75 period. More impressive still is that, just after the more favorable tax treatment of capital gains was approved, the estimated number of new owners during the next 1 1/2 years was 14% greater than in the entire 4-year period from January 1975 to December 1978.

Stock Market Indices

Equity investment over the 1970s lost its long-held position as the traditional hedge against inflation. Investment funds increasingly flowed into real estate, metals, art, and other tangibles. Yet, in the 1979-80 period, two years characterized by persistent double-digit inflation, unprecedented high levels of interest rates, and the deterioration of the financial position of many corporations, the stock market indices recorded significant gains.

Table 5

Percentage Gains in Stock Market Indices

Period	S&P 500 Index	NYSE Common Stock Index	AMEX Market Value Index	NASDAQ Index
12/78 - 12/79	12.3%	15.5%	64.1%	28.1%
12/79 - 12/80	25.8%	25.7%	41.3%	33.9%

While the S&P 500 and NYSE Common Stock indices made notable gains in 1978-80, the increases registered by the AMEX Market Value and NASDAQ indices are most impressive. These latter two indices represent the stocks of smaller capitalized companies, the value of which increased a substantial 132% on the AMEX index and 72% on the NASDAQ Index between 12/78 and 12/80. The individual investor traditionally focuses his attention on the smaller companies, hoping for significant growth in such companies, which would be reflected in higher share prices and capital gains when sold. Moreover, of particular importance given our present economic condition, these small, developing enterprises create a disproportionately large share of new jobs.

Initial Public Offerings and Venture Capital

The increased value placed on the stocks of smaller companies has led to a market atmosphere conducive to the initial public offerings of many lesser known companies. From 1969 through 1975, following increased capital gains taxes, initial public offerings by small companies and the capital raised through those offerings virtually disappeared, declining an incredible 99%. When passage of the 1978 Revenue Act was imminent in the second half of that year, initial public offerings jumped to about 3 times the first half's level and $250 million in new equity capital was raised in 46 offerings. Although there was a dramatic 63% increase in the 1977-78 period, the amount of new capital raised in 1979 and 1980 was even more striking. In 1979, 81 public offerings were made amounting to $506 million. In 1980, 237 initial public offerings came to market, raising $1.4 billion in new equity funds.

New capital raised by venture capital firms also picked up noticeably in late 1978, rose to a relatively high level in 1979, and surged in 1980. This new capital allowed venture capital firms to substantially increase disbursements to $1 billion in 1979 and is estimated at $1 billion in 1980 -- 2 1/2 times the pre-1978 level.

Impact of Various Tax Proposals

Despite the recent criticism of econometric models, they are useful in indicating the direction and the relative impact of various tax proposals on the economy. One of the reasons for the inaccuracy of macroeconomic forecasts in the last few years is that most models are based on the economic experience of this country since World War II. However, economic conditions in the last few years have been very dissimilar to that of earlier decades.

DRI has been engaged in research to incorporate the tax and economic developments since the capital gains tax cut in 1978 in their quarterly economic model of the U.S. This research provides for a more comprehensive analysis of the response of savings, consumption and the holdings of household assets relative to after-tax returns. Dividends and stock prices (proxied by the expected earnings per share) are also related to the after-tax return on savings.

The revised model contains new specifications for the impact of after-tax returns on personal savings, and the impact of changes in the taxation of investment income (capital gains, interest and dividends) on household holdings of assets, consumption, investment, dividend payout ratios and stock prices. No less than seven different categories of consumption are impacted by changes in taxes on investment income. Household holdings of corporate bonds, deposits, commercial paper, mortgages, and assets were also affected by changes in the taxation of investment income as was household debt. Projections of both consumption and household holdings of assets were improved, especially in the most recent periods, using the new model.

An example of how these changes affect the model follows. Lower capital gains taxes increase the after-tax return on equities, leading to a shift away from other financial assets toward equities. This shift raises stock prices and reduces the cost of equity financing, thereby stimulating investment. Households spend more because of their increased wealth resulting from higher stock prices. Nevertheless, they also have a greater incentive to save because of higher after-tax returns on equities. Finally, dividends decline because retained earnings as reflected in higher stock prices have a larger return.

All of these relationships are incorporated in the new DRI model, thereby eliminating the need for assumptions about changes in stock prices and dividend payout ratios with modifications in capital gains taxes. Work is continuing on the new specifications so current estimates should be interpreted as suggestive rather than final.

Impact of Different Tax Proposals

Several thoughtful bills aimed at stimulating savings and investment have been introduced by members of the Senate Finance Committee. SIA has chosen to simulate an increase in the capital gains exclusion from 60% to 75% as incorporated in S. 75 and a reduction in the maximum tax on investment income from 70% to 50%, which is included in S. 936 and has strong support in the Ways and Means Committee. In addition, we have simulated the impact of increasing the interest exclusion to $1,000/$2,000 and then increasing the interest/dividend exclusion to $1,000/$2,000 as embodied in S. 492.

Increasing the capital gains exclusion has a very positive impact on the economy while very little tax revenues are lost. Over the 1981-83 period, real GNP, investment, savings and consumption increase by $4.8 billion, $.8 billion, $1.3 billion and $4.2 billion, respectively. At the same time, real Federal tax revenues decline by only $.5 billion as increased realizations, resulting from lower capital gains taxes, almost offset completely the impact of lower rates on capital gains.

Lowering the maximum tax on investment income to 50% also has very beneficial results for the economy. Real GNP, investment, savings and consumption increase by $7.6 billion, $1.4 billion, $1.8 billion and $6.5 billion, respectively. Over the

1981-83 period, real Federal receipts fall by $1.8 billion. In estimating the impact on revenues, we relied on the initial static revenue loss provided by the Treasury of $4.6 billion, which fails to take into account the change in investment patterns from tax shelters and tax-exempt activities to taxable instruments now subject to a lower effective rate. In addition, efforts expended in escaping Federal taxes completely through the subterranean economy will be curtailed. Thus, although the econometric simulations of the benefits of lowering the maximum tax are helpful in providing guidance for policymakers, we have less confidence in estimating the impact of lowering the maximum tax on investment income on Federal tax revenues.

Finally, we simulated an increased exclusion for interest receipts alone and for interest and dividend receipts together using 1977 statistics of income data adjusted through 1980. These proposals are not as efficient as the increased capital gains exclusion or lowering of the maximum tax in stimulating savings and investment. Individuals with savings or dividends receive a tax benefit without increasing their savings or stock ownership with an increased exclusion. With less taxes imposed on interest and/or dividends, the Federal government receives lower revenues.

A change in the interest exclusion alone to $1,000/$2,000 increases real GNP by $39.3 billion. At the same time, real investment, real savings and real consumption increase by $7.6 billion, $7.9 billion and $34.6 billion, respectively. However, there is a significant revenue cost to this proposal. Using 1972 as the base year, real Federal tax revenues fall by $25.7 billion

Table 6

Absolute Changes in Selected Variables
Under Various Tax Proposals
($ Billions)

Variable	Lowering the Maximum Tax on Investment Income from 70% to 50% 1981-83	Increasing the Capital Gains Exclusion from 60% to 75% 1981-83	Increasing the Exclusion for Interest Income to $1,000/$2,000 1981-83	Increasing the Exclusion for Interest/Dividend Income to $1,000/$2,000 1981-83
Real GNP	$7.6	$4.8	$39.3	$51.0
Real Investment	1.4	0.8	7.6	9.0
Real Savings	1.8	1.3	7.9	9.6
Real Consumption	6.5	4.2	34.6	45.4
Real Federal Tax Receipts & Revenues	(1.8)	(0.5)	(25.7)	(33.0)

from 1981 to 1983. In current dollars, the decline would be $54.5 billion.

Increasing the interest/dividend exclusion to $1,000/$2,000 generates greater increases in real GNP, real investment, real savings, and real consumption than if the exclusion were confined to interest income only. However, the loss in tax revenue is also somewhat higher.

A key concept should be considered in the tax treatment of interest and dividend income. If there were an increase in the exclusion, the increase should apply to both interest and dividends. With the increased exclusion effective in 1981 and 1982 of $200/$400, the distinction between the double taxation of dividends and other sources of income may have been forgotten.

Because dividends are taxed twice, once at the corporate level in the form of corporate profits, and again at the individual level when distributed to shareholders, the exclusion prior to 1981 had been considered as offering some relief to double taxation.

Dividends should be treated no worse than interest revenues. The preferential tax treatment now given interest deductions vs. dividend payments by corporations has played an important part in the use of debt rather than equity by corporations. This has caused a deterioration in corporate balance sheets and an unhealthy financial trend. At the very least, we should do nothing more to promote this type of trend.

Efficacy Ratios

Because of the very different magnitudes of the tax proposals being discussed, the efficacy ratio is a good measure of a proposal's relative efficiency and effectiveness. Table 7 displays the efficacy ratios of the various proposals. The figures should be interpreted as follows: how much additional activity is created per dollar of tax revenue lost. For example, lowering the maximum tax on investment income to 50% generates \$4.51 of real GNP in 1982 per dollar of tax revenue lost, while \$4.85 would be generated in 1984.

In relation to the per dollar of tax revenue lost, both the lowered maximum tax on investment income and the increase in the capital gains exclusion are highly efficient. The efficiency of the increase in the interest and dividend exclusion is considerably below that of the first two proposals because of the substantial tax revenue loss. In other words, the relatively large impact of the increased dividend/interest exclusion is reduced in

Table 7

Efficacy Ratios of Various Tax Proposals

Proposal	Change in Real GNP Per Dollar of Tax Revenue Lost		Change in Real Investment Per Dollar of Tax Revenue Lost		Change in Real Savings Per Dollar of Tax Revenue Lost		Change in Real Consumption Per Dollar of Tax Revenue Lost	
	1982	1984	1982	1984	1982	1984	1982	1984
Lowering the Maximum Tax on Investment Income from 70% to 50%	4.51	4.85	0.59	1.71	1.20	1.15	3.77	3.79
Increasing the Capital Gains Exclusion from 60% to 75%	14.13	4.60	1.25	1.91	3.88	1.74	11.81	3.20
Increasing the Exclusion for Interest Income to $1,000	1.91	1.75	0.36	0.36	0.50	0.09	1.59	1.63
Increasing the Exclusion for Interest and Dividend Income to $1,000	1.96	1.73	0.33	0.33	0.48	0.07	1.66	1.64

terms of efficiency by the relatively large tax revenue loss. For example, in 1982, the efficacy ratios with respect to savings are 1.20, 3.88, and 0.48, for the lower maximum tax, the increased capital gains exclusion, and the increased interest/dividend exclusion, respectively. In terms of investment, again the first two proposals prove more effective producing efficacy ratios in 1982 of 0.59 and 1.25, in contrast to a ratio of 0.33 for the increased interest/dividend proposal. In terms of stimulating savings and investment, the results indicate that "directly targeted" proposals, particularly the lowering of the maximum tax on investment income and the increased capital gains exclusion, are much more efficient than across-the-board personal cuts alone as indicated in earlier testimony by SIA.

International Tax Treatment of Capital Gains and Dividend and Interest Income

While the 1978 Revenue Act was a welcomed step in reducing capital gains taxation, compared with rates in 10 major foreign countries, the resultant 28% maximum tax on long-term gain in the U.S. is the second highest. A recent study prepared by Arthur Andersen (see attached) for SIA shows that only the United Kingdom has a higher maximum tax on capital gains. Moreover, six of the ten foreign countries exempted capital gains from taxation entirely. Only Canada includes a greater percentage of long-term gain in taxable income than does the U.S. In Canada, however, there is no holding period required for long-term capital gains treatment and the maximum tax rate on income is 43% as compared with 70% in the U.S.

The Arthur Andersen study also reviewed the taxation of dividend and interest income. Compared with ten major foreign countries, tax rates in the U.S. again ranked among the highest. Regarding the taxation of dividend income, only the Netherlands has a higher maximum effective rate than the U.S. While Japan has a maximum marginal rate of 70%, the same as the U.S., many Japanese residents can avail themselves of the 20% taxation at the source rules. In addition, seven of the ten countries studied have adopted some type of integration system to reduce the burden of double taxation of corporate earnings at both the corporate and shareholder level. Moreover, both Belgium and France have measures specifically designed to encourage portfolio investment in stocks. In considering the taxation of four chief sources of interest income, three of the ten foreign countries have maximum tax rates slightly exceeding 70%. However, two of the three have interest income exclusions which also exceed the $200 individual exclusion in the U.S. The seven other foreign countries have tax rates substantially lower than the U.S. Eight of the ten foreign countries have special exclusions, allowances, and rates, in many cases significantly more generous than the current dividend/interest exclusion in the U.S.

Conclusion

The U.S. economy, as well as the world economies, has undergone very dynamic changes since World War II, thus rendering demand-oriented policies ineffectual in curing supply-side problems. Traditional policies of stimulating demand are but short-term remedies for long-term ills. Without increased savings and

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investment by both corporations and individuals, the U.S. faces the prospects of stagnating growth.

Tax policy which encourages savings and investment directly provides a stronger stimulus than reductions of individual rates alone. The 1978 capital gains tax cut established an impressive record for effectiveness and at a very modest revenue cost. We believe a further cut in the capital gains tax and a reduction in the maximum tax on investment income would continue to produce beneficial effects on savings and investment and the nation's economy.

Senator CHAFEE. Now the next panel—Dr. Charls Walker, familiar to this chamber, Mr. Michael Bell, Mr. James Glanville, and Mr. Peter Sprague. Gentlemen, we are glad you are here. Dr. Walker, why don't you lead off?

Dr. WALKER. Thank you, sir.

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

Dr. WALKER. Thank you, Mr. Chairman. I shall do that. My name is Charls E. Walker and I am chairman of the American Council for Capital Formation. We appreciate the opportunity to testify and we strongly support President Reagan's program for economic recovery, including its spending and tax component.

However, if Congress decides to include targeted savings proposals in the initial tax package or in a followup second bill, we urge that three guiding principles be considered.

First, such proposals should stimulate additional savings, not simply shift funds. Second, such proposals should meet the standard of simplicity. And third, such proposals should be evaluated in terms of their revenue impact because some savings proposals are more cost effective than others.

There is a growing awareness that the 1978 reduction in capital gains taxes, which cut the maximum tax for individuals from about 49 to 28 percent and the corporate rate from 30 to 28 percent, has been an overwhelming "success story" in terms of its economic impact and in generating added Federal revenues.

First, the 1978 cut has exerted a powerful leverage effect on the equity investment process, stimulating higher equity values, more venture capital, more equity capital for rapidly growing companies, greater common stock ownership, and increasing common stock offering.

Second, according to newly released Treasury data, taxes paid on capital gains income of individuals in 1979 actually rose from $8.3 billion to $10.1 billion, an increase of $1.8 billion—the largest absolute gain in the history of the tax.

The American Council strongly supports further reductions in capital gains taxation through cuts in individual marginal rates, increases in the capital gains exclusion, and the immediate reduction of the maximum tax on investment income from 70 to 50 percent.

All three approaches meet the suggested guidelines for targeted savings proposals.

In conjunction with individual capital gains cuts, two conforming changes should, we believe, be made. First, when the top capital gains rate is lowered, the top rate of the alternative minimum tax should be lowered to insure that taxpayers subject to this tax would not have a higher marginal tax rate applicable to capital gains than other taxpayers.

Second, the corporate capital gains tax rate should be lowered from the current 28 percent to a rate equivalent to the maximum individual capital gains rate in order to maintain the historic parity between the two rates.

We also urge serious consideration of other targeted savings proposals which have the potential to promote the new saving and investment so necessary for a strong economy in the 1980's.

In this respect, we have singled out two proposals for favorable discussion. This does not mean that other savings proposals aren't good. I think almost any savings incentive is good legislation, but some are better than others.

The two we discussed are the so-called two-stack approach which Secretary Chapoton referred to and Dr. Martin Feldstein's approach, which has been proposed in legislation by Senator Schmitt, who testified earlier.

That approach would ultimately treat dividend and interest income in the same manner as capital gains. It would be very simple and easy to understand. It would be neutral as compared with competing financial institutions and move in the direction of ultimately exempting savings and investment from taxation in the United States, which we believe to be the ultimate goal.

Thank you.

Senator CHAFEE. Well, first I want to commend you for that fine statement.

Going back to a point in your summary; further reductions in capital gains taxation through cuts in individual marginal rates. The President has proposed that. You don't set a specific figure?

Dr. WALKER. We support the Wallop-Moynihan bill with an exclusion of 75 percent.

Senator CHAFEE. Please review the immediate reduction in the maximum rate on investment. If you cut the maximum rate on investment income from 70 to 50 then the tax would be 50 times the 25 percent. Is that right? Fifty percent of the 25 percent available for taxation.

Dr. WALKER. Yes, the maximum rate on individual capital gain should be 12.5 percent.

Senator CHAFEE. 12.5 percent.

Dr. WALKER. In the top bracket. In the lowest bracket, if you had the 10-10-10 cut, that would reduce the lowest bracket individual rate to 10 percent so that capital gains taxed in the lowest bracket would be 2.5 percent. When you raise the exclusion, you affect taxpayers in all brackets.

Senator CHAFEE. I thought the points Mr. Chapoton raised against the two-stack approach were rather telling.

Dr. WALKER. Very important points to be considered. It has been reported and I think it is well known, that in President Reagan's task force on tax policy during the transition which I was privileged to chair, we discussed that proposal at considerable length.

These points were raised by task force members. The economists thought that the two-stack was a very, very powerful savings incentive. On the other hand, various tax lawyers pointed out the sorts of difficulties that Mr. Chapoton referred to.

Partly for those reasons, I personally am leaning more toward the Feldstein approach as a savings incentive. It does have some problems, too, as Mr. Chapoton's statement pointed out. I am not sure he pointed it out in his oral testimony with respect to getting the exclusion on your interest income and in turn, borrowing money simply to get more interest income and deducting that particular interest payment.

There would have to be some sort of provision in the law to control or prevent that sort of arbitrage. If you can do that, the Feldstein approach, to me, phased in over a period of time, knowing that it is coming, would be a very, very powerful device and ultimately move toward not taxing savings and investment income. This is the proper goal.

Senator CHAFEE. Do you think that because had we got in 1978 a large unlocking of capital gains or capital investment subject to capital gains tax, that what occurred then would then occur now that we are in the lower brackets?

Dr. WALKER. To a considerable degree, because you still would be taxing capital gains if you adopted the Wallop proposal. You would be taxing gains at a maximum rate of 12.5 percent, which cuts the current 28 percent rate by more than one-half.

You have to recall that there is a new dimension in the investment markets. Since 1978, there has been a very significant rise in equity value. You see it in the Dow Jones average and in the New York Exchange, but you see it more in smaller companies and growth stocks on the American Exchange and in the over-the-counter market.

There has been plenty of ammunition added by the increase in equity values since 1978 to provide for another significant round of unlocking.

As I said in my statement, I do not think that the purported revenue impact of these capital gains tax changes should be a material consideration to the committee. I think we have a very good chance that there would be no negative revenue impact whatsoever and maybe even a gain. I would look at the proposal strictly on its merits and not to the revenue impact as the major factor on that particular point.

Senator CHAFEE. If we followed those recommendations you have, then it wouldn't be necessary to follow the suggestion of Senator Cranston regarding tax-free rollover.

Dr. WALKER. Tax-free rollover which Senator Cranston compared to purchasing a home, selling a home, purchasing another home and rolling over the tax on the capital gains is a different animal which has much going for it.

One of the biggest advantages that you get from rollover is the mobility that you provide for capital. For example, if I own stock in

Xerox and I have a substantial capital gain and sell it and buy stock in IBM or whatever, what is the argument for taxing that mere transfer from one sort of capital to another?

You especially see the damage that does to the economy if you are deterred from moving out of older, established companies into younger, growth, maybe high-technology companies. You now have to pay a penalty for making that shift.

The rollover proposal has a great deal of merit in terms of providing mobility and not deterring but actually encouraging those sorts of things.

Senator CHAFEE. But, if you get your rate down to 12.5 percent maximum it is not too much of a penalty for the shift.

Dr. WALKER. Well, it is, at the margin, a factor which will have some effect. I think the beauty of this is, Senator, that you——

Senator CHAFEE. Isn't there an IRS problem in basing these?

Dr. WALKER. It is a typical audit problem. When you have a major sale of a home, the IRS is going to look at it and be sure that you have all the data there to show.

I am not fully familiar with Senator Cranston's proposal, but in fact, we have supported and continue to support a rollover provision that has been introduced in the House by Mr. Holland and Mr. Martin and I believe Senator Heinz and others over here.

The problem that you referred to, I believe, is taken care of in the Holland-Martin-Heinz proposal, and I think so also through the Cranston proposal by requiring the individual to set up a specific account in a bank or other financial institution, called a "rollover account," and it is no more difficult to follow than a Keough account in that respect.

Senator WALLOP. Senator Chafee, I think that rollover is fairly equal tax incentive. Ultimately, most people would make the decision to pay taxes I am convinced.

One of the things that is interesting about the data of the 1978 tax cuts is that it proposed that taxpayers at the $100,000-plus income accounted for over 40.9 percent of that share of the payments compared with their share of 28.6 percent the year before. In other words, high-income groups actually paid more in taxes.

Dr. WALKER. I think that is true, Senator. I see no reason why the experience this time around should be different. People in upper income groups are more active in investing in common stocks.

They will have a considerable amount of the gain that has occurred in the stock market advance from 1978 to 1981. Incidentally, that was predicted by studies that were made by Chase Econometric. We were arguing with Treasury and others at that time about the impact of the capital gains cut.

Furthermore, with respect to the cut of the maximum rate from 70 to 50 percent, I saw some figures not too long ago in the Wall Street Journal which trace through what happened to taxes paid by high income people—"fat cats," if you will—in 1964, 1965, 1966, following the reduction, in a very beautiful supply side tax cut, from 91 to 70 percent in the top bracket and 20 to 14 percent in the bottom bracket.

As I recall, Federal taxes paid by those with large incomes who benefited from the 91 to 70 percent cut actually went up even though the rate dropped drastically.

Senator WALLOP. So, the net gain was that when you would anticipate a similar kind of consequence that we are able to enact.

Dr. WALKER. I think both the 70–50 cut and the increase in the exclusion have a very good chance of at least paying for themselves in a short period of time.

Senator WALLOP. Reducing the unearned income from 70 to 50 percent would have the effect of reducing maximum rate on individuals, but it wouldn't have any effect on corporate tax rates.

At present there is parity between corporate and individual tax rates. I am wondering if you think the Congress sould take some action to see that that parity continues to exist.

Dr. WALKER. Yes, sir, I do. There are two basic reasons for that. First, if you don't have the parity, it affects your decision as to the way you do your business, that is, whether you operate as an individual, a sole proprietorship, or in corporate form.

When you have different tax rates affecting activities on one versus the other, it leads to decisions as to which way you go and that is not necessarily beneficial to the economy.

Second, the case for lower capital gains rates on corporations is very strong, particularly when you note how much of the venture capital has been supplied since the 1978 act reduced the corporate rate from 30 to 28 percent.

Much of that has taken place through corporations going into new ventures. I think it is very important that you maintain the parity between corporate and individual capital gains rates. That parity was maintained for many years until the 1969 legislation which raised the corporate capital gains rate from 25 to 30 percent.

The 25-percent maximum rate had been traditional for years, for both individuals and corporations. I think we should keep them the same.

Senator WALLOP. The last question. When we are reducing the maximum rate—from 70 to 50 percent over the figured 3-year reduction, we are running into a possible lock-in effect through——

Dr. WALKER. There will be some risk of that, so I think the case is very clear. Doing it all at one time, in 1 year will avoid that sort of problem.

Senator WALLOP. Thank you.

Senator CHAFEE. Mr. Bell.

STATEMENT OF MICHAEL BELL, PRESIDENT, HIXON VENTURE CO.

Mr. BELL. Thank you, Mr. Chairman, Senator Wallop. I appreciate the opportunity to appear this morning.

My name is Michael Bell. I am president of Hixon Venture Co. of San Antonio and a general partner of Southwest Venture Partners also in San Antonio. This a jointly managed venture capital entity. Hixon Venture is a corporation. Southwest Venture Partners is a limited partnership.

I am also the volunteer and the recently elected executive vice president of the National Venture Capital Association. This is a 107-member association which seeks to foster broader understanding of the importance of capital formation in the vitality of the U.S. economy and to try to promote the freer flow of capital between those who have capital to invest and those companies who need it.

The members of the this association comprise institutions, wealthy families, and individuals across the country.

I am here today on behalf of the NVCA, but also on behalf of those companies in whom the members of the NVCA do make investments.

We think a reduction in capital gains and an elimination of the discrimination between earned and unearned income would be beneficial to the investment process, primarily because it will increase the net ultimate return to the investor.

It will make companies who cannot currently make a case for the high risk in liquid kinds of investments that the capital providers in the venture community must see. It will make those companies who have somewhat more difficulty in making those projections attractive, that much attractive. It will unlock the capital, Senator Wallop, that you were asking about, because it makes that return to be sought occur sooner and allow the investor to make a decision to realize upon his investment that much quicker and therefore, redeploy those funds back into an investment process again, promoting other companies.

The capital gains reduction in 1978 provided a beautiful laboratory to study the effect of reduction and what could occur. I think the fact that revenues have actually been gained during the Treasury during this period, and we have seen a very broad and deep impact on the stock market and on the amount of capital committed to the venture capital community.

It indicates, at a time, when much of the other economic news was negative, inflation, attitude by Government toward the investment process, all kinds of political and other activities throughout the world that certainly didn't encourage people to take long-term risks, you still saw a net result of some $900 million in new venture capital funds coming into the industry in 1980.

We have seen a large number of new companies started up in the last 2 years. My firm, alone, which has only 3 partners in it, looks at over 500 proposals a year. This is indicative and typical of the whole industry. In fact, I am sure there are some of the larger firms that do a great deal more than that.

We are encouraged to make these investments by the opportunity to realize a greater return when we take the risk of the long-term lockup, the inflation rate we have to take into account and the alternative investments that are currently available in the stock market which is active and in long-term debt instruments which are at high rates, as we all know.

When you consider all those things, it is imperative that we see a reduction in capital gains and an elimination of the unearned impact so that those will equalize and encourage the deployment of capital into this sector of our economy.

Thank you, sir.

Senator WALLOP. Thank you, Mr. Bell. The fact that both the elimination between earned and unearned income and the increased capital gains tax exclusion would increase investment?

Mr. BELL. Absolutely.

Senator WALLOP. And it would increase the level of productivity and economic vitality.

Mr. BELL. Well, I think it is commonly accepted at this time, certainly by the members of our investment community and I think by most of the Members of Congress that investment in smaller companies that are innovative, that are introducing new products, new services and growing at rapid rates, and I must tell you that the companies we look at have to be projecting, with reasonable basis for expectation that it will be achieved, growth rates in the range of 40 to 50 percent annually before we are willing to risk our capital in those as investments because we are investing frequently at absolute startup when there is a new product proposed or a new service expected.

Those companies, by and large, do realize those kinds of growth rates. Our average investment portfolio growth from 1975 to 1980 and our fund, was about 37 percent.

When that is occurring, there are many jobs being created, there is lots of new taxes being paid, there is lots new equipment and facilities being purchased or constructed. There are all kinds of ripples out through the economy that are obviously very beneficial.

I think the effect, when focused on this section of the economy, is magnified many times.

Senator WALLOP. Do you see these kinds of programs reidentifying the industrial base in America? As we are working now, there are a number of old and traditional industries.

How many of those industries are in trouble?

As the investment climate eases, can we reestablish a new industrial underpinning and is that beneficial?

Mr. BELL. I think it has been clear that in the last 20 years, our economy has swung more and more to a service-based economy as opposed to a productive-based economy of heavy capital equipment and so forth.

I think there is some danger to that, absolutely. I think that our own defense depends on our ability to service our own needs in the event of a world crisis. Certainly, a long-term world crisis. That obviously requires attention.

On the other hand, many of the innovative companies in our particular area of investment interest, are high technology companies which provide a lot of new equipment, a lot of new capabilities for equipment where you can get more out of a plane or a tank or a computer or whatever and do more things with it.

If it hadn't been for the computer industry and the high technology silicone industry, the chips and so forth, we wouldn't have seen the space achievement we have just recently observed and the miniaturization that has occurred through the very, very large amounts of research and development dollars that have been spent by these kinds of companies over the last 20 years, or 30 years.

I think both sectors of our economy are deserving and require attention. I think reduction of capital gains reaches one of those goals that Dr. Walker mentioned. That is simplicity. It helps everybody.

Senator WALLOP. This increased investment, in your opinion, translates into dollars?

Mr. BELL. Absolutely. No question about that.

Senator WALLOP. What about the criticism that it records so-called unearned income——

Mr. BELL. Well, a job cannot be held unless a man has a workplace and tools and all of the other accoutrements to surround him that give him the ability to do a job. It takes investment to do that.

When inflation is running as it is, the ordinary man doesn't have a disposable income to invest. That is one of the reasons the President's other proposals for tax cuts can be helpful in that regard.

Senator WALLOP. Thank you, Mr. Bell. Mr. Glanville.

STATEMENT OF JAMES GLANVILLE, CHAIRMAN, REALTORS LEGISLATIVE SUBCOMMITTEE ON FEDERAL TAXATION

Mr. GLANVILLE. Thank you, Mr. Senator.

I am James Glanville. I am a realtor from Houston, Tex., and I am chairman of the Realtors Legislative Subcommittee on Federal Taxation.

On behalf of the more than 700,000 members of the national association, we greatly appreciate the opportunity to present to you today, our views on tax policies to encourage savings, to be available for investment in both industry and housing.

President Reagan's proposal to slow spending and taxing growth provides the essential basis for response to the serious problem of inadequate savings and investment in the United States.

With reference, though, to the particular concerns of this subcommittee, we believe that the administration's program needs improvement to increase and make more reliable the savings by individuals to provide funds needed for investment in both industry and housing.

First, we specifically recommend expanding interest and dividend excludability from $200 for individuals and $400 for joint returns, to at least $500 for individuals and $1,000 for joint returns, effective July 1, 1981.

This would generate additional savings which would be available for increased investment. In future years, 1982 to 1985, we recommend increasing the amount from $500 to $1,000 to a minimum of $1,000 to $2,000.

This recommendation closely resembles S. 142, introduced by Senator Bentsen and we appreciate his foresight in having introduced this legislation.

This type of tax cut, in addition to being uniformly available to all taxpayers, whether using the short form 1040 or the long form, would particularly benefit lower income taxpayers because the incentive would represent a larger percentage increase in their aftertax income when compared with middle and upper income groups.

The elderly would also benefit more because that group receives approximately 25 percent of their income from dividends and interest.

Second, we recommend a reduction in the rate of tax on capital gains to an absolute maximum of 20 percent or less in order to encourage additional investment in productive assets.

Reducing capital gains tax rates could particularly stimulate new rental housing construction since the prospects of long-term capital gains provide one of the few remaining incentives for investing in such structures.

We, therefore, strongly support both Senate bill 75 introduced by yourself and Senator Moynihan, and Senate bill 145.

It should be recognized, though, that S. 75 goes further than S. 145 in providing additional investment incentives for most taxpayers.

Third, to the extent that any investment income is subject to Federal taxation, we support, in principle, the two-stack approach advocated in S. 936, introduced by Senators Roth, Bentsen, and Kasten.

Lowering the marginal tax rates on investment income would significantly increase investment incentives. Lower interest rates would increase productivity, and stimulate the production of plant, equipment, and rental housing.

However, the arbitrary limitation of S. 936 which denies eligibility for two-stack treatment of investment income for those with more than $10,000 in preference income would rob the bill of much of its beneficial impact.

To insure that the considerable potential economic benefits of the savings incentives are, in fact, realized, all taxpayers should be eligible for two-stack treatment of investment income regardless of the size of preference income.

To preserve tax equity, particularly for the elderly who rely on interest income for about a quarter of their taxable income, we recommend that the two-stack approach should also include comparable provisions for the treatment of exclusions on each of the two stacks as under present law.

Savings and investment would be further stimulated tremendously if the maximum tax rate on nonpersonal service income for individuals were reduced from 70 to 50 percent.

These proposals would overcome what we see as a fundamental weakness in the administration's broad economic program, by providing a reliable basis for the urgent needed increase in savings and investment.

By targeting the incentives specifically and stimulating savings and investment, the effectiveness of these measures in helping to increase productivity, to lower interest rates and inflation, and to boost economic growth per effective dollar of tax relief, would be significantly greater than a general across-the-board reduction in marginal tax rates as advocated by the administration.

Thank you for the opportunity to present these to you today, sir.

Senator WALLOP. Thank you, Mr. Glanville.

You know the Congress recently increased the exclusion from $200 for an individual to $400. I wonder if you think that that increase proposal has been effective and if there are any studies or statistics that would substantiate your case?

Mr. GLANVILLE. In response to your specific question, I think that they have been beneficial, although I think that probably the biggest effect has been psychological. But, as commented earlier by some of the other gentlemen here at the table and in the room, they are a step in right direction but the numbers need to be substantially larger to really be meaningful and to get the impact going in the right way.

Senator WALLOP. One of the reasons, as I recall, when we were doing that is that everybody liked the concept of being able to expand savings incentives.

It has a significant revenue effect——

Mr. GLANVILLE. Again, I think there are two aspects of that. First of all, if some day a general goal may truly be to have very, very little or no tax on savings and investment income, it gets us started in that direction.

Second, I think that we would probably dispute that the effect on overall revenue has much impact because revenues are replaced or even grow as a result of the incentives.

But, we do believe that it is extremely critical coupled with all of this, to follow through on the cutting of the growth and spending of the Federal Government simultaneously.

Senator WALLOP. I agree with that but obviously that is one step lower——

Mr. GLANVILLE. Well, as more money is encouraged to go into savings instead of consumer spending, as more money is available accordingly in savings accounts, there is more to borrow and the cost of that money should go down.

Senator WALLOP. Do you think this would induce capital out of the cash bucket? There is the very large sort of unrecorded, underground economy.

Do speculate as to the exact type of results we will have from tax cuts?

Mr. GLANVILLE. I think that as we move more and more in a direction of reducing taxes, the perceived need to be a part of the underground economy will be reduced.

I think these things can strongly encourage people who now spend a great deal of their time figuring out ways to conserve or keep what they have made in basically a nonproductive investment to go ahead and put that capital into investments that generate jobs, generate tax dollars, because they can afford to pay the tax rates. I think those would be far more productive in that general direction.

Senator WALLOP. Thank you.

Senator CHAFEE. Mr. Sprague.

STATEMENT OF PETER SPRAGUE, CHAIRMAN, NATIONAL SEMICONDUCTOR CORP.

Mr. SPRAGUE. Mr. Chairman. My name is Peter Sprague. I am chairman of the National Semiconductor Corp. and I am pleased to have the opportunity to testify today on behalf of the Alliance for American Innovation, a business association headquartered in San Francisco.

National Semiconductor, which was formed in 1959, today has 34,000 employees. We have raised more capital from the sale of our shares to our employess than we have from any other source with the exception of retained earnings.

I commend you, Mr. Chairman, for your initiative in holding this subcommittee hearing to examine, in detail, proposals for tax law changes that are targeted to encourage capital formation and new investments.

Reducing capital taxes generally, is a highly desirable objective. The effect of the 1978 change has substantially increased the supply of investment capital.

I would like, specifically today, to discuss the merits of S. 889, the American Innovation and Employee Stock Ownership Act as proposed by Senators Wallop, Long, Roth, and Bentsen.

Under this proposal, capital gains tax rates for individuals and corporations would be reduced by half for investments in certain small businesses that are in part owned by their employees and that fulfill a basic research and development requirement.

Under current law, 40 percent of long-term gain is taxable as ordinary income. The bill would create significantly more favorable treatment for qualifying investments.

Under it the deductions for individuals would be increased to 80 percent leaving 20 percent to be taxed as ordinary income.

For corporations the alternative tax would be reduced from 28 to 14 percent. To qualify for this special capital gains tax treatment, the investment would have to be in a small company which has diversified share ownership among its employees and that meets the test for R. & D. spending.

To be considered small, the company must have two of the following characteristics: total gross revenues of not more than $30 million, net worth of not more than $15 million, and not more than 1,000 employees.

To qualify under the employee ownership criterion, 25 percent or more of the nonmanagement employees of the business must own an amount of shares equal to at least 15 percent of the total outstanding shares of the company.

We define nonmanagement personnel as all of the employees other than the officers and members of the board of directors of the company. This provision insures that lower level managerial and support staff, as well as hourly employees, can benefit.

Under the bill, employee ownership can be achieved in a number of ways. An employee stock ownership trust is an obvious method but stock could also be distributed by giving shares as bonuses, selling stock to employees at concessional prices, or through employee stock options.

In addition, the corporation must have expended an average of 2.5 percent of its gross revenue on research and development for the 3 prior taxable years or for the taxable year during which it has been operating if the corporation is less than 3 years old.

Entrepreneurs, particularly innovators who do not yet have a record of business success, have traditionally found obtaining investment capital the most difficult hurdle to leap in forming a new company.

This situation has recently somewhat, in the case particularly, of entrepreneurs who have a record of prior success and who are involved in high technology areas. But I believe the current greater availability of risk capital for certain types of ventures will prove to be a transient phenomena.

There continues to be a need to reduce capital gains taxes in such a way as to stimulate new ventures. Thus, S. 889 helps address the critical problem of providing capital for new ventures by providing incentives for investors in smaller firms.

Because of the sequence of revenue flow of a new company, we believe the bill will result in a net positive flow of funds to the Treasury.

When an investor or a group of investors first invests in a company, they generally do so with the expectation that they will be unable to sell a portion of their shares in the company for several years. During this period, of course, the company has hired personnel, invested in plant and equipment and R. & D., and undertaken other activities that generate tax revenues.

This economic activity must, of course, take place before the original investors can sell their shares at a profit, realized capital gain, and take advantage of the special tax treatment provided in the bill.

In the interim, a chain of economic activity has occurred which will generate additional tax revenues. Thus, this bill should result in a net revenue gain to the Treasury. Although on that point, I understand that the Joint Tax Committee staff estimates a revenue loss of $125 to $175 million.

We believe S. 889 should help fill a void. It creates a strong, new incentive for management to share ownership among employees at a time when employee motivation is most critical to the company's success. By enabling employees to acquire stock at the outset of the company's existence, employees will be better able to realize the most appreciation in the value of the stock after the company has become successful.

The bill approaches the goal of employee stockownership in a new way. Previous efforts to encourage employee stockownership have focused primarily on ESOP's. Our proposal, however, provides an incentive for investors and management to share stockownership in a number of ways.

By creating favorable capital gains tax treatment for the sale of stock in companies in which ownership has been shared with the employees, investors have a strong incentive to dilute their ownership by setting aside a block of shares for nonmanagement employees. Thus, the investors, in effect, finance the employee ownership of shares, the Government does not.

Thank you, very much.

Senator CHAFEE. Thank you very much, Mr. Sprague. I must say I have heard a lot about Silicone Valley and all the excitement out there. It is nice to see a real live success from that area.

Mr. SPRAGUE. Thank you, sir.

Senator CHAFEE. I think there is a lot of merit in what you say here, the problem, of course, is the complexity of it. Wouldn't we achieve the same purpose if we just followed these suggestions before you, of just getting on with reducing very drastically the whole capital gains rate? Wouldn't that do as much for you?

Mr. SPRAGUE. I certainly enjoyed the word very drastic and if very drastic brought it to the 80-percent level——

Senator CHAFEE. Well, Mr. Brock was in here at 12.5 percent, which seems very modest to meet.

Mr. SPRAGUE. I should think that would be barely sufficiently drastic.

Senator CHAFEE. What do you think, Mr. Walker, of this proposal?

Dr. WALKER. I haven't studied it. I listened to it and with the complications I had a little trouble following it. I haven't studied it.

Senator CHAFEE. One of the things we are trying for, Mr. Sprague, is to make our laws more simple. I would say we are frequently unsuccessful.

It is an interesting idea and I know that Senator Long has a great interest in this field. We will certainly give it every thought and appreciate your coming.

Mr. SPRAGUE. Thank you very much.

[The prepared statements of the preceding panel follow:]

SUMMARY

Statement of Dr. Charls E. Walker
Chairman, American Council for Capital Formation
Before the Subcommittee on Savings, Pensions, and Investment Policy
of the Senate Committee on Finance

Monday, May 4, 1981

1. The American Council for Capital Formation strongly supports President Reagan's Program for Economic Recovery, including its spending and tax components. However, if Congress decides to include targeted saving proposals in the initial tax package or in a follow-up second bill, we urge that three guiding principles be considered. First, such proposals should stimulate additional savings, not simply shift funds. Second, such proposals should meet the standard of simplicity. Third, such proposals should be evaluated in terms of their revenue impact because some saving proposals are more cost effective than others.

2. There is a growing awareness that the 1978 reduction in capital gains taxes, which cut the maximum tax for individuals from about 49 percent to 28 percent and the corporate capital gains rate from 30 percent to 28 percent, has been an overwhelming "success story" in terms of its economic impact and in generating added revenues. First, the 1978 cut has exerted a powerful leverage effect on the equity investment process, stimulating higher equity values, more venture capital, more equity capital for rapidly growing companies, greater common stock ownership, and increasing common stock offerings. Second, according to newly released Treasury data, taxes paid on capital gains income of individuals in 1979 actually rose from $8.3 billion to $10.1 billion, an increase of $1.8 billion--the largest absolute gain in the history of the tax.

3. The American Council for Capital Formation strongly supports further reductions in capital gains taxation through cuts in individual marginal rates, increases in the capital gains exclusion, and the immediate reduction in the maximum tax on investment income from 70 to 50 percent. All three approaches meet the suggested guidelines for targeted saving proposals.

4. In conjunction with individual capital gains cuts, two conforming changes should be made. First, when the top capital gains rate is lowered, the top rate of the alternative minimum tax should be lowered to insure that taxpayers subject to this tax would not have a higher marginal tax rate applicable to capital gains than other taxpayers. Second, the corporate capital gains tax rate should be lowered from the current 28 percent to a rate equivalent to the maximum individual capital gains rate in order to maintain the historic parity between the two rates.

5. We also urge serious consideration of other targeted savings proposals which have the potential to promote the new saving and investment so necessary for a strong economy in the 1980's.

Statement of Dr. Charls E. Walker
Chairman, American Council for Capital Formation
before the
Subcommittee on Savings, Pensions and Investment Policy
of the
Senate Committee on Finance

Monday, May 4, 1981

Mr. Chairman and Members of the Committee, my name is Charls E. Walker. I am volunteer chairman of the American Council for Capital Formation. I appreciate the opportunity to present the views of the American Council on legislative initiatives before this Committee to reduce the existing disincentives in our tax code against saving and investment.

The American Council for Capital Formation is a rapidly growing association of individuals, businesses, and associations united in their support of legislation to eliminate the tax bias against saving and productive investment. Our members, individual as well as business, support legislative measures which are designed to encourage the productive capital formation needed to sustain economic growth, reduce inflation, restore productivity growth and create jobs for an expanding American work force.

By considering measures that would help redirect our tax system in favor of saving and investment, this hearing will focus public attention on the savings problem in the U.S. and provide a forum for the evaluation of proposals designed to accomplish that goal. The American Council applauds the foresight of the Subcommittee on Savings, Pensions and Investment Policy, and its Chairman, Senator John Chafee, in calling this timely hearing.

The Need to Encourage Saving

An economy's ability to invest in new plant and equipment, and thus to grow, depends on its saving rate. Savings, both personal and business, provide the resources for investment. Yet, to the extent that income from saving and investment is taxed, the incentives to save and invest will be eroded. The poor performance of the U.S. personal saving rate underscores the need for legislative measures to reduce the tax burden on individual saving and investment income and thus encourage these activities.

According to the latest Commerce Department figures, the personal saving rate fell to 4.7 percent in the first quarter of 1981. This dangerously low saving rate compares unfavorably with past levels of saving in the United States. For example, personal saving as a percent of disposable income averaged about 7 percent in the 25 years prior to 1977. In 1977, the rate fell to 5.6 percent and has yet to return to its pre-1977 trend.

Moreover, recent figures comparing personal saving rates in eight industrialized countries show that the U.S. trails with a lower rate of saving than any of the other countries. In a study based on Commerce Department statistics, the New York Stock Exchange compared personal saving rates in eight countries on average from 1975 to 1979 and found that while our major industrialized competitors had rates of personal saving ranging from 21.5 percent (Japan) to 10.3

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percent (Canada), the U.S. rate of personal saving trailed with a meager 6.3 percent over the same time period. In addition, a look at savings trends in other industrialized countries shows that while most other countries have enjoyed a general upward trend in the pattern of personal saving rates over the past decade, the U.S. rate has fallen sharply since the mid-1970's.

The President's Program for Economic Recovery

The President's Program for Economic Recovery is designed to increase saving and productive investment. The American Council for Capital Formation strongly supports the President's program, including its spending and tax components. However, if Congress, in its wisdom, decides to include targeted saving proposals in the initial tax package or in a follow-up second bill, we urge that three guiding principles be considered in the evaluation of targeted savings incentives.

First, such proposals should stimulate additional saving, and not simply shift funds from one form of saving to another.

Second, such proposals should meet the standard of simplicity, and not clutter the already burdensome and complicated tax code.

Third, such proposals should be evaluated in terms of their revenue impact. There are saving proposals which would "cost" a lot of money but produce little change in aggregate saving; there are proposals which would "cost" less money but produce a lot of additional saving.

Adherence to these three principles will assure the passage of economically sound and efficient reductions in tax disincentives to saving.

The 1978 Reduction in Capital Gains Taxes

There is a growing awareness among financial experts, the business community, and Members of Congress that the 1978 capital gains cut has been an overwhelming "success story" in terms of its economic impact and also in generating additional revenue. This landmark legislation increased the portion of capital gains excludable from taxable income from 50 percent to 60 percent which, combined with other provisions in the Revenue Act of 1978, reduced the maximum capital gains tax for individuals from about 49 percent to 28 percent. This legislation also reduced the capital gains tax rate for corporations from 30 percent to 28 percent.

The evidence to date strongly suggests that the cut "worked."

First, the 1978 capital gains tax cut has encouraged individuals to invest in America. According to a recent New York Stock Exchange survey, nearly 2.4 million shareowners have entered the market since early 1979 when the favorable tax treatment of capital gains became effective, playing a significant role in the 18.1 percent increase in shareowners since 1975.

Second, the 1978 capital gains tax cut has had a significant effect on the new issues market. Stock issues of firms going public for the first time are on the rise. Estimates indicate that in 1980, new capital raised through initial stock offerings rose to about $1.35 billion. This compares to a yearly average of less than $225 million in new issues for the three years prior to 1978.

Third, the 1978 capital gains tax cut has stimulated a substantial increase in commitments to venture capital funds. Venture capital is a major source of funds for new ideas and innovative businesses which can turn the new ideas into reality. Commitments to venture capital funds, which totaled only $39 million in 1977, rose to $900 million in 1980.

Finally, the 1978 capital gains tax cut has exerted a powerful leverage effect on the equity investment process, stimulating higher equity values, more venture capital, more equity capital for rapidly growing companies, greater common stock ownership, and increasing common stock offerings. Yet, a 1980 Arthur Andersen & Company report concluded that many industrialized countries tax capital gains from productive investment less than the U.S. Further reductions are needed in the U.S. rate on capital gains to maintain our competitive standing and encourage greater investment.

Equally important in this period of budget restraint is the most recent data from the Treasury Department on the revenue impact of the 1978 cut on capital gains.

There are three revenue effects associated with a capital gains tax cut. First, a lower tax rate alone results in a revenue loss to the Treasury. This is the "static" revenue loss to the Treasury. Second, a lower capital gains tax rate stimulates realizations and, therefore, generates a revenue gain to the Treasury. This is the "unlocking" effect. Third, the investment that is stimulated by a lower capital gains tax rate helps raise the rate of economic growth and thus increases the base of taxable income for individuals and businesses. The higher tax revenues that result are often called the economic "feedback" effect.

The evidence to date suggests that the 1978 capital gains tax cut has not been a revenue drain on the U.S. Treasury--in fact, just the opposite occurred. Treasury originally estimated that the 1978 rate reduction would reduce revenues in 1979 by a net $1.7 billion; a static revenue loss of $2.6 billion would be partially offset by $0.9 billion of tax liability generated by induced realizations. However, taxes paid on capital gains income of individuals in 1979 actually rose from $8.3 billion to $10.1 billion, an increase of $1.8 billion--the largest absolute gain in the history of the tax.

A further cut in the capital gains rate this year can again be expected to "unlock" additional holdings and increase realizations. Because of this, capital gains tax cuts provide a very big "bang for the buck." Consequently, the revenue implications of an additional capital gains tax cut should not be a significant factor in considering whether to enact it.

It is also important to note that the largest proportion of the increase in realized capital gains in 1979 came from "fat cats"--taxpayers with adjusted gross income in excess of $100,000. Their share of realized capital gains increased from about 29 percent in 1978 to nearly 41 percent in 1979, according to the latest Treasury figures. Thus, the new data on the distribution of capital gains for 1978 and 1979 show clearly that the 1979 increase in tax receipts were derived largely--if not completely--from high bracket taxpayers. Wealthy taxpayers paid significantly more in capital gains taxes at the lower 1979 rates than they did at the higher 1978 levels.

Proposals to Increase Saving

The American Council strongly supports further reductions in capital gains taxation through cuts in individual marginal tax rates, increases in the capital gains exclusion, and the immediate reduction in the maximum tax on investment income from 70 to 50 percent. All three approaches meet our proposed guidelines for targeted savings proposals--additional saving, simplicity, and revenue impact.

First, the Administration's proposals to reduce all individual income tax rates by 30 percent over three years would significantly cut the high marginal rates which blunt incentives to save and invest, and which also converted a 1930's Depression-oriented "soak-the-rich" concept into a modern day "clobber-the-middle-class" tax policy. After this restructuring of the individual income tax system, tax rates would range from a minimum of 10 percent to a maximum of

50 percent. Since 40 percent of net long-term capital gains is included in adjusted gross income, under the Administration's proposal the top rate on capital gains would be reduced from 28 percent under current law to 26.4 percent in 1981, 24.0 percent in 1982, 21.2 percent in 1982, and 20.0 percent in 1984.

A second approach to fostering capital formation is through an increase in the capital gains exclusion for individuals. Two proposals to increase the capital gains exclusion have been introduced by members of the Finance Committee. S. 75, sponsored by Senators Wallop and Moynihan, would increase the excludable portion of capital gains from 60 to 75 percent and would reduce the top capital gains rate for individuals from 28 percent under the present law to 17.5 percent. It also would reduce the capital gains tax rate for corporations from 28 percent under present law to 17.5 percent. S. 145, sponsored by Senator Moynihan, would increase the excludable portion of capital gains from 60 to 70 percent and would include a reduction in the top marginal tax rate for individuals from 70 percent to 67 percent, thereby reducing the top capital gains rate for individuals from 28 percent under present law to 20.1 percent. It also would reduce the corporate capital gains rate from 28 percent to 20 percent.

There are two principle advantages to the exclusion approach to lowering the tax on capital gains. First, this approach reduces the capital gains tax rate for all taxpayers at all income levels. Second, this approach provides for an up-front cut in the existing capital gains tax rate and avoids potential capital gain "lock-in" that may be associated with gradual reductions in marginal rates.

Finally, the American Council supports an immediate reduction in the maximum tax on so-called "unearned" income from 70 percent under present law to 50 percent, thus equalizing the tax treatment of wage and salary income, and saving and investment income. The proposal also would lower the top individual rate on capital gains from 28 percent under present law to 20 percent. Current law differentiates between so-called "earned" and "unearned" income. "Earned" income--wage and salary income--is taxed at rates up to a maximum of 50 percent. "Unearned" income--including interest, dividends, capital gains, and rent--is "stacked" on top of earned income and taxed at marginal rates that go as high as 70 percent.

The "70-50" proposal would have three significant impacts. First, it would reduce the tax on "unearned" income, thus encouraging greater saving and productive investment. Second, it would make tax avoidance less attractive and encourage investors to shift out of noneconomic investment into productive investment. Third, it would increase revenues by making taxpayers out of those who shelter their income because of the current prohibitive tax rates.

<u>Conforming Capital Gains Tax Changes</u>

The individual marginal tax cuts in the Administration's proposal, increases in the capital gains exclusion and the "70-50" proposal all result in reductions in individual capital gains rates. Conforming changes in the alternative minimum tax applicable to capital gains and in the corporate capital gains tax rate also need to be made in the tax code when individual capital gains rates are reduced.

First, a conforming change should be made in the alternative minimum tax applicable to capital gains. Under present law, there is an alternative minimum tax that taxpayers must pay if it is higher than their combined regular and minimum tax liability. It was the intent of Congress in the Revenue Act of 1978 that the alternative minimum tax be <u>lower</u> than the top individual capital gains tax rate. The current maximum individual capital gains rate is 28 percent; the maximum alternative minimum tax is 25 percent. The Administration's tax proposal, the Wallop-Moynihan capital gains exclusion approach, and the "70-50" proposal all substantially reduce the maximum individual capital gains tax rate. Thus, conforming changes should be made in the alternative minimum tax schedule in conjunction with reductions in the regular tax rates on capital gains.

Second, a conforming change should be made in the corporate capital gains tax. The Revenue Act of 1978 cut the top rate for individuals to 28 percent and the corporate rate to 28 percent, bringing the rates back into parity, as was the case for many years prior to the 1969 increases in capital gains taxes for individuals and corporations. The Administration's proposed individual marginal tax cuts, the "70-50" proposal, or increases in the capital gains exclusion result in reductions in individual capital gains tax rates, but not in corporate capital gains tax rates. Therefore, in conjunction with any of these approaches the corporate capital gains tax rate should be reduced from the current 28 percent rate to a rate equivalent to the maximum individual capital gains rate.

Additional Proposals to Increase Saving

This Committee has before it other meritorious proposals to increase incentives for saving. The three standards for targeted saving proposals--additional saving, simplicity, and revenue impact--should also be applied here.

We particularly urge this Committee to carefully consider two targeted savings proposals. One is S. 936, a proposal put forth by Senators Roth and Bentsen of this Committee. Another suggested by Harvard Professor Martin Feldstein, president of the National Bureau of Economic Research, warrants serious attention.

The Roth-Bentsen proposal would decouple "earned" and so-called "unearned" income for tax purposes by taxing each type of income separately at rate schedules ranging from 14 percent to 50 percent. Under present law, "unearned" income--including interest, dividends, capital gains, and rent--is stacked on top of earned income and taxed at rates up to 70 percent. Under this proposal, the first dollar of "unearned" income would be taxed at the lowest bracket rate, rather than at the highest rate after earned income. The "two-stack" structure would only be available to individual taxpayers with less than $10,000 in preference, or tax sheltered income.

This proposal would have a powerful economic impact. Most of a taxpayer's saving income would be taxed at substantially lower rates, thus sharply raising the after-tax yield on saving and investment. Under the current, very progressive tax structure, saving is taxed at an individual's highest tax rate. Since saving is the marginal discretionary income of the taxpayer, this severe disincentive to saving would be relieved by the Roth-Bentsen "two-stack" approach.

The Feldstein proposal would exclude 60 percent of interest and dividends from adjusted gross income. Under present law, only capital gains are allowed a 60 percent exclusion from adjusted gross income. Interest and dividends in excess of a small $200 ($400 for joint returns) exclusion are stacked on top of earned income and taxed at progressive ordinary tax rates up to 70 percent. Under the Feldstein proposal, interest and dividends would be treated like capital gains. There would be no "cap" and, thus, the reward from saving would be increased for each additional dollar of saving.

Because of the short-run revenue impact, the Feldstein proposal should be phased-in over a period of several years.

This proposal is similar to those offered by Senator Schmitt (S. 155) and Senators Nunn and Huddleston (S. 819). For example, Senator Schmitt's proposal would increase the existing exclusion for certain interest and dividend income to $200 ($400 for joint returns) plus 25 percent of additional interest and dividends up to $50,000, phased-in over five years.

The percentage exclusion approach is very appealing for several reasons. It is simple and easily understood. It would treat dividend and interest income in the same manner as capital gains income. It would afford neutrality among types of saving and the institutions that hold and invest individual savings. And it would provide a powerful incentive for additional individual saving at the margin without encouraging a mere shifting of savings from one type to another.

In conclusion, Mr. Chairman, there are a number of ways in which tax policy can promote the new saving and investment so necessary for a strong economy in the 1980's. This is good news in itself, but equally gratifying is the fact that a strong and wide consensus exists in favor of enacting such proposals into law at the earliest possible moment. We are convinced that the legacy of the 97th Congress will indeed be constructive measures to encourage saving and investment.

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STATEMENT OF

MICHAEL BELL

President
HIXON VENTURE COMPANY

General Partner
SOUTHWEST VENTURE PARTNERS

and

Executive Vice President
NATIONAL VENTURE CAPITAL ASSOCIATION

before the

UNITED STATES SENATE
SUBCOMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT POLICY
OF
THE COMMITTEE ON FINANCE

May 4, 1981

SUMMARY OF TESTIMONY

MICHAEL BELL
EXECUTIVE VICE PRESIDENT

NATIONAL VENTURE CAPITAL ASSOCIATION

1. Achievement of President Reagan's goals for the economy requires that investment be stimulated and that consumptive spending be moderated.

2. Reduction of capital gains tax rates in 1978 has dramatically stimulated venture capital formation and investment in small business. Data presented covering 1979 and 1980 indicate nearly a ten-fold increase in activity. Preliminary estimates indicate a substantial revenue gain by the Treasury for 1979 and 1980 as a result of increased capital turnover activity.

3. Further reduction of capital gains tax rates or elimination of taxation of capital gains is recommended. DRI econometric model simulations indicate dramatically positive benefits for the economy from such action.

4. The creation of incentive stock options such as those described in the Packwood-Bentsen bill (S.639) is recommended. Such options will assist small business in attracting qualified management personnel needed for growth.

STATEMENT OF

MICHAEL BELL

PRESIDENT, HIXON VENTURE COMPANY

GENERAL PARTNER, SOUTHWEST VENTURE PARTNERS

and

EXECUTIVE VICE PRESIDENT OF THE NATIONAL VENTURE CAPITAL ASSOCIATION

BEFORE THE

SUBCOMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT POLICY

OF

THE COMMITTEE ON FINANCE

May 4, 1981

Mr. Chairman and Members of this Distinguished Committee:

My name is Michael Bell of San Antonio, Texas. I am President of Hixon Venture Company, a corporation, and General Partner of Southwest Venture Partners, a limited partnership, which two organizations have a combined capital of $32 million devoted to venture capital investing. HVC was formed in 1975, and SwVP was formed in January, 1981. Prior to the formation of HVC, I was Vice President for venture capital for Midland Investment Company, a privately held corporation formed in 1922 which, among other investments, engaged in venture capital investing. Since 1977, I have been a Director of the National Venture Capital Association, a 107 member association representing most of the organized venture capital firms in the country. I presently serve as its Executive Vice President as well.

Prior to initiating my career in venture capital, I served as a corporate finance officer for a New York stock exchange firm and before that I practiced law.

I am pleased to have been permitted the opportunity of testifying before this distinguished committee. I appreciate the opportunity to explore with you possible solutions to the economic problems of the country. Today my comments are on behalf of The National Venture Capital Association. The NVCA's membership consists of firms located throughout the country which in the aggregate have approximately $4.5. billion invested in small businesses. That $4.5 billion is especially critical as it constitutes the seed capital for the technology industry of this country. Our sole objective is to provide equity funding and sophisticated management and technical assistance primarily to new, high risk, growth oriented companies. While the focus of venture capital has tended to be on high technology, often more mundane areas of business are financed by the venture industry. An example of such a company is Federal Express. Federal Express, financed by the venture capital industry, has beat the United Parcel Service and the U.S. Postal Service at their own game by providing a profitable and efficient service badly needed by the marketplace.

I am appearing here today to urge you to include in the tax reduction package two specific tax law changes:

- Elimination or further reduction of capital gains taxes; and
- Authorization of an Incentive Stock Option Plan.

We are fully supportive of President Reagan's goals including:

- Gradually reducing growth of the federal money supply;
- Reducing growth of federal expenditures in relation to Gross National Product;
- Enactment of tax incentives to encourage investment, and;
- Adoption of proposals to induce greater savings by individuals.

Achievement of these goals requires stimulation of demand for investments and moderation of consumptive spending. We question whether the tax package pending before Congress will sufficiently stimulate saving and investment and it is for this reason that we believe capital gains tax reductions and stock option provisions should be included in the tax package.

I. <u>Elimination or Reduction of Capital Gains Taxes</u>

The most compelling reason to further reduce or eliminate capital gains taxes is the need for equity capital by small business. The combination of runaway inflation and record high interest rates has worked inexorably to weaken

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small companies. The need for new equity is immediate if these companies are to survive and grow. The current "weakness" of small companies can best be expressed through their debt to equity ratios. For the period 1961-1970, debt to equity ratios of small firms averaged 0.93 : 1; for the 1971-1975 period, the ratio increased to 2.12 : 1; and such ratios are now estimated by many to average as much as 4 : 1 and higher. This kind of balance sheet condition is often fatal particularly during periods of economic downturn.

Small businesses, when provided with adequate risk capital, can achieve remarkable things which include:

- The creation of jobs - Secretary Regan says that 85% of a'` net new jobs are created by small business;
- Increased research and development expenditures vital to innovation and productivity;
- Stimulation of exports important for balance of trade and stability of the dollar, and;
- Increased competition and economic diversity assuring a dynamic economy which is desired by the Congress and by the people.

Detailed survey analysis presented to this Committee by Dr. Zschau three years ago indicates that within five years, each $1.00 invested in small company equity produces each year:

- $0.70 in exports;
- $0.33 in R&D expenditures;
- $0.30 in taxes paid to the Federal Government;
- $0.05 in taxes paid to State and Local Governments.

This adds up to a total of $1.38 in benefits for all for each equity dollar invested, each and every year. On a present value basis, $0.30 a year forever is worth $3.28. Thus, when government decides to tax an equity dollar at $0.70, $0.50 or $0.20, it is deciding to accept these proceeds now instead of something worth $3.28 now. This does not even take into account the additional benefits in the area of exports, R&D spending, job creation and State and local taxes.

The 1978 Capital Gains Tax Reduction has had dramatic effects. There has been a massive capital infusion into venture capital firms who in turn have invested this capital into small businesses. In addition, more seasoned concerns have been able to raise capital in the public market which has been stimulated by the reduction. The data are as follows:

- Venture Capital firms raised:

  8 years - 1970-1977 $466 million
  3 years - 1978-1980 $1.789 billion

- Venture Capital firms invested:

  8 years - 1970-1977 $2.935 billion
  3 years - 1978-1980 $2.550 billion

- Companies with less than $5 million net worth raised:

  8 years - 1970-1977 $2.202 billion
  3 years - 1978-1980 $1.092 billion ($820 million in 1980 alone)

Stated another way:

- Venture Capital firms raised annually an average of:

  1970-1977 - $58.25 million
  1978-1980 - $596 million, an average annual increase of 923% over previous 8 years.

- Venture Capital investments averaged annually:

  1970-1977 - $369 million
  1978-1980 - $850 million, an average annual increase of 132% over previous 8 years.

  (Estimated Fundings and Disbursements table attached.)

In addition to the benefits for the small companies, the government has made money as well. In 1978, the Joint Tax Committee estimated that the capital gains tax reduction would cause a revenue loss to the Treasury of $2.6 billion for 1979. Treasury now estimates that there was a

$1.1 billion revenue gain in 1979 (14% more than collected in 1977 and 1978) and a $900 million gain in 1980.

Recent testimony to the House Budget Committee by Sam I. Nakagama, Chief Economist of Kidder, Peabody and Company suggested the elimination of taxes on capital investments made subsequent to March of 1981. This proposal would have the potential to immediately "unlock" the estimated $350 billion in outstanding capital investments which could generate revenue to the Treasury of approximately $42 billion at currently effective tax rates. Future benefits of such a scenario as determined by the DRI econometric model include:

- GNP would grow at a faster rate to $4.8 trillion by 1985 compared to reaching $4.4 trillion in 1985 under current policy;
- Business Fixed Investment (in constant 1972 dollars) would grow to $197 billion in 1985 compared to $177 billion under current policy;
- By 1985, 1.6 million more jobs would be created than forecast under current policy, yielding an unemployment rate then of 6.5% compared to 7.7%.
- The federal budget deficit would be reduced in the first year by $21.5 billion, and by 1985 we would have an $89.3 billion surplus compared to a surplus of $16 billion under current policy.

(Zero capital gains model tables attached.)

II. Incentive Stock Options

The Incentive Stock Option is important in enabling small companies to attract key management personnel. Most often such personnel are critically needed when the companies are in very early stages of development and are extremely cash poor. Small companies just cannot compete with the salaries and other benefits offered by large companies.

Incentive Stock Options reward employees in direct correlation to their performance. This has the benefit of specifically motivating improvement in productivity and efficiency.

"Non-qualified" options, granted under the current law, while better than nothing, are largely useless for inducing innovation and risk taking. The employee is forced to pay tax at ordinary rates on a "phantom" profit at the time of exercise of his option. He must provide the capital in "real" dollars to pay such taxes. While it is possible to construct plans by which company loans and grants are made available to enable the employee to pay taxes, they do not work in companies that have not yet reached profitability or are cash poor. In addition, such plans are in general too complex to be communicated effectively to employees. Thus, the plan is poorly understood and much of the potential for increasing productivity is lost. This problem can be cured by a bill similar to the Jones-Frenzel bill of last year (not introduced yet in the 97th Congress) or the Packwood-Bentsen Bill S.639 introduced recently.

The Incentive Stock Option proposal is another plan which benefits both business and government. Treasury revenues are increased because corporations lose the current front-end deductions achieved with the non-qualified option law. Various groups have analyzed the effect of the Incentive Stock Option proposal on Treasury revenue. The results of these estimates show gains in the second to third year, with the magnitude of the increase reaching $30-$60 million annually by 1985.

In conclusion, I urge you to include in the tax bill provisions to reduce or eliminate capital gains taxes and provisions for an Incentive Stock Option Plan. These proposals benefit both business and government. The DRI econometric model projects dramatic effects on the economy by eliminating capital gains taxes entirely. The NVCA certainly supports this idea. It is clear from the results of the past two years that any reduction in capital gains taxes would have a beneficial impact and a revenue gain for the Treasury. The Incentive Stock Option Plan also provides a revenue gain although it is more modest. Each of these proposals specifically targets the supply side and dampens the demand side with everyone winning--small business, the employees of small business, the investing public and the Federal government.

I thank you for your attention and would welcome your questions.

jj

VENTURE CAPITAL INDUSTRY

ESTIMATED
FUNDINGS AND DISBURSEMENTS
(Millions of Dollars)

Year	New Private Capital Committed to Venture Capital Firms	Estimated Disbursements to Portfolio Companies	Public Underwritings of Companies with a Net Worth of $5 Million of Less	
			Number	Amount
1980 (Est)	$900	$1,000	(135)	$ 820
1979	319	1,000	(46)	183
1978	570	550	(21)	89
1977	39	400	(13)	43
1976	50	300	(29)	145
1975	10	250	(4)	16
1974	57	350	(9)	16
1973	56	450	(69)	160
1972	62	425	(409)	896
1971	95	410	(248)	551
1970	97	350	(198)	375
1969	171	450	(698)	1367

Total Capital Committed to the Organized Venture Capital Industry
Estimate at December 31, 1980

Independent Private Venture Capital Firms	$1.8 billion
Small Business Investment Companies	1.4 billion
Corporate Subsidiaries (Financial and Non-Financial)	1.3 billion
Total	$4.5 billion

This pool remained static from 1969 through 1977 at some $2.5-to-$3.0 billion (with new fundings more or less equal to withdrawals).

SOURCE: VENTURE CAPITAL JOURNAL

ECONOMETRIC ANALYSIS using DRI model
Prepared by Sam I. Nakagama, Kidder-Peabody and Co., Inc.
February 26, 1981

Zero Capital-Gains Tax Proposal
With Non-Accommodating Monetary Policy

	Baseline Projections Assuming No Tax Changes					Projections Assuming Zero Capital-Gains Proposal*				
	1981	1982	1983	1984	1985	1981	1982	1983	1984	1985
Gross National Product	2,910.2	3,252.1	3,611.8	3,986.1	4,418.3	2,959.3	3,374.0	3,810.0	4,273.3	4,810.2
% change	10.7	11.7	11.1	10.4	10.8	12.6	14.0	12.9	12.2	12.6
GNP in 72 Dollars	1,485.4	1,515.5	1,547.3	1,586.6	1,632.7	1,511.1	1,560.0	1,602.2	1,649.8	1,703.4
% change	0.2	2.0	2.1	2.5	2.9	2.0	3.2	2.7	3.0	3.2
GNP Deflator (1972 = 1.00)	1.959	2.145	2.334	2.512	2.706	1.958	2.162	2.378	2.589	2.823
% change	10.4	9.5	8.8	7.6	7.7	10.4	10.4	9.9	8.9	9.0
Business Fixed Investment, 72 Dollars	153.0	158.3	163.3	169.2	176.7	156.5	169.2	179.6	188.2	197.0
% change	−3.0	3.5	3.2	3.6	4.4	−0.0	8.1	6.2	4.8	4.7
Personal Consumption Expenditures, 72 Dollars	944.0	952.2	963.1	985.3	1,004.5	966.9	985.1	1,005.8	1,033.9	1,060.5
% change	1.1	0.9	1.1	2.3	2.0	3.5	1.9	2.1	2.8	2.6
Total Employment, in millions	98.1	100.4	102.0	103.3	104.8	98.4	101.5	103.4	104.8	106.4
% change	0.8	2.3	1.6	1.3	1.5	1.2	3.1	1.9	1.4	1.5
Unemployment Rate	7.8	7.5	7.7	7.9	7.[illegible]	7.5	6.6	6.6	6.7	6.5
M2	1,779.1	1,897.3	2,032.9	2,172.4	2,310.[illegible]	1,776.0	1,914.0	2,056.5	2,173.2	2,275.6
% change	6.9	6.6	7.2	6.9	6.3	6.7	7.8	7.4	5.7	4.7
Nonborrowed Reserves	40.05	41.68	43.94	47.14	48.71	40.05	41.68	43.94	47.14	48.71
% change	−2.9	4.1	5.4	7.3	3.3	−2.9	4.1	5.4	7.3	3.3
Three-Month Treasury Bill Rate	13.19	13.75	12.28	9.54	9.43	13.15	13.33	12.51	10.74	11.02
Twenty-Year Government Bond Rate	12.29	12.06	11.71	10.74	10.65	12.27	12.35	12.39	11.81	11.91
S&P Stock Price Index (1941-43 = 10)	131.16	127.45	134.47	147.82	161.54	147.59	152.94	161.36	177.38	193.85
% change	10.4	−2.8	5.5	9.9	9.3	24.3	3.6	5.5	9.9	9.3
Federal Budget Position, NIA Basis	−54.5	−35.1	−20.0	−12.2	16.0	−33.0	7.7	37.4	48.3	89.3
Personal Taxes	299.1	339.0	381.8	426.6	475.6	308.4	352.2	398.4	451.5	514.2
% change	15.9	13.3	12.6	11.7	11.5	19.5	14.2	13.1	13.3	13.9

* Assumes capital gains tax reduced to zero on new investments without accommodating monetary policy.

Table 1
Zero Capital-Gains Tax Proposal
With Accommodating Monetary Policy

	Baseline Projections Assuming No Tax Changes					Projections Assuming Zero Capital-Gains Proposal*				
	1981	1982	1983	1984	1985	1981	1982	1983	1984	1985
Gross National Product	2,918.2	3,252.1	3,611.8	3,986.1	4,418.3	2,980.1	3,378.7	3,806.3	4,295.1	4,893.5
% change	10.7	11.7	11.1	10.4	10.8	12.6	13.9	12.9	12.8	13.9
GNP in '72 Dollars	1,485.4	1,515.5	1,547.3	1,586.6	1,632.7	1,511.4	1,558.7	1,601.9	1,656.7	1,719.8
% change	0.2	2.0	2.1	2.5	2.9	2.0	3.1	2.8	3.4	3.8
GNP Deflator (1972 = 1.00)	1.959	2.145	2.334	2.512	2.706	1.958	2.162	2.376	2.592	2.845
% change	10.4	9.5	8.8	7.6	7.7	10.4	10.4	9.9	9.1	9.8
Business Fixed Investment, '72 Dollars	153.0	158.3	163.3	169.2	176.7	156.6	169.0	179.4	189.2	200.4
% change	−3.0	3.5	3.2	3.6	4.4	−0.7	8.0	6.1	5.5	5.9
Personal Consumption Expenditures, '72 Dollars	944.0	952.2	963.1	985.3	1,004.5	967.8	984.4	1,005.8	1,037.6	1,069.4
% change	1.1	0.9	1.1	2.3	2.0	3.5	1.8	2.2	3.2	3.1
Total Employment, in millions	98.1	100.4	102.0	103.3	104.8	98.5	101.5	103.4	104.9	106.7
% change	0.8	2.3	1.6	1.3	1.5	1.2	3.0	1.9	1.5	1.7
Unemployment Rate	7.8	7.5	7.7	7.9	7.7	7.5	6.6	6.6	6.6	6.2
M2	1,779.1	1,897.3	2,032.9	2,172.4	2,310.1	1,774.8	1,905.7	2,063.1	2,229.4	2,396.1
% change	6.9	6.6	7.2	6.9	6.3	6.6	7.4	8.2	8.1	7.5
Nonborrowed Reserves	40.05	41.68	43.94	47.14	48.71	39.99	41.51	44.46	48.53	50.80
% change	−2.9	4.1	5.4	7.3	3.3	−3.0	3.8	7.1	9.2	4.7
Three-Month Treasury Bill Rate	13.19	13.75	12.28	9.54	9.43	13.19	13.62	12.01	9.08	8.09
Twenty-Year Government Bond Rate	12.29	12.06	11.71	10.74	10.65	12.27	12.40	12.32	11.56	11.65
S&P Stock Price Index (1941-43 = 10)	131.16	127.45	134.47	147.82	161.54	147.59	152.94	161.36	177.38	193.85
% change	10.4	−2.8	5.5	9.9	9.3	24.3	3.6	5.5	9.9	9.3
Federal Budget Position, NIA Basis	−54.5	−35.1	−28.0	−12.2	16.0	−32.7	6.0	36.1	58.9	122.6
Personal Taxes	299.1	339.0	381.8	426.6	475.6	308.5	352.1	397.8	453.0	522.8
% change	15.9	13.3	12.6	11.7	11.5	19.6	14.1	13.0	13.9	15.4

* Assumes capital gains tax reduced to zero on new investments and accommodating monetary policy.

Statement of the
NATIONAL ASSOCIATION OF REALTORS®

With reference to the particular concerns of this subcommittee, we believe that the Administration's program needs improvement to increase and make more reliable the savings by individuals to provide funds needed for investment in industry and housing.

We also believe that the Administration's proposals for revising depreciation laws need to be modified to ensure funds are not siphoned out of rental housing. Attachment 1 to my written statement includes our recommendations to improve the Administration's total economic program and the expected results if these recommendations are accepted.

To improve the President's proposal for savings, we strongly recommend that tax relief be designed so that all Americans are directly encouraged to save.

First, we recommend expanding interest and dividend excludability from $200 for individuals and $400 for joint returns to at least $500 for individuals and $1,000 for joint returns, effective July 1, 1981. This would generate additional savings which would be available for increased investment (see Table 2, $500/1,000 impact). In future years, 1982-1985, we recommend increasing the amount from $500/1,000 to $1,000/2,000. This recommendation closely resembles S.142 introduced by Senator Bentsen and we appreciate his foresight in having introduced this legislation.

This type of tax cut, in addition to being uniformly available to all taxpayers whether using the short form 1040 or the long form, would particularly benefit lower income taxpayers because the incentive would represent a larger percentage increase in their after-tax income when compared with middle and upper income groups. The elderly would also benefit more because that group receives approximately 25% of their income from dividend and interest.

Second, we recommend a reduction in the rate of tax on capital gains to a maximum of 20% in order to encourage additional investment in productive assets. Reducing capital gains tax rates could particularly stimulate new rental housing construction since the prospects of long term capital gains provide one of the few remaining incentives for investing in such structures. We therefore strongly support both S.75 introduced by Senators Wallop, Moynihan et al., and S.145 introduced by Senator Moynihan. It should be recognized, however, that S.75 goes further than S.145 in providing additional investment incentives for most taxpayers.

Third, to the extent that any investment income is subject to Federal taxation, we support, in principle, the "two stack" approach advocated in S.936 introduced by Senators Roth, Bentsen and Kasten. Lowering marginal tax rates on investment income would significantly increase investment incentives, lower interest rates and stimulate the supply of productivity-increasing plant, equipment and rental housing. However, the arbitrary limitation of S.936 which would deny eligibility for "two-stack" treatment of investment income for those with more than $10,000 in preference income would rob the bill of much of its beneficial impact. To ensure that the considerable potential economic benefits of the savings incentives are, in fact, realized, all taxpayers should be eligible for "two-stack" treatment of investment income, regardless of the size of preference income. To preserve tax equity, particularly for the elderly who rely on interest income for one quarter of their total taxable income, we recommend that the "two-stack" approach should also include comparable provisions for the treatment of exclusions on each of the "two-stacks" as under present law.

These proposals would overcome a fundamental weakness of the Administration's broad economic program by providing a reliable basis for the urgently needed increase in savings and investment. By targeting the incentives specifically at stimulating savings and investment, the effectiveness of these measures in helping to increase productivity, lower interest rates and inflation and boost economic growth, per dollar of tax relief, would be significantly greater than the general, across-the-board reductions in marginal tax rates advocated by the Administration.

BACKGROUND

Two of the major factors behind the recent acceleration in inflation have been the emerging shortgage of housing and the slow growth in worker productivity (even after allowing for the impact of cyclical downturns in output and employment).

As much as half of this slowdown in productivity growth in the United States is attributable to the virtual stagnation in capital per worker. During the current period of very rapid growth in the labor force, rapidly rising energy prices and high environmental investing, it is vital that the rate of capital formation be increased in order to restore the growth in productivity to normal levels and fight inflation.

Residential investment also needs to increase to alleviate the emerging housing shortage and hold down future rent and housing price increases.

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.

Moreover, residential investment has fallen to only 3.5% of national output under pressure from high inflation and interest rates. This inadequate investment in housing below the post war average is also showing up in the very low rental vacancy rates experienced over the last 15 months.

Business investment within the United States has been low mainly because of higher interest rates and because after tax profits from current production have fallen to less than 4¢ on each sales dollar and are forecast to drop below 3¢ 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% of profits from current production during 1981.

U.S. savings performance ranks the lowest of major industrial countries--only 5 percent of personal disposable income was saved by households in 1979 compared with 13% in West Germany and 20% in Japan. Although some modest increase in the savings rate in the U.S. occurred during 1980 as a result of the recession, without effective efforts to boost personal savings it is unlikely that the savings rate will rise significantly above 7% over the next 5 years.

One of the major reasons for our poor savings performance has been the relatively heavy reliance on personal income taxes as a source of government revenue in the United States together with steadily rising effective personal income tax rates.

Overall, at least 50% of any tax relief provided over the next few years should be devoted specifically to stimulating savings and investment, and at most 50% in the form of general relief in individual income tax rates.

This is in contrast with composition of the tax relief package advocated by the new Administration. The new Administration has supported a 10% reduction in individual tax rates during each of the next three years beginning July 1, 1981, accompanied by a very inadequate package of investment incentives. Over the next few years, this tax package would involve 4 dollars in consumption oriented tax relief to every one dollar of relief specifically directed at savings and investment. This is the most anemic proportion of tax relief to stimulate savings and investment in twenty years.

More importantly, tax relief must be tied to a slowdown in Federal spending growth. Otherwise consumption-stimulating tax relief, such as general reductions in individual income tax rates could increase rather than decrease inflation, drive up interest rates and reduce new housing starts by over 200,000 units a year.

S.142, S.75, S.145 and S.936

The real earnings for 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 keeping with our view that tax relief must be non-inflationary and encourage investment and economic growth, we strongly support legislation that would provide tax incentives for savers and investors.

We congratulate the Congress for recognizing the need to encourage savings and investment and appreciate the legislation recently passed by the Congress by initiating the first step--$200 interest and dividend excludibility for individuals and $400 for a joint return. Now, second steps should be enacted to provide an adequate stimulus to savings. We strongly support increased tax incentives specifically targeted to encourage more savings.

S.142, S.75, S.145 and S.936 would all provide tax incentives to encourage savings and investment and we applaud the sponsors of these bills for recognizing that savings and investment must be encouraged.

S.142, introduced by Senator Lloyd Bentsen, would increase the current interest and dividend exclusion to $1,000 ($2,000 for joint returns) and make this exclusion permanent; S.75, introduced by Senators Wallop, Moynihan, and others, would increase the capital gains deduction to 75% for noncorporate taxpayers and reduce the maximum rate on corporate capital gains to 17.5%; S.145 would also reduce capital gains reduction by reducing the corporate rate to 20%, increasing the noncorporate deduction to 70%, and reducing the maximum rate for individual income taxes from 70% to 67%; S.936, introduced by Senators Roth, Bentsen and Kasten, would allow individuals to compute taxes separately on personal service income and investment income, thereby permitting the first dollar of each type of income to start in the 14% tax bracket.

In our view, the problems of the economy are such that increased savings and investment in all sectors of the economy and in all income groups should be encouraged--increased savings and investment in one area should not come at the expense of savings and investment in other areas. Some of the bills discussed here today fall into this desirable category of equitably stimulating savings and investment in all sectors. Others could be easily modified to achieve this goal.

The NATIONAL ASSOCIATION OF REALTORS® supports increasing (and making permanent) the amount of interest and dividend income excludable from Federal tax to at least $500 for individuals (and $1,000 for joint returns) effective July 1, 1981. Further increases in the exclusion level to at least $1,000/$2,000 should be phased in by 1985 to maintain adequate savings incentives in future years.

S.142 introduced by Senator Bentsen provides even larger exclusions for certain interest income and represents an important effort to stimulate an increased supply of personal savings. However, this bill could be improved by extending the eligible categories of excludable income to include other interest and dividend income. This would ensure that the resultant increases in savings flows were not encouraged to move into certain fixed interest assets at the expense of stocks and other investments. Modified in this way, we believe S.142 could result in a substantial better economic performance. We estimate that as a result of S.142 alone (with modifications) long term interest rates would be lowered by nearly 1 percentage point and consumer prices by 0.4 percent. After 4 years, new housing starts could be boosted by nearly 250,000 units per year as a result of S.142 (see Table 2).

At the same time, S.142 would be a progressive tax reduction: the tax cut would represent a higher proportion of gross adjusted income for lower income taxpayers than for higher income earners (see Table 3). S.142 would also particularly benefit elderly taxpayers who rely on interest and dividends for an average 25% of total income.

S.936 introduced by Senators Roth, Bentsen and Kasten represents a slightly different approach for stimulating personal saving. By allowing taxpayers to separately compute taxes on investment income and personal service income, marginal tax rates on interest and dividend income would be lowered substantially. For example, a typical single taxpayer earning less than $2,200 ($3,200 for joint returns) would be subject to zero marginal tax rate on savings income. For taxpayers in these investment income brackets, the effect on personal savings of S.936 is similar to those for S.142. However, S.936 would also lower marginal tax rates (and provide a stimulus to savings) on taxpayers with larger amounts of investment income. S.142, on the other hand, would have no impact on marginal tax rates for those taxpayers with investment income higher than the exclusion amount.

However, one provision in S.936 severely restricts its effectiveness in lowering marginal tax rates on taxpayers with higher investment incomes: only those taxpayers with less than $10,000 of preference income would be eligible for the separate treatment for computing taxes on investment income. This arbitrary provision would deny "two stack" treatment of investment income to more than 75% of those taxpayers with the largest savings responses to targeted savings incentives.

Modified to eliminate this arbitrary restriction for eligibility to use the "two stack" treatment of investment and personal service income, S.936 could provide significantly greater economic benefits than S.142 because it would raise the after tax rate of return on incremental saving (by an average of 25 to 30%) on a larger number of taxpayers.

S.936 would also provide a much more efficient way of encouraging increased savings than the Administration's proposed across-the-board reductions in income tax rates. S.936 would raise the after tax return on incremental savings by more than the Administration's proposal, particularly for many taxpayers with the highest propensity to save. The reduction in revenue inflow to the Treasury per dollar of savings stimulated would also be significantly smaller under S.936 than the Administration's proposal.

While we have not yet completed our analysis of the economic impact of S.936, preliminary results show that lowering marginal tax rates on investment income in this way could reduce consumer prices by up to 4%, lower long term interest rates by as much as 1.5 percentage points and boost new housing construction by 400,000 units per year after 4 years. 1/ We would be glad to share the full results of our analysis with the members of this Committee as soon as they have been completed.

1/ Assuming that the $10,000 preference income restriction in S.936 was eliminated.

Reducing the rate of tax on capital gains to a maximum of 20% would substantially encourage investment in productive assets. This is particularly true for rental housing, where severe shortages have already emerged and are likely to persist over the next decade. Even if Congress enacts substantially improved depreciation provisions this year, prospective investors in rental housing will be reluctant to invest because of the very low rates of return on such investment (negative in most cases) and a prolonged expected stream of negative cash flow during the first 10 or 15 years of the investment life. In this situation, the prospect for long term capital gains offers one of the only remaining incentives to invest in rental housing. Lower capital gains tax rates, together with substantially improved depreciation provisions, could therefore help restore the rental housing industry to economic viability.

The gross reduction in revenue to the Treasury from enactment of S.75 would be very modest (less than $3 billion per year) and would be more than recouped from the expanded level of new investment in productivity-increasing investment in new plant, equipment and rental housing resulting from reduced capital gains taxation.

We therefore strongly support either S.75 and S.145, but we wish to point out that S.75 goes further than S.145 in providing additional investment incentives for most taxpayers.

Another bill of particular concern to this subcommittee is S.701 introduced by Senator Bentsen. S.701 would enable regulated financial institutions to offer deposits with tax exempt interest. The funds raised by these deposits would be required to be used by the institution for home mortgage lending purposes. We welcome the spirit of Senator Bentsen's amendment in trying to stimulate the housing industry and strongly support the thrust of this bill. However, we would point out that S.701 fails to address the additional need for increased mortgage flows into multi-family housing, and especially multi-family rental units. S.701 also fails to stimulate much needed savings flows into other areas such as new productivity-increasing commercial and industrial structures and equipment. We therefore feel the nation's economic interests are better served by measures designed to stimulate overall savings to flow into specific industries.

CONCLUSION

The NATIONAL ASSOCIATION OF REALTORS® strongly supports legislation to provide direct tax incentives for savings and reduced capital gains taxes as a means to help control inflation, reduce interest rates, and encourage vitally needed capital formation.

The legislation we have proposed would serve to accomplish these goals by providing a meaningful tax incentive to increase the low rate of savings we are experiencing today. The increased flow of savings into lending institutions will be invested in new housing, structures and equipment and will serve to increase productivity and real economic growth. We urge this Committee to favorably report such legislation at the earliest opportunity.

We thank the Committee for the opportunity to present our views on this important matter. We will be happy to answer any questions the Committee may have.

TABLE 1

IMPACT OF PROPOSED TAX INCENTIVES FOR SAVERS
ON THE ECONOMY AFTER FOUR YEARS

	Increased Exclusion of Interest and Dividend Income			Increased Ceilings from $1,500 to $7,500 and Increased Participation in Individual Retirement Accounts
	Constant $500/$1000 over next 4 years	Initial $500/$1000 increasing to $1000/$2000 over 4 years	Constant $1000/$2000 Over 4 years	
Gross National Product (Percent Difference in Levels)	0.4	0.6	0.9	0.3
Consumer Prices (Percent)	-0.2	-0.3	-0.4	-0.1
Long Term Interest Rates (Percentage Points)	-0.4	-0.6	-0.9	-0.3
Average Spendable Income per Household with Interest Income and/or IRA ($, 1981 Prices)	230	450	670	600
Employment (Jobs)	100,000	150,000	220,000	100,000
New Housing Starts (Units)	120,000	170,000	250,000	90,000
Non-Residential Investment (Percent Difference in Levels)	4.0	5.5	8.5	2.7
Productivity (Percent Difference in Levels)	0.3	0.4	0.7	0.2
Revenue Reductions (Including Feedback Effects of a Stronger Economy)	5.0	9.3	13.9	6.3

Source: NATIONAL ASSOCIATION OF REALTORS®, Forecasting and Policy Analysis Division.

TABLE 2

EFFECTS OF $500/$1,000
INTEREST AND DIVIDEND EXCLUSIONS
BY INCOME GROUP
(Dollars)

Gross Adjusted Income	Number of Returns with Interest Income (Millions)		Average Interest Payment per Return ($ dollars)		Tax Reduction from $500/$1,000 at Typical Marginal Tax Rate 1/		As a Percent of Average Taxable Income	
	Individual	Joint	Individual	Joint	Individual	Joint	Individual	Joint
Less than 6,000	6.59	2.13	1,120	680	-	-	-	-
6,000-11,999	5.08	4.13	1,130	1,100	54	108	0.7	1.7
12,000-15,999	2.24	3.59	946	1,230	57	114	0.5	1.0
16,000-19,999	1.24	4.35	800	1,350	78	126	0.5	0.9
20,000-24,999	0.68	4.94	830	2,080	90	144	0.5	0.8
25,000-29,999	0.28	3.19	1,130	2,790	102	168	0.4	0.7
30,000-49,000	0.29	3.91	1,690	4,350	132	222	0.4	0.7
Over 50,000	0.11	1.24	5,280	9,980	204	384	0.3	0.5

1/ Relative to current law including $200/$400 interest and dividend exclusion.

Source: Based on 1977 IRS data. Calculations by NATIONAL ASSOCIATION OF REALTORS®

ATTACHMENT 1

RECOMMENDATIONS FOR IMPROVEMENT

We recommend the following concerning the President's program:

(1) The Congress should accept the magnitude of the President's spending slowdown (which generally coincides with our own petitions to the Federal government during the last 13 months).

(2) The Congress should insist on trimming most programs except the truly needy. Equal sacrifice for a better future is appropriate for all Americans. We continue to offer to do our share by supporting cuts in budget proposals for programs affecting our industry. We have written to every major trade and professional association to recommend they do likewise.

(3) Slower spending and tax relief should be tied together so that the Federal deficit will trend downward each year towards balance by at least 1984. Because of the need for keeping spending reductions and tax relief linked, we recommend limiting across-the-board personal income tax relief to 5% annually, which is large enough to offset higher personal income tax receipts caused solely by inflation. Both tax relief for individuals and business should not begin prior to July 1, 1981. This recommendation reflects the view of several industries, including bankers, savings and loans, mutual savings banks, mortgage bankers, home builders, and REALTORS®.

(4) Tax relief should be provided to directly stimulate savings, such as raising interest and dividend excluded from taxable income from the current $200 for individuals and $400 for joint returns to at least $500/$1,000 effective July and expanding to at least $1,000/$2,000 during the next four years. Also raise the ceiling on Individual Retirement Accounts from $1,500 to $7,500 during the next five years and extend eligibility at half the ceiling to people with inadequate private pension plans. The larger interest/dividend exclusion would generally benefit lower income and elderly people; and the increase in the IRA ceiling and eligibility would benefit middle income people and help provide a retirement "safety net" for about one-half of workers who do not have private pension programs. Both would provide for more planned savings to match the need for expanded investment.

(5) Depreciation lives for similar long-lived structures should be the same: 15 years straight line depreciation for commercial, industrial and rental residential structures regardless of whether owner-occupied, investor-provided, work place, or home place. Low income rental housing needs special incentives to encourage additional construction: tax lives on these structures need to be lowered to at least 12 years for low income rental housing. (The phase-in of a five-year depreciation life for machinery and three-year depreciation life for vehicles appears appropriate and will greatly stimulate investment and productivity.)

(6) The Congress should allow current expensing of interest and taxes incurred during construction and remove the $10,000 investment interest limitation on individuals which are not imposed on corporations.

RESULTS OF RECOMMENDATIONS

If these recommendations are accepted, inflation will be lower, more jobs will be created, the average American will be ensured of more adequate food, clothing and shelter, interest rates will be lower, investment in industry and housing will be higher and countries around the world will be better off.

ATTACHMENT 1

CHANGES IN ECONOMIC OUTLOOK IN 1984
PRESIDENT'S PROGRAM PROPOSED AND LIKELY
COMPARED WITH REALTORS®' RECOMMENDATIONS

	President's Proposal		REALTORS®' Modifications
	Full Spending Cuts	Half Spending Cuts	
Real U.S. Output (GNP)	0.5%	2.1%	3.2%
Real Consumption	1.1%	2.6%	2.0%
Consumer Inflation (CPI)	Zero	0.8%	-1.8%
Mortgage Interest Rates (Percentage Points)	Zero	0.5	-2.0
Real Investment			
Non-Residential Structures	11.1%	14.0%	19.0%
Equipment	12.7%	16.0%	23.0%
New Housing:			
Starts (Units)	27,000	-164,000	500,000
1981-84	Zero	-125,000	1,950,000
Net Exports	-10.5%	-17.9%	-5.0%
Jobs	200,000	800,000	1,200,000
Productivity	0.3%	1.3%	2.0%
Average Household Income:			
Annual	$790	$1,360	$1,770
1981-84	$1,600	$3,000	$3,990

STATEMENT OF PETER SPRAGUE
CHAIRMAN, NATIONAL SEMICONDUCTOR CORPORATION
ON BEHALF OF
THE ALLIANCE FOR AMERICAN INNOVATION
BEFORE THE SENATE COMMITTEE ON FINANCE
SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT POLICY
MAY 4, 1981

Mr. Chairman:

My name is Peter Sprague, I am Chairman of the National Semiconductor Corporation, and I have been engaged during my career in starting up and turning around a number of businesses.

I am pleased to have the opportunity to testify today on behalf of the Alliance for American Innovation, a business association headquartered in San Francisco. The Alliance has two main purposes. It is a public affairs organization that represents the interests of successful American enterprises at the national level, and it is a service organization that offers a number of services to would-be innovative entrepreneurs and start-up companies. Its concern is with the leading edge, usually technology-based new ventures which hold the promise of strong growth potential.

National Semiconductor has sales of well over $1 billion. Fourteen years ago our sales were $7 million. We managed this growth largely without acquisition. One of our major sources of financing has been purchase of stock by employees. Despite our current large size, we continue to consider ourselves a highly innovative company with a heavy commitment to research and development.

I commend you, Mr. Chairman, for your initiative in holding this Subcommittee hearing to examine in detail proposals for tax law changes that are targeted to encourage capital formation and new investment. We join you in expecting that these hearings will assist the Finance Committee by exploring important current tax proposals, without diverting the full Committee's attention from the major issues of overall rate reduction and accelerated cost recovery.

I would like specifically to discuss the merits of S.889, the American Innovation and Employee Stock Ownership Act, as proposed by Senators Long, Roth, Bentsen, and Wallop.

Under this proposal, capital gains tax rates for individuals and corporations would be reduced by half for investments in certain small businesses that are in part owned by their employees and that fulfill a basic research and development requirement.

Under current law, 40 percent of long-term gain is taxable as ordinary income. The bill would create significantly more favorable treatment for qualifying investments. Under it, the deduction for individuals would be increased to 80 percent, leaving 20 percent to be taxed as ordinary income. For corporations, the alternative tax would be reduced from 28 percent to 14 percent. To qualify for this special capital gains tax treatment the investment would have to be in a small company that had diversified share ownership among its employees, and that meets a test for R&D spending.

To be considered "small", a company must have at least two of the following characteristics:

Total gross revenues of not more than $30 million;

Net worth of not more than $15 million;

Not more than 1000 employees.

To qualify under the employee ownership criterion, 25 percent or more of the non-management employees of the business must own an amount of shares equal to at least 15 percent of the total outstanding shares of the company. We define non-management personnel as all employees other than officers and members of the Board of Directors of the Company. This provision ensures that lower level managerial and support staff as well as hourly employees can benefit.

Under the bill employee ownership can be achieved in a number of ways. An employee stock ownership trust is an obvious method; but stock could also be distributed by giving shares as bonuses, selling stock to employees at concessional prices, or through employee stock options.

In addition, the corporation must have expended an average of 2.5 percent of its gross revenues on research and development for the three prior taxable years, or for the taxable year during which it has been operating if the corporation is less than three years old.

Effect on Investment in New Ventures

Entrepreneurs - particularly innovators who do not yet have a record of business success - have traditionally found obtaining investment capital the most difficult hurdle to leap in forming a new company. This situation has recently eased somewhat, in the case particularly of entrepreneurs who have a record of prior success and who are involved in high technology areas. But I believe the current great availability of risk capital for certain types of ventures will prove to be a transient phenomenon. There continues to be a need to reduce capital gains taxes in such a way as to stimulate new ventures. Traditional lending institutions are generally averse to loans to untried innovators for untried ideas. Entrepreneurs have traditionally had to turn to other sources for start-up financing.

S.889 helps address the critical problem of providing capital for new ventures by providing incentives for investors in smaller firms. And it has other important objectives.

Revenue Effect

Because of the sequence of the revenue flow of a new company, we believe the bill will result in a net positive flow of funds to the Treasury. When an investor or a group of investors first invest in a company they generally do so with the expectation that they will be unable to sell a portion of their shares in the company for several years. During this period, of course, the company has hired personnel, invested in plant and equipment and R&D, and undertaken other activities that generate tax revenues.

This economic activity must, of course, take place before the original investors can sell their shares at a profit, realize capital gain, and take advantage of the special tax treatment provided in the bill. In the interim, a chain of economic activity has occurred which will generate additional tax revenues. Thus, this bill should result in a net revenue gain to the Treasury.

In a preliminary discussion, Treasury's Office of Tax Analysis has indicated that the bill would have a very minor negative effect on revenues, perhaps in the area of $25 million.

Productivity & Employee Ownership

The provision addresses the problems of productivity and employee stock ownership in a new way. The most critical phase for a new company is its first several years. It is during this time that a company needs all the skills, creativity, ingenuity, and energy that its employees and management can muster. Productivity and innovation are the result of a team effort, with employees and management working together to make the company successful. Employee stock ownershop can be crucial to creating such dedication and motivation at this early stage of a company's existence.

We believe S.889 should help fill a void. It creates a strong new incentive for management to share ownership among employees at a time when employee motivation is most critical to the company's success. And by enabling employees to acquire stock at the outset of the company's existence, employees will be better able to realize the most appreciation in the value of the stock after the company has become successful.

A New Approach to Employee Ownership

The bill approaches the goal of employee stock ownership in a new way. Previous efforts to encourage employee stock ownership have focused primarily on ESOP's. ESOP's are a technique of corporate finance intended to encourage companies to finance their growth (or transfers in ownership) so as to share ownership with the employee group. Our proposal, however, provides an incentive for investors and management to share stock ownership in a number of ways.

By creating favorable capital gains treatment for the sale of stock in companies in which ownership has been shared with the employees, investors have a strong incentive to dilute their ownership by setting aside a block of shares for non-management employees. Thus, the investors in effect "finance" the employee ownership of shares, the Government does not.

Conclusion

Mr. Chairman, the times demand that we focus policy on promoting change-inducing innovation, in part through increased investment in newer, more innovative firms that stress research and development. These companies have been shown to be the most innovative and job-creating sector of the economy. A much-cited National Science Foundation study found that small firms are 24 times more innovative per research dollar than firms employing 10,000 or more people. In a related finding, the Commerce Department reports that innovation accounted for 45 percent of economic growth in the United States from 1929 to 1969. Finally, a study from the Massachusetts Institute of Technology found that firms with under 500 employees generated 86.7 percent of all new ideas in the United States.

It's from such companies that the industries of the 1990's and the next century will spring. Here the example of National Semiconductor is again most apt. To nourish and stimulate this sector is an important goal, one, Mr. Chairman, in which we encourage your continued interest.

Senator CHAFEE. Thank you, gentlemen.

Now we have a panel of six. Four organizations on this panel were represented at our prior hearing. As on February 24?

Let's start with Mr. Riordan and I think the national savings and loans testified last time. Excuse me.

PANEL. Yes, sir, we did.

Senator CHAFEE. All right, why don't you go ahead and in view of the fact that you testified last time, I would appreciate it if you would be as brief as possible.

Thank you.

STATEMENT OF DALE P. RIORDAN, CHIEF ECONOMIST, NATIONAL SAVINGS & LOAN LEAGUE

Mr. RIORDAN. Thank you, Mr. Chairman. My name is Dale Riordan. I am chief economist for the National Savings & Loan League. We appreciate the opportunity to again testify before this subcommittee on the need for savings incentive legislation.

These hearings come at a particularly critical time for the savings and loan industry because as you may know, last month, savings and loan associations experienced the largest outflow in net new savings in recent history—$2.3 billion in a 4-week period.

Added onto the experience in the first 2 months, this resulted in a first-quarter performance of a negative $800 million in net new savings. That compares rather unfavorably with previous periods. In 1980, it was $1.5 billion; in 1979, $10 billion in the same 3-month period; and in 1978, $7.5 billion.

Thus, it is clear to us, painfully clear in fact, that the current experience, in terms of savings, is significantly worse than previous periods have indicated.

In addition, the preliminary indications that we have and that the Federal Loan Bank Board has are that the month just passed, that is April, will be even worse than March. Therefore, the savings and loan industry is particularly sensitive to the need to increase savings incentives instead of consumption.

If we do not, then very frankly, Mr. Chairman, we in the savings and loan industry will find it very difficult to continue in our role as home finance lenders.

It is imperative, therefore, that this subcommittee and the Congress include targeted savings incentives and tax legislation passed this year. We believe this is the missing element in the Reagan program.

As you have indicated, Mr. Chairman, the National Savings and Loan League has testified before this committee on IRA accounts several months ago. That continues to be our major priority. However, the savings situation is so critical that we believe that this subcommittee may need to discuss and consider a variety of other incentives, not just IRA's, to reverse the current trends. We are pleased that you have chosen to do so.

Such a program could include supplemental IRA's, exemption from taxes for interest earned and possibly some innovative instrument like the tax-exempt housing savings certificate which I will discuss in a minute.

A number of bills have been discussed in depth early this morning, so I won't go over them, in order to be brief. S. 936, the two-stack approach, has been dealt with in depth and we share some of the concerns that Mr. Chapoton expressed, although we also think in theory that this would be a very effective bill.

One other concern is that this is not exactly the simplest approach to take and since the IRS has not shown a penchant for simplicity in the past, success of this program, we believe, would depend on a very detailed scrutiny and oversight by the Congress.

S. 155, introduced by Senator Schmitt and discussed by him this morning and similar bills——

Senator CHAFEE. I would just like to jump back for a moment. Mr. Evans of Evans Economics says that reducing the maximum tax rate from 70 to 50 would increase Treasury revenues by $3 billion. Has that figure been bantered around before?

Mr. RIORDAN. Not that particular—I believe that Mr. Evans testified before the House Ways and Means Committee approximately 1 month ago.

Senator CHAFEE. That is an incredible prediction.

Mr. RIORDAN. Mr. Evans is not known for conservative predictions.

Senator CHAFEE. As a matter of fact, statistics that were shown to us by an earlier witness show the loss of revenue to be something like $700,000. You don't know when this increase in Treasury revenue of $3 billion would occur do you?

Mr. RIORDAN. I believe the increase he is talking about would occur in the first fiscal year after it is adopted. Mr. Evans' model is a very supply side oriented model and in that respect perhaps differs somewhat from those models used by the Joint Committee for Taxation or other groups.

Senator CHAFEE. Take the specific bill.

Mr. RIORDAN. We would support S. 155 and S. 819. We find them to be better than the general flat exclusion bills simply because they have potential for a broader coverage of interest and they also deal with savings incentives at the margin and therefore, should have a greater effect in stimulating new savings.

One bill, Mr. Chairman, I would like you to consider in your deliberations over the coming weeks is one introduced recently, in fact Thursday, by Senator Boren who is a member of the Senate Finance Committee.

It is a tax-exempt savings certificate bill wherein depository institutions, savings and loans, credit unions, savings banks and commercial banks, could be allowed to offer these tax-exempt certificates for a limited 3 to 5 year maturity with the yield on these certificates tied to a Treasury index—a portion of the Treasury index, 75 percent, I believe is the number in Mr. Boren's bill.

The proceeds of these certificates would then be directed into mortgage finance and therefore, besides having the specific benefit of increasing the rate of savings, we believe it will also help to lower the current high mortgage interest rates which are now 15.5 percent and rising, not falling.

It would also help stimulate the housing industry and employment in the housing sector.

Senator CHAFEE. The punch to that would be its tax exempt status.

Mr. RIORDAN. Yes, sir. The certificate would be tax exempt.

As many witnesses have indicated this morning, the Department of Commerce and others have shown that the savings rate has fallen substantially in the last several quarters and there is no immediate prospect, we believe, that this situation will change. That seems to be what the money markets are telling us, as Mr. Ture and others have indicated, just last week in the Wall Street Journal and in other places.

Therefore, while we support the efforts of the administration and the Congress in reducing spending, it is clear that the benefits will only come over time. I submit, Mr. Chairman, that mortgage finance industry, the housing industry, and other industries who depend on the flow of capital cannot wait for those beneficial effects.

We believe something needs to be done right now to induce savings and we believe that these bills represent the articulation of that need and represent the missing elements in the President's program.

Thank you very much for your time and consideration.

Senator CHAFEE. Thank you very much, Mr. Riordan for that testimony.

[Senator Durenberger arrived.]

Senator CHAFEE. Senator Durenberger.

All right, Mr. Granados.

STATEMENT OF LUIS GRANADOS, ESOP ASSOCIATION OF AMERICA

Mr. GRANADOS. Thank you, Mr. Chairman. My name is Luis Granados. I represent the ESOP Association of America and I very much appreciate the opportunity to share our views with you today.

The ESOP Association of America is a trade association of companies with employee stock ownership plans which as the name implies are plans for providing employees of corporations with stock in the companies for which they work.

Over 4,000 American corporations have adopted some form of ESOP since 1975.

The two-stack approach of S. 936, separating labor income from capital income for tax purposes, seems to us to parallel the philosophy of the originator of the ESOP, Mr. Louis Kelso,

That philosophy involves the recognition that there really are two separate factors of production. The human factor or labor and the nonhuman factor or capital.

Kelso argues, persuasively, that capital income ought to be spread as widely throughout the economy as labor income is. Unfortunately, the ownership of capital has become highly concentrated in America.

Studies show that 1 percent of people in America own over half of all individually held capital wealth and 6 percent of the people own about three-quarters of it.

We think the Congress should be concerned with enacting tax and other laws that not only increase the Nation's capital stock and investment, but also serve to spread out the ownership of the newly created capital.

S. 936 appears to us to be an excellent method for achieving both of these objectives. That bill would permit a person's income from capital to be taxed separately from the person's income from labor so long as the person had less than $10,000 of tax preference income.

That would have the effect of greatly reducing the rate of taxation on capital income for Americans with small capital estates, thus, both enabling and encouraging millions of Americans of modest means to become owners of capital.

We believe that another important effect of S. 936 would be a healthy shift in the bargaining priorities of America's labor unions. The principal benefits unions bargain for today are wages, pensions, and other items that would fall into the category of labor income.

If S. 936 were to become law, then it would become much more attractive to bargain for income that could be characterized as capital income which would give the union members some much more favorable tax treatment. That would probably mean bargaining for more and better ESOP's.

That shift would have a very positive effect on our economy. Many studies have been done proving out the commonsense notion that employee stock ownership does improve employee productivity. The most comprehensive such study showed that when you compare firms with substantial ESOP's to similar size firms in similar industries, the profitability the ESOP firms is 50 percent higher.

The ESOP creates a commonality of purpose between workers and management somewhat similar to that enjoyed by many Japanese firms which could dramatically improve our economy.

We also support the concepts behind the bill to raise the present interest and dividend exclusion. However, we do want to bring to the attention of the subcommittee a serious problem in the present operation of that exclusion.

The ESOP is unique among all tax qualified deferred compensation plans because when an employer pays a dividend or stock held by its ESOP, the ESOP can pass that dividend through in cash to its participants. However, the Internal Revenue Code, apparently, does not call that passed through dividend a dividend to the person who receives it because he is not eligible for the $200 exclusion.

We think that if section 116 is going to be changed, then ESOP participants ought to be included into the deal.

Finally, let me add our strong endorsement to the statement of Mr. Sprague supporting Senate bill 889 cosponsored by Senator Wallop.

We think that if the capital gains rate is going to be reduced then average working people ought to be cut in on at least part of the benefits. S. 889 does that by including an employee ownership component as a requirement and we enthusiastically support it.

Thank you, Mr. Chairman.

Senator CHAFEE. Thank you, Mr. Granados for your testimony. Senator Durenberger?

All right, Mr. Morton.

STATEMENT OF DONALD F. MORTON, CHAIRMAN OF THE BOARD, ARLINGTON HEIGHTS FEDERAL SAVINGS & LOAN ASSOCIATION, ARLINGTON HEIGHTS, ILL.

Mr. MORTON. Thank you, Mr. Chairman. My name is Donald F. Morton. I am chairman of the board of Arlington Heights Federal Savings & Loan Association of Arlington Heights, Ill. I appear here, today, on behalf of the U.S. League of Savings Associations.

We appreciate this opportunity to testify on S. 936 which encourages savings through separate taxation of personal service and investment income and really all of the six bills that are providing for some exclusion from taxation for a person with interest income.

We support each of these measures since each one would encourage thrift and help rebuild capital so desperately needed to restore the health of the housing industry and noninflationary economic growth.

However, we need exclusion immediately to hold our current savings.

Because of the limited time for oral comments I would like to direct your specific attention to only the last three pages of my prepared testimony beginning on page 8.

We wish to submit a new variation to the savers incentives theme. An amendment which adds new dimensions to the tax break for savers, the objectives shared by the bills before you today. Unlike the others, our plan would not only reward depositors, but would lower the cost of credit to borrowers and it would also restore the vitality of our hard pressed institutions.

In recognition of the near-term concerns about budget deficits and revenue impact, it is carefully limited in both amount and duration.

Our proposal to exclude interest earned to $1,000 for individual taxpayers and $2,000 in a joint return on savings committed to a special 1-year account opened during the period from July 1 of this year to June 30 of 1982. This 1 year special tax exempt account would be available from banks, savings banks, credit unions, and savings and loan associations.

In recognition of the tax exempt feature, the ceiling rate for this special account might be limited to 70 percent on an index based on 1 year Treasury bills and adjusted periodically.

This would provide lower cost funds to the institution so they in turn could offer affordable rates to the borrowers. From mortgage lenders like ourselves, new borrowers could receive rates like 11 percent rather than the 15 and 16 percent we must charge today.

Because of the interplay between the $1,000–$2,000 exclusion and the indexed rate, we anticipate that this account would be of greatest appeal to middle income taxpa ., those in the brackets between 30 and 45 percent.

We estimate that as much as $180 billion in savings would be attracted at all types of regulated institutions. At our savings and loans, we expect $80 billion in lendable funds.

We are preparing a supply side analysis to compare static revenue forgone by the Treasury with revenue gained from the rejuvenated housing sector.

It should be finished within a week or two and will be forwarded immediately to your subcommittee.

Now, incidentally, such a plan would enable our institutions to contribute tax revenues to the Treasury this year, rather than claim lost carrybacks and refunds from the Treasury.

Our proposal would provide stability for a financial system. It would give us a competitive tool immediately to challenge the money market and mutual funds without escalating our operating costs. It could remove the much publicized possibility of special Federal assistance to the ailing thrift industry.

The one term on the account provides true capital formation, not the temporary parking of hot money which turns investment uses of questionable long-term benefit for economy.

We ask your careful consideration of this plan for a 1-year program, providing 1-year savings accounts with tax exclusion of the depository institution.

On behalf of the U.S. League, I welcome the opportunity. Thank you very much.

Senator CHAFEE. Thank you, Mr. Morton. I appreciate what the thrifts are going through. I must say this is what you call a targeted piece of legislation if I have ever seen it.

What happens at the end of the year?

Mr. MORTON. It seems to me, Mr. Chairman, that the results during that year would be terribly important in order to answer that question. Maybe Congress will want to extend it, but maybe it would provide the relief until the rate of inflation comes down and rates come down of their own accord. That, of course, is the ultimate relief we need.

Senator CHAFEE. Frankly, I just don't understand how these thrifts are surviving this outflow of funds.

Senator Durenberger.

Senator DURENBERGER. Your proposal—I know you have abbreviated the presentation—does not target the loans as some that we have heard about. In other words, what do you do with your money as a condition for the rate break?

Mr. MORTON. That is correct. Our proposal——

Senator DURENBERGER. Would you comment briefly if that is correct then on some of the problems that you would see with regard to the proposals that would target your lending as in housing, for example.

Mr. MORTON. Yes, sir. There are two sections to your question, in my opinion. First of all, capital formation generally, not just for the housing industry—we have proposed this to be capital formation for the economy in general, not just housing. Many bills do relate to use of the money for housing purposes only.

As to targeting a program of any kind, specifically for our institutions to make loans on houses only with that money, it seems me to raise a problem.

Maybe it is a discrimination problem. If we can raise, let's just say in my association $1 million in the month of May, and I take applications for loans for that $1 million and the next person comes in am I to say to that next person I am sorry the fund has run out and your rate has to be 15 or 17 percent because that money has disappeared.

I think if we concentrate on raising capital in total without specifically targeting, the overall economy would do a better job.

Thank you very much.

Senator CHAFEE. Thank you, Mr. Morton.

Mr. Jones.

Senator DURENBERGER. Mr. Chairman, if I may just briefly interrupt before Scott speaks. I know you are very familiar with Minnesota but I wanted to indicate to you that one of the reasons Scott is here is that Red Wing, Minn., is one of the oldest communities in our State and yet it is probably one that has done the best over the years in thriving in adversity.

It is an old river town. It is served by a variety of transportation and therefore knows the problems of inadequate transportation. It is an agricultural center and if I had to choose the community and a representative of the community to talk of the problems for which you have called this hearing, at least in my State and maybe representative nationally, we could not find a more typical community.

It makes a lot out of a little and whatever Scott has to say, it is not just by way of complaint about the economy. I think it is a realistic appraisal of what we ought to be doing with regard to the tax code in particular.

Senator CHAFEE. Well, Mr. Jones with that warm introduction why don't you proceed?

STATEMENT OF SCOTT JONES, PRESIDENT, GOODHUE COUNTY NATIONAL BANK, RED WING, MINN.

Mr. JONES. Thank you, Senator Durenberger and Mr. Chairman.

I am Scott Jones, president of the Goodhue County National Bank in Red Wing, Minn., an independent community-sized bank.

I am pleased to be before you this morning to discuss S. 330, a bill which addresses the important question of how can Government encourage individuals to save money when inflation which has been termed the cruelest tax of all is running in the neighborhood of 10 percent and when current tax laws reward consumption and penalize savings.

In an inflationary economy there is no incentive for the American public to save or accumulate capital. Nontraditional investment opportunities, such as gold or diamonds, attract what little investable money there is into the areas that do not bolster the American economy, nor create jobs for the American people.

On the other hand, investments in savings deposits of America's financial institutions make more money available for large businesses, small businesses, farmers, housing, and the rest of the productive side of the Nation's economy.

In 1979, the Federal income tax burden on the individual taxpayer, exclusive of social security, was 15.6 percent of personal income.

In 1979, then, the average return after Federal income taxes on a 5.25 percent savings account, was only 4.431 percent. That is not too enticing when we consider that inflation was running at 13.1 percent by the end of 1979.

The point is that as inflation and taxes increase, incentives for people to save decrease. Passage of S. 330 will help provide the necessary incentives for savers to attract savings deposits necessary to stimulate this productive side of our economy.

I will not get into part of my testimony that deals with figures that have already been referred to, only to amplify, Mr. Chairman, your earlier comment about the savings rate in the United States.

This week's Business Week does indicate that through the end of the first quarter, on an annualized basis, the annual savings rate in the United States is 4.7 percent which still stands considerably lower than that of other western industrialized nations, such as West Germany and Japan.

Now, I would like to turn to a smaller scale analysis of the problem which is Red Wing, Minn. At the end of 1980, total savings and time deposits of the three Red Wing banks totaled $68,870,000. The population of Red Wing is approximately 15,000 people, thereby, creating an average savings deposit of approximately $4,600 per capita.

Presume for a moment that S. 330 is passed into law. If each savings deposit were to increase 10 percent or approximately $460, that would translate to $6,900,000 of additional money available for investment into businesses, farms, and the housing industry in Red Wing, Minn.

To those of you who are used to dealing in billions of dollars, that may not sound too significant, but in Red Wing, Minn., it is truly remarkable.

Because of inflation and the resulting high rates of interest, the savings growth of Red Wing's banks has been virtually nonexistent.

For the year ended March 31, 1981, regular savings deposits at our bank decreased $1,585,000. I do not have to tell you what that does to our ability to supply needed capital to businesses, farms, and the housing industry in Red Wing.

Finally, you gentlemen are also currently considering President Reagan's economic proposal. One of the major principals of the President's plan is that the tax cut that you are contemplating will be put into savings accounts by the American people.

Savings incentives encompassed in S. 330 will help create a climate in which people will save, not only their tax cut, but additional dollars as well.

The progression of events seems clear. Incentives to savers leads to more dollars saved, which leads to more money invested in business, agriculture and housing which leads to a stronger economy and more jobs for our people.

I urge you to support S. 330.

Senator CHAFEE. Thank you very much, Mr. Jones, for this good picture of what the actual effect would be on one town.

Senator Durenberger?

Senator DURENBERGER. One question, Scott. I think it was Mr. Granados who earlier made the excellent point about the need to spread the ownership apple in this country.

When we introduced the $200–$400 bill last year and when we were doing the windfall profit tax, we heard the same thing from the IRS that I understand we heard this morning.

That is, that, a bill like S. 330 only rewards people who are already saving and doesn't provide much of an incentive for new savings. I wonder if you would comment, from your perspective on the value of a flat exclusion such as we are proposing in S. 330 in contrast to the argument made by IRS.

Mr. JONES. Well, Senator, I do not believe that the only people that will benefit from a flat exclusion will be those who are already saving.

I think as we have seen in our bank in Red Wing, we have lots of people today that are not saving when they were saving a year ago, 2 years ago, whatever, because of nontraditional forms of investment.

The savings outflow at the Goodhue County National Bank, for example, typifies this sort of drainage of savings, not only in the banking industry, but for savings and loans associations as well.

If there were incentives for people to save in the form of a flat exclusion, I believe strongly that it would bring new savings dollars back into the banking community creating more capital and ultimately, I think, certainly for small businesses in our community, lowering the rate of interest that we would have to charge them.

Senator DURENBERGER. Thank you very much.

Senator CHAFEE. Your suggestion is to juggle up to $1,250 to $2,500. If you are not seeing more savings with the $200-$400, why would you see more savings with the $1,250-$2,500?

Mr. JONES. I think there are two reasons, Mr. Chairman. One, I don't think is as important as the other. The one you allude to is that the existing tax exclusion is not well known, I think in part is true.

Senator CHAFEE. Do you actually charge that in your bank now, starting the first of the year? Frankly, we passed it last year and I looked at my return this year and thought it was effective. I was chagrined to find out that it isn't.

Mr. JONES. You will have to speak to Senator Durenberger about that.

Senator CHAFEE. Are people making plans and ready to benefit from this?

Mr. JONES. I think so, Senator. I think the more important point is though the amount of exclusion standing at $200 for an individual taxpayer equates on a 5-percent basis to about $4,000 of savings.

In our particular community, as I have mentioned in my testimony, the average savings account per capita is $4,600. I believe that that figure would be much higher than that, the average savings deposit per capita, if the exclusion were higher.

There is no incentive for people to bring money into savings accounts beyond the $4,000 limit because there is no benefit to do so. You are falling behind by doing it.

Senator CHAFEE. Thank you very much. We appreciate your being here.

Mr. JONES. Thank you.

Senator CHAFEE. Mr. Hutchinson.

STATEMENT OF JOHN J. HUTCHINSON, PRESIDENT, NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS

Mr. HUTCHINSON. Thank you, Mr. Chairman.

Mr. Chairman, Senator Durenberger, I am John J. Hutchinson, president of the National Association of Federal Credit Unions and also general manager of the Hamilton Standard Federal Credit Union in Windsor Locks, Conn.

There are 12,716 Federal credit unions throughout the country whose 25.9 million members hold more than $36.5 billion in savings.

I appreciate the opportunity to appear before you today, as you consider savings incentive proposals. Each of the bills before this subcommittee, today, attempts to meet these important goals.

Seven of these proposals would expand or make permanent the partial tax incentive for savers already provided in Public Law 96-223, S. 142, and S. 492. We firmly support the concept of providing a tax exclusion for interest and/or dividends. The increase in the exclusion is certainly one more step in the right direction.

Likewise, S. 330 and S. 243, introduced by Senator Chafee, chairman of this subcommittee, which would create a new source of savings by opening individual retirement accounts to the wage earner.

This would provide and stimulate long-term stable saving while encouraging consumers to save for their retirement.

It is the position of the National Association of Federal Credit Unions, as well as my own personal conviction, that such actions by the Congress would be noninflationary, encourage savings, assist in capital formation, and provide the added benefit of easing pressure on the social security system by allowing more long-term consumer savings.

S. 155, S. 936, likewise, we support in concept. I will not comment orally on S. 75, S. 145, S. 141, or S. 457 since they deal primarily with business investment incentives not directly relevant to credit union members.

Each of the bills mentioned has much to recommend it and each parallels the goal of our association which recognizes the need for the trend reversal of the savings pattern of American consumers.

We support the administration in its effort to provide tax cuts. Simultaneously, however, we urge Congress to enact incentives for savings so that the tax cuts do not result in further inflation.

We, therefore, endorse prompt action by Congress to expand and make permanent the tax exclusion for interest and/or dividends.

In addition, we strongly urge the expansion of eligibility criteria for individual retirement accounts as we see this as a most effective incentive to new savings.

The exclusion for interest and/or dividends will reward those who are already saving, but the IRA legislation would avail 60 million more workers a new opportunity and we believe, open a whole new source of savings deposits.

Mr. Chairman, I might just insert here—there was an article in the Hartford Current, yesterday and I take no pride of authorship of this, they are talking about the shift of funds from money market away from the savers.

According to the investment company institute an investor of the 30-percent income tax bracket, assuming an inflation rate of 11 percent, who invested in a 5-percent savings account, gets a real rate return of −7 percent.

I thank the subcommittee for the opportunity to appear. I will be pleased to answer any questions you might have.

Senator CHAFEE. Thank you, Mr. Hutchinson. I appreciate your testimony. We heard from the Federal Credit Unions on February 24. Senator Durenberger?

Senator DURENBERGER. As I understood your abbreviated testimony, you seem to be saying that if we can only invade the present tax revenues by so much, you would rather go the IRA route than some of the other suggestions that have been made by various Senators. Is that correct?

Mr. HUTCHINSON. We are in favor of both the tax incentive on savings, of course, and we do endorse the IRA concept. We feel that that will be a source of new funds in the credit unions.

Senator DURENBERGER. Which of the tax incentives on savings do you prefer?

Mr. HUTCHINSON. We were referring you to the expansion, in particular, of the exemption on the taxation of the dividends. We feel that $200-$400 could be expanded to a higher amount and at that the $200-$400 should also be made permanent.

Senator DURENBERGER. Then I did not hear you correctly when you said that expanding the exclusion was a reward for existing savers.

Mr. HUTCHINSON. That is correct; the greater benefit would come from IRA expansion.

Senator DURENBERGER. Thank you very much.

Mr. HUTCHINSON. Thank you, Senator.

Senator CHAFEE. Thank you. Mr. Hoyle.

Mr. HOYLE. Thank you, Senator. We testified also in February. I have curtailed my statement. I have that economic study of Mr. Evans, if you would like it for the committee.

Senator CHAFEE. Yes, I would be interested in that.

[Study of Mr. Evans submitted.]

TESTIMONY BY MICHAEL K. EVANS, EVANS ECONOMICS, INC.

For the third straight year in a row, the inflation rate in this country will remain in the double-digit range. Meanwhile productivity growth has all but ground to a halt, with a miniscule increase of only 0.5 percent per year since 1973. The personal saving rate continues to decline, sliding under 4 percent in February for the first time in over 30 years.

Clearly there s a close correlation between all these factors, as many witnesses have testified before this Committee. It is no accident that of the 11 major industrialized countries of the world, the U.S. has the lowest national saving rate and the slowest growth in productivity. Nor does it come as a shock any more when statistics show that the U.S. is now only sixth in per capita income, instead of the first place rung we used to occupy.

Since these facts have been recited so frequently in the recent past, we dwell not on the statistics but on the methods for raising the rate of personal saving. While several methods have been suggested, budget considerations also loom large. A bill that would increase personal saving but raise the public sector deficit by an even larger amount is not one which will be received by the Congress with a great deal of enthusiasm. Similarly, any tax reduction which purports to encourage saving should result in an actual increase in new saving and not merely serve as a reward to those who have already saved and are now earning interest and dividend income.

Several such bills have recently been analyzed and submitted for possible legislation this year. These include the immediate reduction at the maximum tax rate from 70 percent to 50 percent—a move which would increase saving by $9 billion while actually increasing Treasury receipts by $3 billion per year—and the decoupling of the tax tables for wage and nonwage income. Today, however, I would like to focus attention on a very powerful and efficacious method of increasing personal saving, which is by enlarging the size and scope of Individual Retirement Accounts (IRAs). In particular we have analyzed H.R. 1250, better known as the Saving and Retirement Income Incentive Act of 1981. My comments will focus primarily on the expansion of IRAs rather than the increase in the dividend and interest exclusion from $500 to $1,000 for taxpayers aged 65 and older.

The main features and benefits of H.R. 1250 are as follows. First, with the exception of the increased exemption for those over 65, taxes will be reduced only for those who save more. Second, the plan is broad-based, encompassing all employees whether upper, middle, or lower income. Third, it redresses a previous imbalance which prohibited an employee from starting an IRA if he was employed by a firm which had its own pension plan, even if the employee did not like that pension plan or was not even covered by it. Fourth, for every $1 billion in lost Treasury revenues, personal saving will increase by $4.7 billion, an unusually high ratio.

The major features of this bill which we consider are as follows:

1. Make IRAs available to all employees, not just those who are not currently covered by a pension plan.

2. Enlarge the maximum amount of tax-deductible contribution from $1,500 to $2,000 per year.

3. Permit an additional non-deductible contribution of $2,000 per year plus an additional $8,000 over the employee's lifetime.

Our first task is to calculate the amount of additional saving which will be generated by these three features, and the amount of static revenue loss to the Treasury; that is, before considering the gains in revenue from a more buoyant economy.

First, we need to know how many people currently subscribe to IRAs, and how much they pay. Figures are not available for 1980, but we do have preliminary IRS estimates for 1979. These show that 2.47 million tax returns included deductions for an IRA, with an aggregate amount of $3.22 billion, or an average payment of $1,304. It should be noted that in the upper-income brackets the average IRA per tax return is over $1,500, indicating that in some cases both husband and wife have set up IRAs.

According to several estimates, approximately 30 million taxpayers are eligible to set up IRAs. At present, approximately 2.5 million of them have taken advantage of this part of the tax code, or about 8.3 percent.

At present the number of employees in the U.S.—excluding self-employed but including government workers—is approximately 90 million. Thus if IRAs were to be made available to all employees, that would triple the number of eligible taxpayers.

In our calculations we have assumed that the same proportion of taxpayers would take advantage of the plan as is now the case. Hence the number of IRAs would triple, from 2.5 to 7.5 million. The increase in saving, assuming that the size of the average IRA remained unchanged at $1,304, would be $6.5 billion.

If the maximum size of an IRA were increased by one-third, we assume that the average size would also increase by one-third, or from $1,304 to $1,739. For those who already have IRAs, this would represent an increase in saving of $435 × 2.5 million, or $1.1 billion. In addition, this higher ceiling benefit would also be available to all those starting IRAs for the first time. Since there are assumed to be twice as many new beneficiaries as old ones, the total increase in saving due to the rise from $1,500 to $2,000 maximum per IRA would total $3.3 billion.

We now come to the problem of how much saving would be increased by the nondeductible portion of the expansion in IRAs. In this case we cannot work from existing numbers, since all IRA contributions have heretofore been deductible.

The principal assumption we have used in this part of the study is that taxpayers will value this new expansion of IRAs proportionately to the tax benefits which it brings. Suppose someone is in the 50 percent tax bracket, and saves $1,500 through an IRA in a debt instrument with an interest rate of 12 percent. His tax-free income from this source is $180 per year.

Now let us assume that the interest is tax deferred, but not the principal. On the same pre-tax basis, he would be left with only $750 to invest after taxes, since he is in the 50 percent tax bracket. The IRA would be only half as valuable.

Thus we assume that this investor would only invest half as much of that $2,000 per year or $10,000 maximum lifetime contribution to an IRA, providing he was in the 50 percent tax bracket. It he were in the 30 percent tax bracket, it is assumed that he would invest 70 percent as much, and so on.

TABLE 1

Size of adjusted gross income	Payments to an individual retirement arrangement: Number of returns	Payments to an individual retirement arrangement: Amount	Marginal tax rate for that income class	Estimated amount of IRA if principal were nondeductible
All returns, total	2,467,265	$3,223,565		
No adjusted gross income	3,411	2,923		$2,423
$1 but under $1,000	555	809		809
$1,000 but under $2,000	2,791	2,915		2,915
$2,000 but under $3,000	4,977	2,448	0.14	2,105
$3,000 but under $4,000	9,449	5,340	0.15	4,539
$4,000 but under $5,000	11,618	5,085	0.15	4,322
$5,000 but under $6,000	18,111	10,112	0.16	8,494
$6,000 but under $7,000	32,087	20,154	0.17	16,728
$7,000 but under $8,000	23,929	18,723	0.19	15,166
$8,000 but under $9,000	33,371	27,362	0.19	22,163
$9,000 but under $10,000	50,081	46,248	0.19	37,461
$10,000 but under $11,000	39,748	36,747	0.22	28,663
$11,000 but under $12,000	55,617	60,113	0.22	46,888
$12,000 but under $13,000	60,840	64,315	0.22	50,166
$13,000 but under $14,000	49,701	53,525	0.22	41,749
$14,000 but under $15,000	60,276	67,409	0.22	52,579
$15,000 but under $16,000	54,403	62,272	0.25	46,704
$16,000 but under $17,000	69,014	88,413	0.25	66,310
$17,000 but under $18,000	53,014	61,325	0.25	45,994
$18,000 but under $19,000	52,789	63,630	0.25	47,723
$19,000 but under $20,000	75,388	94,582	0.25	70,936
$20,000 but under $25,000	327,043	402,866	0.28	290,064
$25,000 but under $30,000	310,709	409,494	0.32	278,456
$30,000 but under $40,000	485,034	671,364	0.37	422,959
$40,000 but under $50,000	251,403	388,344	0.44	217,473
$50,000 but under $75,000	214,118	348,549	0.50	174,275
$75,000 but under $100,000	61,515	106,326	0.55	47,397
$100,000 but under $200,000	46,952	84,772	0.60	33,909
$200,000 but under $500,000	8,271	15,464	0.62	5,876
$500,000 but under $1,000,000	834	1,546	0.63	572
$1,000,000 or more	216	388	0.65	136

In order to calculate the amount of saving which would be generated by this nondeductible IRA, we need to have figures on investment in IRAs by income class and tax bracket. Fortunately, the IRS has provided some preliminary figures for 1979 to us for purposes of this study, and these figures, together with some of our own calculations, are given in Table 1. After doing the arithmetic, we find that the average marginal tax rate for those investing in IRAs is 35 percent. According to our logic, that means that the nondeductible contributions for the IRA will be 65 percent of the deductible contributions.

We now translate that figure into the actual amount saved. We have a total number of 7.5 million taxpayers who probably would invest in IRAs after the enabling legislation to make them available to all employees. The average amount investment would be $1,741 × 65 percent, or $1,132, where the $1,741 figure is the average IRA under the statutory maximum limit of $2,000. Thus the total saving is equal to $1,132 × 7.5 million, or $8.5 billion.

Thus the total increase in saving due to expansion of the coverage of IRAs as given in H.R. 1250 is as follows:

$6.5 billion—making IRAs available to all employees;

$3.3 billion—raising the maximum amount deductible from $1,500 to $2,000 per year;

$8.5 billion—adding a nondeductible contribution not to exceed $2,000 per year or $10,000 over the employee's lifetime; and

$18.3 billion—total increase in saving.

We now turn to the question of the static revenue loss to the Treasury from the expansion of this bill. However, that calculation is quite straight-forward, since we have already calculated that the average marginal tax rate for those investing in IRAs is 35 percent. The deductible portion of the increase in IRAs, as calculated above, comes to $9.8 billion. Multiplying that by 0.35 yields a static revenue loss of $3.4 billion.

In addition to that we must also include the fact that all the interest and dividend income generated in the expanded IRAs is tax-deferred. We assume an average yield of 8 percent as representing a weighted average of the yield on stocks and debt instruments. This part of the tax loss would be $18.3 × 0.08 × 0.35, or an additional $0.5 billion per year. Hence the total static revenue loss would be $3.9 billion per year.

We now take these estimates of the increase in saving and the revenue loss to the Treasury and use them as inputs to the Evans Economics macro model in order to determine the effect of this plan on economic growth, total saving, productivity, inflation and employment over the next five years. These results are summarized in Table 2.

In the short run, an increase in IRAs means that consumers save more, and hence spend less, for any given level of income. Thus the initial effect of the increase in IRAs is to reduce consumption and GNP.

In a standard demand-side model, that would be the end of the story. Consumption would be lower, GNP and employment would also diminish, and the economy would apparently be worse off.

That is not what happens in the real world, since the saving is eventually channelled into investment in plant and equipment and in housing. However, this linkage does not happen overnight, and in general takes two to three years before the increase in personal saving is fully translated into higher investment.

TABLE 2

	1981	1982	1983	1984	1985
Real GNP, billions of 1981 dollars:					
Baseline	2,949	3,094	3,242	3,368	3,483
Higher IRA's	2,946	3,080	3,223	3,367	3,506
Difference	−3	−14	−19	−1	23
Real GNP, annual percent increase:					
Baseline	2.7	4.9	4.8	3.9	3.4
Higher IRA's	2.6	4.5	4.6	4.5	4.1
Difference	−0.1	−0.4	−0.2	0.6	0.7
Employment, millions, total nonfarm:					
Baseline	92.9	96.8	100.5	103.2	105.9
Higher IRA's	92.9	96.6	100.1	103.1	106.3
Difference	0.0	−0.2	−0.4	−0.1	0.4
Consumer price index, percent change:					
Baseline	10.4	9.5	9.5	8.5	7.9
Higher IRA's	10.4	9.5	9.4	8.4	7.8
Difference	0.0	0.0	−0.1	−0.1	−0.1
Federal budget surplus or deficit, billions of current dollars:					
Baseline	−37	−28	−15	−3	2
Higher IRA's	−42	−38	−27	−9	6
Difference	−5	−10	−12	−6	4

Once this does happen, we have an increase in real GNP and employment and also a slightly lower rate of inflation. The increase in the value of the capital stock leads to higher productivity, which reduces the growth in prices.

We thus find that the growth in real GNP and employment are initially lower under the expanded IRAs than would otherwise be the case. However, this pattern begins to reverse by 1983 and real growth is higher in 1984 and 1985. By the end of the five year period, real GNP is $23 billion higher in 1981 dollars, employment has been increased by 400,000, and the rate of inflation is slightly lower. Furthermore, the Federal budget shows a slightly larger surplus in spite of the $4 billion reduction in taxes because of the faster growth of the economy.

The simulations of the EEI macro model point out two important relationships. First, an increase in saving and a decrease in consumption will increase GNP in the longer run by raising investment, increasing productivity and lowering the rate of inflation. Second, these changes do not occur overnight, and for the first two to three years real growth in GNP will be slightly lower.

It should be stressed that unlike most tax cuts, H.R. 1250 impacts only on saving and does not provide any initial stimulus whatsoever to consumption. It thus differs from an across-the-board tax cut, where some increase in both consumption and saving would initially be expected. However, in the case of expanded IRAs, consumers are eligible for a lower tax rate only if they save more and spend less. For this reason the beneficial results from the tax cut take longer to develop.

However, by the end of a five year period, the economy is in better shape on all counts. Real growth and employment are higher, inflation is lower, and the Federal budget shows a slightly larger surplus. For this reason it seems eminently reasonable to forego some short-term losses in order to generate much larger long-term gains.

Senator CHAFEE. Thank you.

STATEMENT OF KARL HOYLE, VICE PRESIDENT AND DEPUTY DIRECTOR, GOVERNMENTAL AFFAIRS DIVISION, CREDIT UNION NATIONAL ASSOCIATION, INC.

Mr. HOYLE. Mr. Chairman and members of the subcommittee, my name is Karl Hoyle. I am vice president and deputy director of the Credit Union National Association's Governmental Affairs Division.

For some 3 years now, CUNA has worked closely with Members of both the Senate and House and their staffs in an effort to bring about legislation to encourage savings and to discourage the inflationary mentality that calls for spending now and paying back later with cheaper dollars.

Encouraging savings produces capital formation and results in economic growth and when, and I stress when coupled with cuts in Federal spending, it will help exorcise the inflationary demon from the Nation's economic soul.

The initial revenue loss to the Treasury that would result from such savings incentive programs, would be substantially offset by increased revenues generated by real economic growth.

There are other reasons too, for moving ahead with the savings incentive program now. Today, the Nation's thrift institutions are hemorrhaging. Thrifts, which still provide the bulk of America's home loans, are suffering from a variety of maladies.

A good deal of what ails thrifts is due to the recent demise of savings rate controls, the high cost of competition between the private and public sectors for savings, the advent of high yield savings instruments being offered by nondepository, financial intermediaries, and perhaps, most importantly, increased sophistication on the part of the American saving public.

Credit unions, too, have suffered from the new competition but they did not suffer as greatly as the thrifts. Perhaps it was because of their consumer nature or perhaps it was due to the fact that their portfolios turn over more rapidly than other financial institutions. Credit unions have managed to level off from last year's earnings and liquidity nosedive.

A major problem of the thrifts and in many ways, all depository institutions, is competition from the high-yield money market mutual funds for savers' dollars. These high-yield funds currently top $120 billion and are the apples of some 6 million depositors' eyes, so by popular acclaim, it appears, they are here to stay.

How do you spell relief? TIFS, Senator. Tax incentive for savers is one way. We believe providing financial institutions with a variety of means to encourage savings will help all financial institutions as well as the people who save in them and the Nation.

This is one reason CUNA believes it is essential that Congress include savings incentive measures in the first tax package passed this year.

It is also for this reason that we support the thrust embodied in the legislative proposals before us today.

Further, it is CUNA's opinion that in order to provide a long- as well as short-term solution to the savings problem that expansion of IRA programs be coupled with a tax exclusion on interest earned and be part of any tax package passed this year.

It has been estimated, by Mr. Evans, Senator, that even a modest tax exclusion coupled with an IRA program could boost the Nation's savings by some $20 billion.

The other reason, Senator, for providing a tax incentive to American public in the first tax bill passed this year has to do with perception.

Even though the benefits may not take effect until January 1, 1982, such action could be a sign to the American people of Congress commitment to heal the economy. The passage of meaningful incentives now would result in an increase in savings at all financial institutions, in our opinion, even before such congressionally mandated tax benefits became effective.

Mr. Chairman, that concludes my remarks.

Senator CHAFEE. Thank you, Mr. Hoyle. As I understand, you support the Chafee bill and the Durenberger bill.

Mr. HOYLE. Absolutely, Mr. Chairman and Mr. Durenberger.

Senator CHAFEE. I would like to get back to the point I was asking earlier. That is, here we have this tremendous outflow, we provide the $200-$400 which is exempt from income tax, and yet either people don't know about it or it isn't effective. Why will more of the same do more good? On page 5 of your testimony you support expansion of IRA's coupled with the tax exclusion on interest earned.

We are not getting anywhere with the tax exclusions of the interest.

Mr. HOYLE. Mr. Chairman, I think part of it has to do with the fact that is not widely known. The program has not been widely publicized.

Senator CHAFEE. Who is better acquainted to let it be known than you folks?

Mr. HOYLE. We have through our publications. I think again to get back to this feeling of perception, we are looking at budget cuts and we are looking at increasing the savings incentives. I think the two have to go hand in hand and I think probably what happened in November indicates that the American people are willing to really say, yes, these things are meaningful. We should take advantage of them. We should do something about it.

I don't think that has happened perhaps, to a certain degree, because of cynicism about things like inflation.

Senator DURENBERGER. I would add, Mr. Chairman, cynicism about the $200-$400. None of us were comfortable with the figures $200-$400. It was all we get. What we were doing was buying a first breakthrough in recognizing the fact that we have got to stop taxing savings and dividends the way we do in this country.

What happened out there was that editorially—I know in my State and nationally, we were laughed at because of the $200–$400. No one, editorially, made the point to the American people that this was a major breakthrough in changing this country from a tax goal that penalizes earnings and rewards consumption. That might be part of the problem that everybody has with giving you some proof that it is working.

Senator CHAFEE. Also, you can be in the money markets and get the $200–$400. I suppose that is a substantial reason, too.

Mr. HOYLE. I think too, Senator, that was largely, as the Senator pointed out, a matter of the media and perhaps the public not understanding, or perhaps misinterpreting political reality.

We did the best we could last year. We are attempting to do better this year.

Senator CHAFEE. Well, thank you very much, Mr. Hoyle. Senator Durenberger do you want to add anything?

Mr. HUTCHINSON. Mr. Chairman, can I just make two comments?

I think two things happened in my opinion on the $200–$400. The first one was it was not made effective immediately. I think the fact that it was delayed down the road was counterproductive.

The second thing is, I don't think that we and the institutions that were charged with responsibility of advising our people did the job we should have done. I think we are going to go out and correct that.

Senator CHAFEE. Yes, you may advise them, but the people know they can go put money in the money markets and get a lot more and still can get the exclusion.

Mr. HUTCHINSON. That is true. We will get a percentage of them, hopefully.

[The prepared statements of the preceding panel follow:]

Testimony of
Dale P. Riordan
on behalf of the
National Savings and Loan League
on Savings Incentives Legislation
before the
Subcommittee on Savings, Pensions and
Investment Policy
Committee on Finance
United States Senate
May 4, 1981

Mr. Chairman, members of the subcommittee, my name is Dale P. Riordan. I am Chief Economist and Director of Economic Analysis for the National Savings and Loan League.

The National League appreciates the opportunity to present its views on the need for enactment of savings incentives legislation. These hearings come at a particularly critical time. Last month, savings and loan associations experienced the biggest outflow of net new savings in recent history. The $2.3 billion outflow in March resulted in a first quarter performance of a negative $800 million in net new savings. This compares to $1.55 billion in the first quarter of 1980, $10.1 billion in the first quarter of 1979, and $7.5 billion in the first quarter of 1978. Thus, it is clear that the current experience is significantly lower than the previous period. In addition, preliminary indications are that the month just passed--April--will be as bad as March. Unless action is taken to control inflation and to increase incentives for savings instead of consumption, we in the savings and loan business will be unable to continue our role as home finance lenders. Since we are the primary source of home finance in this country, this would mean that housing opportunities would be denied to many Americans.

It is imperative, therefore, that this Committee and the Congress include targeted savings incentives in tax legislation passed this year. We cannot wait. Nor can those activities, such as capital investment and homebuilding, continue to operate in the way they have if there is not an adequate pool of capital to tap.

Many bills have been introduced which propose a variety of mechanisms to stimulate savings. The National League appeared before this subcommittee in February of this year in support of expansion of the individual retirement account (IRA). The IRA is an extremely important vehicle whose expansion would stimulate savings while giving added benefits of allowing people to provide for their security in retirement. Recent work done by the Urban Institute, Professor Michael Boskin of Stanford University, and Evans Economics, Inc. has demonstrated this. For instance, Professor Boskin estimates that expanded IRA authority would induce an additional $18 billion in savings, which represents nearly 30% of personal savings based on 1976 savings levels, a robust savings year. Michael Evans comes up with a similar estimate.

The savings situation, however, is so critical that we believe you may need a variety of incentives to reverse the current trend of dissavings. We are pleased that this subcommittee has chosen to examine additional tax incentive legislation.

A multi-faceted approach to this problem may indeed be in order if we are to overcome the current bias in our tax code which has taught people that it is better to spend than to save in an inflationary economy. These expectations will not easily be reversed, and it will likely take sustained lower levels of inflation to accomplish this reversal.

We, therefore, urge this subcommittee to consider enactment of a program to give the widest options to the individual saver so that he or she will be encouraged to increase savings no matter what the individual circumstance. Such a program could include supplemental IRAs, exemption from taxes for interest earned and possibly some innovative tool like the tax-exempt housing savings certificate. This program would provide the options that meet the needs of the young and the old, families as well as individuals, and the wealthy and the not so wealthy.

I would now like to turn to the specific legislation under consideration today. In general, all of the bills represent a positive approach to the stimulation of savings.

S. 936

S. 936 introduced by Senators Roth, Bentsen and Kasten represents an innovative approach to taxation of savings. Decreasing the marginal tax rate on investment income should, according to all evidence, increase savings. By allowing investment income to be taxed as a separate entity, savings become more valuable than under the current method. Mr. Evans of Evans Economics, Inc. estimates that reducing the maximum tax rate from 70% to 50% would increase savings by $9 billion and would actually increase Treasury revenues by $3 billion per year.

The only concern I would have is whether such a system would be too complicated and, therefore, not understood by the public. It would be imperative that the system be simply and clearly constructed in its implementation by the Internal Revenue Service. As the IRS has not shown a penchant for simplicity in the past, success of this program would depend on detailed scrutiny and oversight by the Congress.

S. 155 and S. 819

S. 155 introduced by Senator Schmitt and S. 819 introduced by Senators Nunn and Huddleston provide continuation of the current $200/$400 base exclusion and/or additional percentage exclusions of 25% or 30%. These bills are attractive because they have the potential for covering more savings while assuring that the small saver will still benefit from the $200/$400 exclusion. These bills might be preferable to a flat exclusion because of the potential for broader coverage of interest and dividends earned. They, therefore, should have a greater effect in stimulating new savings.

S. 142, S. 330 and S. 492

S. 142 introduced by Senator Bentsen, S. 330 introduced by Senators Durenberger and Boren and S. 492 introduced by Senator D'Amato provide flat exclusion amounts for interest and dividend income. All of these bills provide the minimum exclusion of at least $1000/$2000 we believe necessary to truly stimulate savings. While the other approaches might be preferable because their potential for producing increased savings is greater, these three bills would be a vast improvement over current law.

Tax Exempt Housing Certificate

I would like to offer an additional idea for the subcommittee's consideration which is specifically oriented toward housing. This would be a tax-exempt savings certificate for housing similar in concept to S. 1072 introduced by Senator Boren. Depository institutions could be allowed to offer such certificates for a limited maturity, perhaps three to five years. The maximum yield which could be offered would be tied to a specific index, such as 75% of the Treasury 3- or 5-year rate. The proceeds of these certificates would then be directed to mortgage loans. This certificate would have specific benefits in addition to increasing the rate of savings. It would help to lower the current high mortgage interest rates, helping to bring homeownership within the grasp of more families, especially first-time buying young families. It would also stimulate the home building and construction industries, increasing employment and productive capacity with concomitant increases in tax revenues. Finally, it would provide a mechanism to assure continued viability of certain regulated depository institutions in these difficult economic times. We would urge the subcommittee to explore this idea and give it full consideration in the coming weeks.

The National Savings and Loan League has been, and continues to be, seriously concerned about the low rate of savings in our economy. The U.S. Department of Commerce recently reported that it has fallen to 4.7% of personal disposable income in the first quarter of 1981, a very low figure compared to previous years. There is no immediate prospect that this situation will change, unless inflation subsides quickly and substantially. While we support the efforts of the Administration and the Congress in this respect, it is clear that the benefits will only come over time. I submit, Mr. Chairman, that the mortgage finance, housing and other industries who depend on the flow of capital cannot wait that long. Something needs to be done to induce savings right now, and these bills represent the articulation of that need.

Thank you for your attention and consideration. I will be happy to answer any questions the members of the subcommittee may have.

STATEMENT OF

LUIS L. GRANADOS

LEGISLATIVE COUNSEL

THE ESOP ASSOCIATION OF AMERICA

BEFORE THE

SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT

of the

SENATE FINANCE COMMITTEE

May 4, 1981

SUMMARY OF POINTS:

1. The "two-stack" approach of S.936 is consistent with the "two-factor" economics of Louis Kelso, originator of the ESOP.

2. The ESOP Association supports S.936 as a means of broadening capital ownership.

3. S.936 would change the bargaining priorities of American labor unions in a healthy manner.

4. The dividend exclusion of IRC § 116 should be amended to permit ESOP participants' dividends to qualify.

Mr. Chairman and members of the Subcommittee, my name is Luis Granados. I am the Legislative Counsel for The ESOP Association of America, and I very much appreciate the opportunity to share with you our views on S. 936 and the various dividend exclusion bills being heard today. The ESOP Association of America is a trade association of companies with Employee Stock Ownership Plans, which, as the name implies, are plans for providing employees of corporations with stock in the companies for which they work. Typically, the stock is provided at no cost to the employee. Over 4,000 American corporations have adopted some form of ESOP since 1975, and Congress has enacted 12 laws encouraging their use. And, as might well be expected, the studies that have been done of the performance of ESOP companies have all reached similar conclusions: that when you give employees a meaningful "piece of the action" in their companies, when you give them a real reason for taking an interest in the profits at the bottom line, those employees will begin to become more productive.

You may have seen the recent news stories and advertisements about the employees of Continental Airlines, who have agreed to give up 15 percent of their wages in order to purchase control of that company. That's just one very recent example of the kind of teamwork and cooperative spirit that the ESOP can generate.

The "two-stack" approach of S.936, separating labor income from capital income for tax purposes, seems to us to be quite consistent with the writings and philosophy of Louis O. Kelso, the father of the ESOP as we know it today. That philosophy involves a recognition that there are really two separate factors of production: the human factor, or labor; and the non-human factor, or capital, including all manner of land, plant, equipment, and technology. This is exactly the separation recognized by S. 936. Not only does the capital factor produce goods and services in exactly the same physical, logical, and moral sense that labor does, but the whole thrust of the continuing industrial revolution is to shift the burden of production away from the labor side and toward the capital side. This shift can be of tremendous benefit to mankind, since it frees up man's time to engage in pursuits other than sustaining the needs of his body through his labor. However, both justice and efficiency require that if capital is to do the bulk of the production in an economy, the ownership of that capital must be spread broadly among working Americans. Otherwise, serious dislocation and disruption of the free enterprise system will result.

Unfortunately, exactly such a concentration of capital ownership has already occurred in America. Studies show that one percent of the people now own over half of our capital wealth, and six percent of the people own almost three-quarters of it. This undue concentration has led to exactly the kind of disruptions and dislocations that one might expect, and we are now suffering the consequences of it. Congress should be concerned with enacting tax and other laws that both increase the nation's capital stock and broaden the ownership of the newly-created capital.

S.936 appears to us to be an excellent method for achieving both objectives. This bill would permit a person's income from capital to be taxed separately from a person's income from labor. This would have the effect of greatly reducing the rate of taxation on the capital income for Americans with small capital stakes, thus both enabling and encouraging millions of Americans of modest means to become owners of capital. The bill limits this "two-stack" treatment to taxpayers with less than $10,000 of tax preference, thus targeting its benefits to average working people and not to the already-wealthy. The bill also eliminates the present discrimination in the tax code by reducing the maximum tax rate on capital income to the same level as the maximum rate on labor income. S.936 is far preferable to the approach being proposed in the House of Representatives, which is limited to reducing the maximum tax rate on capital income from 70% to 50%. The only people who benefit from that idea are the tiny handful of Americans whose capital income is large enough to put them into the top tax brackets. S.936 is a much more balanced approach, whose main beneficiaries would be Americans with small capital holdings.

We believe that one important effect of S.936 would be a healthy shift in the bargaining priorities of America's labor unions. The principal benefits unions bargain for today are wages, pensions, and other items that fall into the category of labor income. But picture for a moment the situation of the union bargainer if S.936 were to become law. Then it would not make sense to bargain for more labor income; it would be much more attractive to bargain for more income that can be characterized as <u>capital</u> income, which would give the union members a much more favorable tax <u>treatment</u>. We are confident that ESOP benefits would be one of the main items that unions would begin to bargain for, since they are one of the few possible sources of capital income available to rank-and-file workers on a nondiscriminatory basis. Furthermore, even non-union companies would probably begin trying to attract quality employees by offering low-tax capital income in addition to more highly-taxed labor income.

Such a shift would have some very positive effects on the economy. As I mentioned at the outset, study after study has borne out the common-sense notion that employee stock ownership can improve employee productivity. The best such study was done by the Survey Research Center of the University of Michigan, which showed that when you compare companies with substantial ESOPs to similar-sized firms in similar industries, the profitability of the ESOP firms is <u>fifty percent</u> higher. The ESOP creates a commonality of purpose between workers and management, somewhat similar to that enjoyed by many Japanese firms. It is hard to deny that such a change would be a healthy one for the economy. Furthermore, it would lead to exactly the kind of broadening of capital ownership we need to put the economy on a sounder and more equitable footing.

The ESOP Association also supports the concepts behind the five bills being heard today that would in various ways raise the present interest and dividend exclusions. However, I do want to bring to the attention of this Subcommittee a serious problem in the present operation of this exclusion. The ESOP is unique among all tax-qualified deferred compensation plans in that it is the only plan that permits an immediate "pass-through" to participants of the dividends it receives on its investments in employer stock. When an employer pays a dividend on stock held by its ESOP, the ESOP can immediately pass that dividend through to the participants, who will pay a tax on it in the year it is received. The employee-owners have quite clearly been paid a "dividend" by the corporation, by means of their ESOP. Yet the law does not now treat this payment as a dividend for purposes of the exclusion provided by Internal Revenue Code § 116. Rather, these passed-through dividends are treated as distributions from a qualified plan, and are not eligible for the exclusion. I can see no purpose for this tortured construction of the law. If we are to encourage capital ownership by average working Americans, then we ought not to discriminate against participants of the most effective plan now available for providing capital ownership to working people.

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The members of our Association have observed that the best method available of communicating the true meaning of the ESOP to their employee-owners, and thereby maximizing the productivity benefits of the ESOP, is to pay them a dividend. This benefit can only be enhanced by making a substantial portion of these dividends tax-free. It makes no sense to deny ESOP participants this tax benefit if other share owners are to enjoy it, and I urge the members of this Subcommittee to take the lead in rectifying this inequity if changes are to be made in § 116. I commend to your attention Senator Russell Long's "Expanded Ownership Act," to be introduced shortly, which would solve this problem once and for all.

Thank you again for the opportunity to present these thoughts today.

Summary of Principal Points

STATEMENT OF DONALD MORTON
ON BEHALF OF THE U.S. LEAGUE OF SAVINGS ASSOCIATIONS
TO THE SUBCOMMITTEE ON SAVINGS, PENSION & INVESTMENT
SENATE COMMITTEE ON FINANCE
May 4, 1981

1. The rate of personal savings in our country is inadequate; it compares unfavorably with each of our industrial trading partners -- all of which use tax incentives to promote savings.

2. The flow of funds to home lenders has been depleted by inflationary psychology among consumers and competition from money market mutual funds while savings' costs have skyrocketed; the return on investment portfolios filled with older, low- and fixed-rate mortgages cannot keep pace -- leading to an unprecedented earnings squeeze.

3. The collapse of housing comes as population trends assure record demand in this decade; stimulating savings to provide the capital to meet this demand should be a top national priority.

4. There is no historical experience to suggest that an unspecified, generalized rate cut (as recommended by the Administration) will produce, in the near-term, the volume of savings needed to bring housing out of its doldrums.

5. Now is the time to make the $200/$400 exclusion enacted last year a permanent fixture of our tax laws and expand upon that breakthrough.

6. Nondirected exclusions, as in S. 142, S.155, S.330, S.492, and S.819, fulfill an important purpose in tax-incentives-for-savings policy; such exclusions reward thrift, and reverse the tax code bias against savings, for those unaffected by other (meritorious) targetted proposals (such as an expanded IRA account).

7. The U.S. League of Savings supports S.142, S.155, S.330, S.492, and S.819, and the proposal (S.936) for segregating interest earnings from personal service income; these plans will reward savers.

8. Another refinement could add new dimensions to the tax-break-for-savers objective -- by providing lower-cost credit for borrowers and restoring the vitality of our hard-pressed depository institutions. Our proposal is to exclude interest earned (to $1,000 for an individual, $2,000, joint return) on savings committed to a special one-year account at depository institutions opened between July 1, 1981 and June 30, 1982. The return to depositors on the account would be indexed to the average yield on one-year Treasury bills (at a 70% level, in recognition of the tax-exempt treatment). Middle-income savers would find this appealing.

9. Such an account would provide lendable funds at affordable rates to small businessmen, farmers, home buyers and others who depend on hometown depositories for credit. It would provide traditional depositories a response to the challenge from money market funds without escalating their costs, and it could remove the possibility of Federal assistance to the thrift industry. It would provide true capital formation, not "hot money" of questionable long-term benefit to our economy.

STATEMENT OF DONALD F. MORTON
ON BEHALF OF THE U. S. LEAGUE OF SAVINGS ASSOCIATIONS
TO THE SUBCOMMITTEE ON SAVINGS, PENSION & INVESTMENT POLICY
SENATE COMMITTEE ON FINANCE

May 4, 1981

Thank you, Mr. Chairman and members of this distinguished Subcommittee. My name is Donald F. Morton. I am Chairman of the Board and President of Arlington Heights Federal Savings and Loan Association of Arlington Heights, Illinois, and appear today on behalf of the United States League of Savings Associations, where I serve on the Executive Committee.

We appreciate this opportunity to present our views on S. 936, to encourage savings through separate taxation of personal service and investment income, and S. 142, S. 155, S. 330, S. 492, and S. 819, which provide (in a variety of ways) for an exclusion from taxation on a portion of interest income. Each of these bills contains features which will go far toward encouraging thrift among Americans as well as toward rebuilding the nation's badly depleted capital pool.

*The U.S. League of Savings Associations has a membership of 4,400 savings and loan associations representing over 99% of the assets of the $625 billion savings and loan business. League membership includes all types of associations -- Federal, and state-chartered, stock and mutual. The principal officers are: Rollin Barnard, President, Denver, Colo.; Roy Green, Vice Pres., Jacksonville, Fla.; Stuart Davis, Legislative Chairman, Beverly Hills, Cal.; William B. O'Connell, Executive Vice Pres., Chicago, Ill.; Arthur Edgeworth, Director-Washington Operations; Glen Troop, Legislative Director, Washington; and Phil Gasteyer, Assoc. Director-Washington Operations. League headquarters are at 111 E. Wacker Dr., Chicago, Ill. 60601 The Washington Office is located at 1709 New York Ave., N. W., Washington D.C. 20006, Telephone: (202) 637-8900.

Earlier this year, the Past President of our organization, Mr. Edwin B. Brooks, Jr., was privileged to appear before your Subcommittee in support of Chairman Chafee's S. 243, as well as S. 12 and S. 24, as introduced by Chairman Dole of your parent Finance Committee. We reaffirm our support for those measure to encourage greater use of Individual Retirement Accounts and to provide incentives for families to save for their educational, homeownership, and retirement needs. That testimony also described a "Home Seller Capital Gains Account" which would put to work, without revenue impact, the gains from home sales where owners, under current law, feel compelled to reinvest in more home than they need or desire to avoid tax consequences. We commend that novel -- though admittedly modest -- approach to your attention.

This Subcommittee is familiar, I know, with the sad state of personal savings in our country. The latest monthly figure from the Commerce Department indicated that a mere 4 percent of disposable income was being saved in February. For 1980 it was 5.7%. Most recent available comparisons (1979) show that Canada had a savings rate of 13.9 percent, the United Kingdom 13.8; West Germany 15.9 and Japan an impressive 26 percent. There is no mystery to the savings' success in these, our industrial trading partners. Each utilizes favorable tax treatment to encourage citizens to save rather than consume.

Our tax laws and our inflationary experience in recent years combine to discourage personal savings. Consider this example:

> Assume that in January of 1980 you placed $10,000 in a six-month Money Market Certificate, the highest-rate retail savings, at the then-prevailing rate, 11.86 percent; assume further that you left the funds on deposit for another six months last July, when the rate was 8.59 percent. By January of this year you would have earned interest of $1,022.50, bringing your account total to $11,022.50.
>
> Now, recall that the calendar year 1980 inflation rate was 12.4 percent. Your $11,022.50 savings account is worth only that much -- less the rate of inflation -- or only $9,655.71 in real purchasing power.
>
> Let us next assume that you are in the 25 percent tax bracket. This means that the Federal Government would take away 25 percent of the $1,022.50 interest income or $255.63. The saver is left with an account "worth" only $9,400.08.
>
> Thus, after inflation and Federal income taxation take their bites, the reward for savings is worth only 94 percent of the original amount conserved, rather than spent.

Inflation and the "buy now" psychology have depleted the flow of funds to thrift institutions -- savings and loan associations and mutual savings banks -- which provide the credit "backbone" for the housing sector of our economy and the bulk of the mortgages sought by families buying a home. The ability to provide home financing today is impaired by other factors, as well. Since the authorization of market-related savings in May 1978, the cost of acquiring funds has skyrocketed. Market-related funds -- particularly the short-term six-month Money Market Certificate -- now comprise over half of the deposit base of savings and loan associations. In recent months, the MMC rate has exceeded 15 percent and it continues close to that level -- providing an unacceptable floor under the mortgage rates which must be asked of new home borrowers. At the same time, in performing our Congressionally-mandated function of home finance through the years, thrift institutions have acquired portfolios of long-term, fixed-rate mortgage loans -- investments still yielding 6%, 7%, and 8%. Even with the record mortgage rates of the recent past this "deadwood" depresses portfolio pe-formance. Thus, for example, in September 1979 approximately four-fifths of S&L mortgages carried rates of less than 10%; a year later, two-thirds were still below 10%. The resulting, and much-publicized "earnings squeeze" on our institutions severely handicaps our capacity to compete for funds and perform our specialized housing finance function.

The availability of funds for housing suffers from another development, too -- the explosive growth of unregulated money market mutual funds. The assets of these funds now exceed $118 billion, with some $44 billion added since the first of the year. (By contrast, insured savings and loan associations experienced very substantial outflows in the first calendar quarter, including an all-time monhtly record loss of $2.3 billion in March.) Not only are these funds "disintermediating" savings and loan associations and other regulated depositories, they are creating "disinvestment" problems for the farms, businesses, and commerce throughout Amercia. The deposits attracted away from hometown depositories by the fund managers are put in very short-term, high-yielding investment media, such as money center bank CDs (21%), commercial paper of giant corporations (34%), Eurodollars (10%) and foreign branch deposits of giant, U.S. banks (3%); ten percent or less is invested in U.S. Treasury securities. Importantly, the money funds operate beyond the reach of our monetary control authorities and may, in fact, frustrate their efforts to combat inflation.

While I appreciate that imposition of reserves and other responses to the problems created by the unregulated money funds fall within the jurisdiction of other Congressional Committees, I feel that it is important that this Subcommittee be aware of these problems. In your efforts to foster savings and capital formation, you should not indiscriminately extend further stimulus to their already explosive and disruptive growth.

The collapse of savings flows at our thrift institutions comes at a time when more people than ever before are entering the prime home buying years. A record 42 million people will reach the age of 30 during this decade, 10 million more than in the 1970s. Respected researchers estimate that we will need between 2.1 and 2.5 million new housing units annually to accommodate these individuals and their families. Yet, as you are probably aware, housing starts in 1980 amounted to only 1.3 million units, and last month the annualized rate was even less.

Stimulating savings to meet the demand for greater housing capital must be a top national priority. The Administration's proposal for a generalized reduction in tax rates for individuals does not sufficiently focus, in our opinion, the incentives needed to boost personal savings and assure an adequate flow of capital for housing. To our knowledge, there is no historical experience to suggest than an unspecified, generalized rate cut would produce in the near-term the volume of savings needed by depository institutions to bring the housing industry out of the doldrums. To make sure that a substantial part of the general tax reduction is saved, not spent, we applaud your Subcommittee's efforts to explore specific tax incentives for savings.

The interest exclusion bills before you today expand the important beginning provided by the $200/$400 exclusion developed by your Finance Committee in the 96th Congress. That pointed a new, though modest, direction -- reversing decades of bias in our tax laws toward consumption and against savings. Now is the time to make that breakthrough a permanent fixture of our tax laws and expand upon its promise.

Unquestionably, an expanded exclusion is an immensely popular idea. Some of you may have seen placards and ballots in the lobbies of savings and loan associations across America in the past few months which ask customers: "Isn't it time to give a <u>real</u> tax break to savers?" The Savings and Loan Foundation tells us that they have received over two million replies -- in the affirmative -- to date.

A nondirected savings exclusion (as in S. 142, S. 155, S. 330, S. 492 and S. 819) fulfills an important purpose in an overall program to encourage savings. Many of our customers are in their retirement years already; expanded IRA programs are of little direct benefit to these savers. Other savers are deterred by family financial needs and the stringent tax penalties from committing their funds to savings plans which may only be realized fully in retirement. (Similarly, incentives for education and homeownership -- while meritorious -- have less than universal appeal.)

Nondirected savings exclusions also play a role in discouraging consumption by rewarding thrift -- thereby preserving funds in financial intermediaries during inflationary times. When longer term funds are maintained on deposit, true capital formation may occur. We are not apologetic about reversing a tax code discrimination against those thrifty Americans who have saved, rather than spent, in these inflationary times.

S. 936, by Senators Roth, Bentsen and Kasten, is likewise a worthy concept -- and one with great potential for inducing new savings flows. Segregating interest earnings from personal service income in the application of the tax brackets corrects a powerful disincentive to save -- the application of top marginal bracket treatment to the first dollar of return on savings and investments.

We appreciate that the Subcommittee is understandably concerned about the potential for revenue loss to the Treasury by these various bills. We have long been convinced that the Treasury would gain far more than it would sacrifice as productivity is replenished and jobs created by increased personal savings. It is our understanding that an important "supply-side" analysis is underway in the Joint Committee on Internal Revenue Taxation which, we are confident, will confirm this view when available in the near future.

Before concluding, we would like to direct the attention of the Subcommittee to a new variation on the savings' incentives theme: an amendment which adds new dimensions to the tax-break-for-savers objective. Unlike the other bills discussed today this plan would not only reward our nation's depositors -- but it would lower the cost of credit to borrowers and it would restore the vitality of our hard-pressed depository institutions. In recognition of the near-term concerns about budget deficits, it is carefully limited in amount and duration.

Our proposal is to exclude interest earned, to $1,000 for an individual and $2,000 for a joint return, on savings committed to a special one-year account opened during the period from July 1, 1981 to June 30, 1982. (Any revenue effect is thus distributed over tax years 1981, 1982, and 1983.) The one-year account would be available from depository institutions only -- regulated commercial and savings banks, savings and loans, and credit unions. The return available to the public on the account would be indexed to periodic changes in the average yield on one-year Treasury bills. But, in recognition of the tax-exempt feature, rates of return at time of purchase would be limited to 70% of the T-bill index. This, in turn, would provide lendable funds at affordable rates for small businessmen, farmers, home buyers and others who depend upon their hometown depositories for the productive credit which provides the jobs and opportunities for sustained, non-inflationary economic growth. Because of the interplay between the $1,000/$2,000 exclusion limit and the 70% of T-bill rate ceiling, we anticipate that such an account would be of greatest appeal to middle-income taxpayers -- those in brackets between 30% and 45%. We estimate that as much as $180 billion could be attracted in new savings to all depository institutions. The housing-specialized savings and loan business might see savings growth of $80 billion in funds which could be pumped out in mortgages at rates far more affordable to home buyers than today's 15.5 percent.

We are preparing a detailed supply-side analysis which will be provided in the next few days to the Subcommittee. It will compare static revenue foregone by the Treasury with revenue gained from a rejuvenated housing sector. We anticipate that the difference, if any, will be minimal when revenue gained from new housing starts, reemployed construction workers, business activity in housing-related industries and, not incidentally, taxes paid as our institutions once again become profitable, is calculated.

Important, too, is the stability such a proposal provides to our financial system. It gives depository institutions a competitive tool to meet the challenge from the unregulated money market mutual funds, without escalating operating costs. It could remove the much-publicized possibility of special Federal assistance to the ailing thrift industry. And, of course, by attracting fresh funds committed by the public to savings for one-year terms, it provides true capital formation --not "hot money" which will churn in investment uses of questionable long-term benefit to our economy.

We urge your careful consideration of this plan for a one-year program providing a new one-year savings account with tax-exclusion at depository institutions.

* * *

On behalf of the U.S. League and its 4,400 member savings and loan associations nationwide, I have welcomed this opportunity to present our views. You are to be commended for the leadership this Subcommittee has taken in pursuing tax incentives for savings.

Testimony of

R. Scott Jones, President

The Goodhue County National Bank

Red Wing, Minnesota

on

S.330-Dividend and Interest Exclusion

before the

Subcommittee on Savings, Pensions and Investment Policy

of the Committee on Finance

United States Senate

May 4, 1981

Mr. Chairman and members of the Committee, I'am Scott Jones, president of the Goodhue County National Bank in Red Wing, Minnesota, an independent community sized bank.

I am pleased to be before you this morning to discuss S. 330, a bill which addresses the important question of: How can government encourage individuals to save money when inflation, which has been termed the cruelest tax of all, is running at twelve percent and when current tax laws reward consumption and penalize savings?

In an inflationary economy there is no incentive for the American public to save or accumulate capital. Non-traditional investment opportunities such as gold or diamonds attract what little investable money there is into areas that do not bolster the American economy or create jobs for the American people. On the other hand, investments in savings deposits of America's financial institutions make more money available for large businesses, small businesses, farmers, housing and the rest of the productive side of the nations economy.

In 1979 the federal income tax burden on the individual taxpayer, exclusive of Social Security, was 15.6% of personal income. In 1979 then, the average return after federal income taxes on a 5.25% savings account was 4.431%. Not too enticing when we consider that inflation was running at 13.1% by the end of 1979. The point is that as inflation and taxes increase incentives for people to save decrease. Passage of S. 330 will help provide the necessary incentives for savers and attract savings deposits necessary to stimulate the productive side of our economy.

The United States Savings League has published a study indicating that the American economy will need $7 trillion of savings deposits during the 1980's. Five trillion dollars to restore and maintain the industrial base of the nation's economy and two trillion dollars to support the housing industry.

The report also indicates that the annual savings rate of the American public has been steadily declining since 1973 and by the end of the fourth quarter of 1979 the annual savings rate stood at 3.5%, the lowest in history.

The U.S. Savings league report also indicates that the annual savings rate in the United States is the lowest of all Western Industrialized Nations. In fact, countries such as Japan and West Germany have had incresaes in their annual savings rates while we have shown decreases. During the decade of the 1970's Japan and West Germany had average annual savings rates of 19% and 15.4% respectively while that of the United States was 6.6%, a rather poor performance comparatively speaking. Japan and West Germany do create tax incentives for savers.

Now let us turn to a smaller scale analysis of the problem, Red Wing, Minnesota. At the end of 1980, total savings and time deposits of the three Red Wing banks totaled $68,870,000. The population of Red Wing is appoximately 15,000 people, thereby creating an average savings deposit of appoximately $4,600 per capita. Presume for a moment that S. 330 has passed into law. If each savings deposit where to increase 10% or approximately $460., that would translate to $6,900,000, of additional money available for investment into businesses, farms and housing in Red Wing area. To those of you who are used to dealing in billions of dollars that may not sound too significant but in Red Wing, Minnesota it is truly remarkable.

Because of inflation and resulting high rates of interest, the savings growth of Red Wing's banks has been virtually non-existent. For the year ended March 31, 1981, regular savings deposits at our bank decreased $1,585,000. I do not have to tell you what that does to our ability to supply needed capital to the businesses, farms, and the housing industry in Red Wing.

Finally, you gentlemen are also currently considering President Reagan's economic proposal. One of the major principles of the President's plan is that the tax cut that you are contemplating will be put into savings accounts by

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the American Public. The savings incentives encompassed in S. 330 will help create a climate in which the people will save, not only their tax cut but additional dollars as well.

The progression of events is clear. Incentives to savers leads to more dollars saved which leads to more money invested in business, agriculture and housing which leads to a stronger economy and more jobs for our people. I urge you to support S. 330.

National Association of Federal Credit Unions
1111 N. 19th Street
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Statement of John J. Hutchinson

President of

The National Association of Federal Credit Unions

Before the Subcommittee on Savings, Pensions,

and Investment Policy of the

Committee on Finance

United States Senate

Regarding

Savings Incentive Proposals
(S. 75, S. 141, S. 142, S. 145, S. 155,
S. 330, S. 457, S. 492, S. 819, S. 936)

May 4, 1981

Mr. Chairman and members of the subcommittee, I am John J. Hutchinson, president of the National Association of Federal Credit Unions and manager of Hamilton Standard Federal Credit Union in Windsor Locks, Connecticut. The National Association of Federal Credit Unions (NAFCU) is the only national trade association exclusively representing the interests of our nation's federally chartered credit unions. There are 12,716 Federal credit unions throughout the country whose 25.9 million members hold more than 36.5 billion dollars in savings.

I appreciate the opportunity to appear before you today as you consider savings incentive proposals: S. 75, introduced by Senator Wallop, Senator Moynihan and Senator Cranston; S. 141, introduced by Senator Bentsen and Senator Baucus; S. 142, introduced by Senator Bentsen; S. 145, introduced by Senator Moynihan; S. 155, introduced by Senator Schmitt; S. 330, introduced by Senator Durenberger and Senator Boren; S. 457, introduced by Senator Cranston; S. 492, introduced by Senator D'Amato; S. 819 introduced by Senator Nunn and Senator Huddleston; and S. 936, introduced by Senator Roth, Senator Bentsen and Senator Kasten.

The issues before you today deal with a key element of our nation's economic well-being: ways to provide incentives for consumer savings that will reward savers, stabilize deposits in financial institutions, and contribute to capital formation.

Mr. Chairman and members of the subcommittee, the policy decisions facing you strike at the core of this nation's economic health. As a nation, we are dependent upon one another for our financial success. Increased employment and productivity rely upon capital investment. The source of investment is both personal and business savings. We must reexamine the core of individual savings to restore the missing element of a healthy, productive economy. We are here today to implore the Congress to provide incentives that will raise the personal savings rate from its current historic depths.

Credit unions are one segment of an economic structure which reflects the saving habits of Americans. As consumer-owned institutions, credit unions are very close to the heart of middle-income savers. Those of us who are responsible for the management and direction of our nation's consumer-owned financial institutions are finding it more and more difficult to fulfill our statutory obligations as a result of present economic conditions. In a recent survey of NAFCU members, 96% of credit unions responding encouraged us to seek the passage of legislation that would provide more attractive savings incentives through revisions in the tax code. Why is this necessary? Let's look at some figures. In 1978, savings in Federal credit unions grew by $7 billion at a rate of 2.4%; in 1979, the increase in savings was only 50% as great as it was in 1978. The figures for 1980 again showed an increase but one that did not keep pace with inflation. Despite improved opportunities for rewarding CU savers, the 13.9% increase of 1980 is far below the growth enjoyed through the 1970s.

As you are well aware, the personal savings rate in this country has been declining steadily since 1973. Inflation has been running at a 12% rate although it is currently lower. The nation is in desperate need of economic revitalization. It is urgent, therefore, that this subcommittee shape a tax reduction program that will stimulate savings. The program must offer some assurance that added income from reduced taxes will not simply lead to increased consumer spending, but will be put into personal savings which would make capital available for consumer loans and home mortgages.

In addition, as every member of this subcommittee knows, our nation's regulated depository institutions -- including Federal credit unions -- have been subject recently to an excessive outflow of deposits, in part because of the attractive yields offered by money market mutual funds. These funds have been able to offer a rate of return far superior to that offered by regulated depository institutions. Why? Largely because government-imposed restrictions prevent regulated institutions from matching the yield offered by the money market funds. Many of the proposals under consideration today would, if approved, help to redress this inequitable situation.

The savings rate in the United States is the lowest of all industrialized nations in the western world. The current rate of savings is down to 4.7% of disposable income. This rate, which has remained consistently low over the past two years, reflects a marked change in consumer behavior. Very simply, to many, saving no longer makes sense. As a result of low rates of saving, the nation is suffering economic stagnation. This shrinks the pool of financial capital available to stimulate productivity. This decline in the savings rate must be reversed to hasten the revival of economic growth. Consequently, our system demands saving incentives.

INFLATION AND TAXES DISCOURAGE SAVING

It does not make sense to save in this country today. The symbiotic partnership of inflation and the U.S. tax code discourages the prudent consumer from saving. Earnings are first taxed as income to the recipient. When income is saved, the savings are reduced in value by a high inflation rate, an insidious hidden tax. Then the yield on what has been saved is taxed once again. As a result, the individual often receives a negative rate of return on savings. Therefore, there is little real incentive to save, while spending is immediately forced by price escalation and further encouraged by an inflationary mentality which assumes that what is expensive today will be more expensive tomorrow.

Senators introducing these ten bills have recognized this deplorable situation, which presents Congress with the need to change the laws and to re-stimulate consumer savings.

In the past, the National Association of Federal Credit Unions, with the welcome support of many members of Congress and of this subcommittee, has recommended that the Internal Revenue Code be amended in order to reward, rather than penalize, consumers who save. The tax incentive provision contained in Section 404 of the "Crude Oil Windfall Profit Tax Act of 1980" -- which permits the exclusion from taxable income of the first $200 ($400 in the case of a joint return) of interest and/or dividends earned on savings or investments in domestic corporations during calendar years 1981 and 1982 -- is an encouraging first step. Nevertheless, NAFCU firmly believes that if consumers are to begin building their personal savings, the Congress must go much further in providing truly meaningful savings incentives.

The probability of tax cuts tremendously increases the urgency to reverse the trend of a diminishing rate of personal savings. Personal tax cuts offer the opportunity to stimulate productivity. However, more must be done to assure an increase in consumer savings. We urge Congress to remove the tax on interest and dividends so that the tax cuts will result in stimulation of productivity; increase in saving, and not result in further inflation. Without reversing the downward savings trend, possible inflationary results could be catastrophic.

INTEREST/DIVIDEND EXCLUSIONS

Each of the bills before this subcommittee today attempts to provide some of these needed incentives. Several of these proposals would expand or make permanent the partial tax incentive for savers already provided by Public Law 96-223.

S. 142, introduced by Senator Bentsen and S. 492, introduced by Senator D'Amato, both propose an increase in the interest/dividend exclusion from $200 ($400 for joint return) to $1,000 ($2,000 for joint return). Senator Bentsen also recommends that the temporary exclusion be made permanent.

The National Association of Federal Credit Unions firmly supports the concept of providing a tax exclusion for interest and/or dividends. The increase in the exclusion is certainly one more step in the right direction. The best way to encourage savings is to remove the disincentive that taxes have become.

It is difficult to estimate the impact of increasing the interest and/or dividend exclusion because data is very difficult to find. The current $200/$400 exclusion is in effect for 1981 and 1982; however, statistics on the effect of this exclusion will not be available until 1982.

S. 330, introduced by Senator Durenberger and Senator Boren, would raise this exclusion on interest and/or dividends to $1,250 ($2,500 for joint return) through a gradual phase-in of the increase. This process would encourage saving and reduce the negative effects on the Treasury. We favor more of an increase in the exclusion, but believe Senators

Durenberger and Boren are offering a step in the right direction.

S. 819, introduced by Senator Nunn and Senator Huddleston, again increases this exclusion and offers a gradual increase to be phased in over the next three years. Through increased incentives, the benefits of the tax cuts could be maximized. Senator Nunn has also cosponsored S. 243, introduced by Senator Chafee, Chairman of this subcommittee, which would create a new source of savings by opening Individual Retirement Accounts to wage earners who are already covered by employer pension plans. This would stimulate long-term, stable savings while encouraging consumers to save for their retirement. It is the position of the National Association of Federal Credit Unions, as well as my own personal conviction, that such actions by the Congress would be non-inflationary, encourage savings, assist in capital formation, and provide the added benefit of easing pressure on the Social Security System by allowing more long-term consumer saivngs. I discussed at length the tremendous benefits to be gained by prompt enactment of S. 243 in testimony before this subcommittee on February 20, 1981, and will not repeat myself here other than to reiterate this Association's strong endorsement of S. 243.

S. 155, introduced by Senator Schmitt, would also increase the interest/dividend exclusion by making 25% of such income excludable with a cap of $12,500. This proposal offers a phase-in of 5% increments over a five-year period. NAFCU can support this concept as it recognizes the necessity for savings. We feel, however, that no cap should be placed on such an exclusion.

Senators Roth, Bentsen and Kasten have taken a different approach in S. 936 by treating interest or dividends earned in a separate category from wages earned. Currently, income from savings is taxed at the highest rate imposed on the individual taxpayer. By adding income from saving to other income, the most severe tax treatment is given to that interest and/or dividends. S. 936 would reduce the top marginal rate from 70% to 50% and would treat earned income separately from savings income. Once again, this would benefit our nation's credit unions as consumers would not be as discouraged from saving as they are currently. We would urge the subcommittee, however, to study this carefully so as not to give greater benefits to the wealthy and leave those in the middle to lower tax brackets without help.

Several other bills are before this subcommittee today which would grant incentives to invest in business. S. 75, introduced by Senators Wallop and Moynihan, and S. 145, introduced by Senator Moynihan would reduce the tax imposed on capital gains. S. 145 would also provide for a maximum individual tax rate of 67%. NAFCU agrees with the principles involved in reducing such tax rates, however, we would encourage a greater reduction in personal taxes than Senator Moynihan suggests.

S. 457, introduced by Senator Cranston, and S. 141, introduced by Senators Bentsen and Baucus, encourage capital formation through changes in the tax treatment of reinvestment plans. These proposals encourage further investment from a different perspective. The National Association of Federal Credit Unions recognizes that increased business savings are also necessary. But because personal saving incentives are more directly related to the interests of credit unions, we will confine our comments to legislation addressing such incentives.

Mr. Chairman, another proposal designed to encourage greater consumer savings which I would like to discuss -- although it is not on today's hearing agenda -- is a bill introduced last Thursday by a distinguished member of this subcommittee, Senator David Boren. Senator Boren's "Residential Housing Tax Incentives Act of 1981" (S. 1072) merits serious consideration by this subcommittee and the Congress.

The legislation Senator Boren has introduced would create new three or five-year savings certificates which could be offered by regulated depository institutions. The interest earned on such certificates would be exempt from Federal taxation and would consequently offer a lower yield than comparable term taxable certificates. These lower cost funds would be reinvested into residential mortgage loans at rates below prevailing market rates. These mortgages would assist thousands of moderate income families throughout the country by making home ownership more affordable.

We do, however, have some questions about this proposal, as well as similar legislation introduced earlier. The fundamental question deals with the traditional thrift institution problem of using short-term deposits to finance long-term loans. If the rate on deposits -- as this legislation would mandate -- cannot be greater than 200 basis points over the average rate of interest payable on the corresponding, all financial institutions could well be forced to remain in a position of having relatively low-yielding long-term commitments while being forced to pay a savers' yield beyond the institution's income.

Moreover, while this legislation rightly addresses a serious problem, it intrudes government once again into the marketplace.

SUMMARY

The National Association of Federal Credit Unions recognizes the serious need for a trend reversal in the saving patterns of American consumers. We support the Administration in its efforts to provide tax cuts. Simultaneously, however, we urge Congress to enact incentives for savings so that the tax cuts do not result in further inflation. We, therefore, endorse prompt action by Congress to expand and make permanent the tax exclusion for interest and/or dividends.

In addition, we strongly urge the expansion of eligibility criteria for Individual Retirement Accounts as we see this as the most effective incentive to new savings. The exclusion for interest and/or dividends will reward those who are already saving, but the IRA legislation would avail 60 million more workers a new opportunity, and -- we believe -- open a whole new source of savings deposits.

I thank the subcommittee for the opportunity to appear, and will be pleased to respond to any questions you might have at this time.

ORAL TESTIMONY OF

KARL T. HOYLE

VICE PRESIDENT AND DEPUTY DIRECTOR

GOVERNMENTAL AFFAIRS DIVISION

CREDIT UNION NATIONAL ASSOCIATION, INC. (CUNA)

BEFORE THE

SUBCOMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT POLICY

ON

SAVINGS AND INVESTMENT INCENTIVE TAX BILLS

MAY 4, 1981

THE CREDIT UNION NATIONAL ASSOCIATION, INC. (CUNA) IS AN ASSOCIATION OF CREDIT UNION LEAGUES, REPRESENTING EACH STATE AND THE DISTRICT OF COLUMBIA. THROUGH THE LEAGUES, CUNA REPRESENTS APPROXIMATELY 20,000 FEDERALLY AND STATE CHARTERED CREDIT UNIONS WHICH SERVE MORE THAN 40 MILLION MEMBERS. CREDIT UNIONS ARE COOPERATIVE, NON-PROFIT ASSOCIATIONS THAT OFFER VARIOUS FINANCIAL SERVICES TO THEIR MEMBERS.

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE, MY NAME IS KARL HOYLE. I AM VICE PRESIDENT AND DEPUTY DIRECTOR OF THE CREDIT UNION NATIONAL ASSOCIATION'S GOVERNMENTAL AFFAIRS DIVISION. THROUGH OUR LEAGUE MEMBERS IN ALL 50 STATES, THE DISTRICT OF COLUMBIA AND PUERTO RICO, CUNA REPRESENTS NEARLY 20,000 FEDERAL AND STATE CHARTERED CREDIT UNIONS WITH MORE THAN 40 MILLION CREDIT UNION MEMBERS.

FOR SOME THREE YEARS NOW, CUNA HAS WORKED CLOSELY WITH MEMBERS OF BOTH THE SENATE AND HOUSE AND THEIR STAFFS IN AN EFFORT TO BRING ABOUT LEGISLATION TO ENCOURAGE SAVING AND DISCOURAGE THE INFLATIONARY MENTALITY THAT CALLS FOR SPENDING NOW AND PAYING BACK LATER WITH CHEAPER DOLLARS.

THE MENTALITY IS UNDERSTANDABLE. INFLATION ERODES THE REAL VALUE OF SAVINGS WHILE PUSHING THE SAVER'S INCOME INTO HIGHER TAX BRACKETS. THE RESULTANT DOUBLE BITE MAKES THE AVERAGE WAGE EARNER/SAVER A TWO-TIME LOSER.

A TAX EXCLUSION FOR INTEREST EARNED ON SAVINGS WOULD BE A BIG STEP TOWARD OVERCOMING THIS INFLATIONARY MENTALITY BY IMPROVING REAL AFTER-TAX RETURN TO SAVERS, THUS ENCOURAGING MORE SAVINGS.

ENCOURAGING SAVINGS PRODUCES CAPITAL FORMATION AND RESULTS IN ECONOMIC GROWTH. AND, WHEN COUPLED WITH CUTS IN FEDERAL SPENDING, WILL HELP EXORCISE THE INFLATIONARY DEMON FROM THE NATION'S ECONOMIC SOUL. THE INITIAL REVENUE LOSS TO THE TREASURY THAT WOULD RESULT FROM SUCH SAVINGS INCENTIVE PROGRAMS WOULD BE SUBSTANTIALLY OFFSET BY THE INCREASED REVENUES GENERATED BY REAL ECONOMIC GROWTH.

IF THERE ARE ANY REMAINING DOUBTS THAT SAVING NEEDS ENCOURAGEMENT, THE LATEST STATISTICS ON THE NATION'S SAVING RATE PROVIDE THE POINT. THIS FEBRUARY, FOR THE FIRST TIME IN MORE THAN THREE DECADES, THE PERSONAL SAVING RATE FELL BELOW 4%.

THERE ARE OTHER REASONS TOO FOR MOVING AHEAD WITH A SAVINGS INCENTIVE PROGRAM NOW. TODAY, THE NATION'S THRIFT INSTITUTIONS ARE HEMORRAGING. THRIFTS, WHICH STILL PROVIDE THE BULK OF

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AMERICA'S HOME LOANS, ARE SUFFERING FROM A VARIETY OF MALADIES. A GOOD DEAL OF WHAT AILS THRIFTS IS DUE TO: (1) THE RECENT DEMISE OF SAVING RATE CONTROLS; (2) THE HIGH COST OF COMPETITION BETWEEN THE PRIVATE AND PUBLIC SECTOR FOR SAVINGS; (3) THE ADVENT OF HIGH-YIELD SAVINGS INSTRUMENTS BEING OFFERED BY NON-DEPOSITORY FINANCIAL INTERMEDIARIES; AND (4) PERHAPS MOST IMPORTANTLY, INCREASED SOPHISTICATION ON THE PART OF THE AMERICAN SAVING PUBLIC.

THESE EVENTS MARKED THE END OF AN ERA IN WHICH THE SAVER HAD BEEN CONTENT TO SUBSIDIZE THE BORROWER. HENCE FORTH, THE GOAL WOULD BE TO LET THE MARKET SET THE RATE ON LOANS AND SAVINGS.

CREDIT UNIONS TOO, SUFFERED FROM THE NEW COMPETITION, BUT THEY DID NOT SUFFER AS GREATLY AS THE THRIFTS. PERHAPS IT WAS BECAUSE OF THEIR CONSUMER-OWNED NATURE OR PERHAPS IT WAS DUE TO THE FACT THAT THEIR PORTFOLIOS TURN OVER FASTER, BUT CREDIT UNIONS HAVE MANAGED TO LEVEL OFF FROM LAST YEAR'S EARNINGS AND LIQUIDITY NOSE DIVE. IN 1980, FEDERAL CREDIT UNIONS GREW 13.9% -- AS FAST AS COMMERCIAL BANKS AND FASTER THAN OTHER INSTITUTIONS

IN THE CONSUMER SAVINGS MARKET -- ACCORDING TO STATISTICS COMPILED BY THE NATIONAL CREDIT UNION ADMINISTRATION (NCUA). DURING THE SAME PERIOD, STATE CHARTERED CREDIT UNIONS GREW 10%. THE RESULT, ACCORDING TO THE NCUA, WAS THAT CREDIT UNIONS WERE ABLE TO HOLD THEIR 4.9% SHARE OF TOTAL CONSUMER SAVINGS.

HOLDING YOUR OWN DOES NOT MEAN ALL IS WELL. TO GRANT CREDIT UNIONS RELIEF FROM THE HISTORICALLY HIGH INTEREST RATES OF LAST YEAR, WHICH SUBSTANTIALLY DROPPED THEIR EARNINGS, THE NCUA BOARD GRANTED FEDERAL CREDIT UNIONS FULL AND MODIFIED WAIVERS FROM THEIR RESERVE TRANSFER REQUIREMENTS. A MAJOR REASON FOR THE EARNINGS PROBLEM WAS THE OUTFLOW OF FUNDS TO HIGH YIELD MONEY MARKET INSTRUMENTS. TO KEEP FUNDS, BOTH FEDERAL AND STATE-CHARTERED CREDIT UNIONS OFFERED HIGH YIELD CERTIFICATES -- AT TIMES AT RATES ABOVE WHAT THEY COULD CHARGE FOR LOANS.

THUS A MAJOR PROBLEM FOR THE THRIFTS, AND IN MANY WAYS ALL DEPOSITORY INSTITUTIONS, IS COMPETITION FROM THE MONEY MARKET MUTUAL FUNDS FOR SAVER'S DOLLARS. THESE HIGH YIELD FUNDS CURRENTLY TOP $120 BILLION AND ARE THE APPLES OF SOME SIX MILLION

DEPOSITORS' EYES. SO, BY POPULAR ACCLAIM, IT APPEARS THEY ARE HERE TO STAY.

HOW DO YOU SPELL RELIEF? TIFS -- TAX INCENTIVES FOR SAVERS -- IS ONE WAY. PROVIDING FINANCIAL INSTITUTIONS WITH A VARIETY OF MEANS TO ENCOURAGE SAVING WILL HELP ALL FINANCIAL INSTITUTIONS AS WELL AS THE PEOPLE WHO SAVE IN THEM, AND THE NATION. THIS IS ONE REASON CUNA BELIEVES IT ESSENTIAL THAT CONGRESS INCLUDE SAVING INCENTIVE MEASURES IN THE FIRST TAX PACKAGE PASSED THIS YEAR. IT IS ALSO FOR THIS REASON THAT WE SUPPORT THE THRUST EMBODIED IN THE LEGISLATIVE PROPOSALS BEFORE US TODAY.

FURTHER, IT IS CUNA'S OPINION THAT IN ORDER TO PROVIDE A LONG AS WELL AS SHORT TERM SOLUTION TO THE SAVINGS PROBLEM, EXPANSION OF IRA PROGRAMS BE COUPLED WITH A TAX EXCLUSION ON INTEREST EARNED AS A PART OF ANY TAX PACKAGE PASSED. IT HAS BEEN ESTIMATED THAT EVEN A MODEST TAX EXCLUSION, COUPLED WITH AN EXPANDED IRA PROGRAM, COULD BOOST THE NATION'S SAVINGS BY SOME $20 BILLION.

THE OTHER REASON FOR PROVIDING TAX INCENTIVES TO THE AMERICAN PUBLIC IN THE FIRST TAX BILL PASSED THIS YEAR HAS TO DO WITH PERCEPTION. EVEN THOUGH THE BENEFITS MAY NOT TAKE EFFECT UNTIL JANUARY 1, 1982, SUCH ACTION WOULD BE A SIGN TO THE AMERICAN PEOPLE OF CONGRESS' COMMITMENT TO HEALING THE ECONOMY. THE PASSAGE OF MEANINGFUL INCENTIVES WOULD RESULT IN AN INCREASE IN SAVING AT ALL FINANCIAL INSTITUTIONS EVEN BEFORE SUCH CONGRESSIONALLY-MANDATED TAX BENEFITS BECAME EFFECTIVE.

MR. CHAIRMAN, THAT CONCLUDES MY REMARKS.

Senator CHAFEE. Yes, fine. Thank you.

Now the next to the last panel, gentlemen is Mr. Cohn, Mr. Turner, Mr. Nichols, Mr. Rodgers, Mr. Wilson, Mr. Hollister, and Mr. Goldberg.

All right, gentlemen. Mr. Cohn?

STATEMENT OF HERBERT B. COHN, CHAIRMAN, COMMITTEE FOR CAPITAL FORMATION THROUGH DIVIDEND REINVESTMENT, ACCOMPANIED BY DONALD C. ALEXANDER AND SAMUEL COHN

Mr. COHN. Good morning, Mr. Chairman.

Senator CHAFEE. Good morning.

Mr. COHN. My name is Herbert Cohn. I appear here today as chairman of the Committee for Capital Formation Through Dividend Reinvestment. The 59 companies which are members of this committee are listed in an appendix to my formal statement.

Accompanying me are Donald C. Alexander, our tax counsel, and Samuel Cohn, vice president of Robert R. Nathan Associates, our economic consultants.

Senator CHAFEE. Well, I see your distinguished counsel with you so I am sure you are well advised.

Mr. COHN. We are indeed, sir.

We urge your committee's favorable consideration of the dividend reinvestment legislative proposal embodied in S. 141 introduced by Senator Bentsen on behalf of himself and Senator Baucus and subsequently cosponsored by Senators Packwood, Boren, Mathias, Leahy, and Boschwitz.

The counterpart bill in the House, H.R. 654 has been sponsored by 156 Members of the House including 18 members of the House Ways and Means Committee.

Dividend reinvestment plans for new issue stock have proven to be a most effective vehicle for raising urgently needed new common stock capital.

But, under current tax treatment, where the stockholder elects to reinvest his cash dividend and ends up with stock instead, he is required to pay a current tax on the value of the stock received. This is a major disincentive and a major obstacle to increased participation, savings and investment under these plans.

S. 141 would change this tax treatment. It would defer the current tax on dividends reinvested in new issue stock under qualified plans and treat the stock received, for tax purposes, as the equivalent of a conventional stock dividend which, from the point of view of the stockholder, is precisely what it is.

This would significantly encourage increased participation in these plans, increased savings, capital formation and investment.

Mr. Chairman, I would like to emphasize——

Senator CHAFEE. It would lower the basis of the stock that is held?

Mr. COHN. That is right, sir, just as is true in connection with a conventional stock dividend.

Senator CHAFEE. I see.

Mr. COHN. I would like to emphasize very briefly, four points in support of our recommendation.

First, we believe the dividend reinvestment proposal is one of the most direct, most closely targeted and most cost-effective proposals for encouraging savings, new capital formation and capital investment where it is urgently needed.

It is most direct because the reinvestment of dividends in new issue stock represents the instantaneous formation of new capital. One can see it happen.

It is most closely targeted because it is 100 percent effective in providing new capital to capital intensive companies having an urgent need for such common stock capital.

It is 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.

Senator CHAFEE. How do you figure no revenue loss?

Mr. COHN. Our economic consultants have concluded that because of the stimulative effect on the economy that would be associated with adoption of this proposal, there would be a net revenue loss in the first year of some $350 million, but that the feedback in the second year would lead to a wash and, in the third year, there would be a net gain of $600 million—in the third year and thereafter.

Now, if our economists are correct, there would be no revenue loss over a 3-year period. If you don't believe them and you take the gross revenue loss estimates used by the joint committee staff, we still suggest that that is a modest amount in the context of total amounts that are being considered for any tax reduction legislation.

The second point that I wanted to make, sir, is that the dividend reinvestment proposal will be counterinflationary, in helping to finance increased productive facilities, in absorbing cash dividends, and in substituting capital formation for current consumption.

Third, we estimate that if this legislation is adopted, dividend reinvestment plans for new issue stock will provide in excess of $4 billion of common stock capital annually. This will represent some 50 percent of the total external common stock capital raised in public offerings.

Moreover, this common stock cushion of some $4 billion a year, is essential to the raising of about twice as much, or about $8 billion, in bonds and preferred stock.

Finally, it is important to emphasize that the proposed tax reduction is for the individual taxpayer—and there are about 2 million stockholders now participating in dividend reinvestment plans for new issue stock. And the record is quite clear that the very large majority of the participants in these plans are the smaller stockholders.

In sum, Mr. Chairman, the dividend reinvestment proposal would remove a substantial disincentive to savings and would encourage significant increased savings, increased common stock capital formation, and capital investment where it is essentially needed.

It would be counter-inflationary and it involves a revenue loss which over a 3-year period, as I have indicated, would be either relatively modest or nonexistent.

Accordingly, Mr. Chairman, we strongly urge that your committee give favorable consideration to the dividend reinvestment proposal embodied in S. 141.

Thank you, sir.

Senator CHAFEE. Thank you very much, Mr. Cohn.

Mr. Turner.

STATEMENT OF JOHN J. BROWN, LEGISLATIVE DIRECTOR, INTERNATIONAL UNION OF OPERATING ENGINEERS

Mr. BROWN. Mr. Chairman, I am John J. Brown, legislative director for the International Union of Operating Engineers. Mr. Turner, general president of the Operating Engineers, is still out on the coast and will not be back until tomorrow.

He extends his apologies to the committee and to yourself, sir, for not being able to appear.

Senator CHAFEE. Fine. We will miss him, but I am sure he sent a splendid representative.

Mr. BROWN. If nothing else.

[Reading Mr. Turner's statement.]

Mr. Chairman and distinguished members of the Subcommittee, my name is J. C. Turner, general president for the International Union of Operating Engineers. I am appearing here, today, on behalf of the officers and members of the 425,000 members of the Operating Engineers Union.

In addition, the views I will express at this hearing, are endorsed by several other labor organizations. The following are the International Brotherhood of Electrical Workers AFL-CIO, the International Union of Electrical Radio and Machine Workers AFL-CIO, the Labor's International Union of North American AFL-CIO, and the Building and Construction Trades Department AFL-CIO, representing 4 million construction workers.

On behalf of these organizations, I am here today to speak in favor of the stock dividend reinvestment proposal that is contained in S. 141, as introduced by seven sponsors in the Senate and 157 sponsors in the House.

I want to make it clear that we are here today for the sole purpose of supporting that stock dividend reinvestment legislation.

As you might imagine our overriding concern is a healthy economy and jobs for our people. The unions I represent are particularly active in utility, the electric utility industry. We help build and operate generating plants throughout the country.

As with most other sectors of the economy, inflation in the utility business has driven up the cost of new construction dramatically.

Many utilities just have run out of money necessary for badly needed construction projects. The utility commissions won't give the utilities high enough rates so they build from revenues and they can't sell enough stocks and bonds to build their plants so we are seeing cancellations of building programs all over the country, more and more people out of work.

America runs on electricity. Without it the economy stops, yet we are cancelling new plants that will be essential in the years to come in order to supply power to new industry.

This problem of raising money is not unique to the utility industry, but since about 50 percent of all new issues of common stock are utilities stocks, you can see that this industry has a worse problem of raising money than any other industry.

Many of our members invest in utility stocks. Their holdings usually are small, but such investments give them a real sense of participation in the industry in which we are involved.

However, when a cash dividend is issued, the current tax law provides a disincentive for reinvesting that money in the company's stock. Today, that money is taxed even when it is plowed back into company stock under a dividend reinvestment plan.

The legislation now before your committee would permit deferral of taxation on dividends reinvested in the stock of the company until the shareholder actually sells that stock.

For our members, this is one of the few ways they can be encouraged to invest in a growing economy while saving some of their earnings to plan for their retirement.

This is not a windfall to the rich because the bill limits such tax deferral benefits to a maximum of $1,500 for a single taxpayer and $3,000 for a joint return per year. The rich have many ways to shelter income and some of them have nothing to do whatever for our economy.

Here is a plan that puts the savings of small investors to work for the good of our economy. We understand that a study by the Robert N. Nathan Associates indicates that this legislation, if passed, would add approximately 50,000 per year and we favor creation of new jobs.

Another point that should be considered is that, especially in the utility plant construction field, we are often competing for jobs with Europe and Japan since both tax capital gains on a much more favorable basis than here in the United States.

A bill such as this one, before you, helps put our country in a more advantageous position to compete for those new jobs. This is not a labor issue or a management issue. It is a national issue that unites both of us in a common effort. It seems to us that the stock dividend reinvestment plan helps the economy, helps the consumer, and helps the worker. As such, it has our full support and we especially suggest that it deserves the support of the Congress.

Senator CHAFEE. Thank you very much, Mr. Brown. I appreciate that statement and we will get a few questions later. Mr. Nichols.

STATEMENT OF GUY NICHOLS, NEW ENGLAND ELECTRIC SYSTEM

Mr. NICHOLS. Thank you, Mr. Chairman. I am here this morning representing both the New England Electric System and the Edison Electric Institute. The members of the institute serve more than three-quarters of the electric utility customers of the country.

We support Senate bill 141 because when this bill is enacted it will both increase the amount of common share investment raised through the much more attractive dividend reinvestment programs and two, it will also increase the attractiveness of the shares of those companies that do both pay dividends and offer these programs. This will raise the market price of those shares.

This latter point is critically important to regulated utilities for three reasons. Utilities have an obligation to serve the growing needs of their customers and this requires large amounts of new money some of which must be in the form of common stock.

The second point is that utility shares are now selling at a one-quarter to one-third below their book value.

The third point is that the future earnings of utilities shareholders are a function of the future book value of their investment.

This combination of factors makes it almost impossible to commit to the construction programs that are essential to the national interest. I have five very simple charts I would like to run through, if I may. They were included with my written testimony.

The total common share book value of an electric utility company, is of course, the total of the value of the common shares of the company as shown on the company books. These dollars include the dollars originally invested, the reinvested earnings, and the dollars raised by the new shares that have been issued. That is total book value.

If you divide that by the total number of common shares outstanding, you get the book value per share. From my example, I would like to take a company that has a total common share book value of $1.2 billion and 40 million shares outstanding, giving us a book value per share of $30.

Next, I would like to look at the way this particular company is regulated. With apologies to the regulatory commissions, I have oversimplified this greatly, but utility commissions look at the total common book value and decide that this has a certain worth for the historical period that they are evaluating.

They think that book value should have been allowed to earn a certain percentage return. In today's world 13.5 to 14.5 percent allowed return is common. For our example, they have given this company hypothetical earnings during that historical test period, of $168 million.

To this they add all the expenses that they believe are appropriate, the interest, the taxes, the preferred dividends, all of the operating expenses, for this example $1.832 billion, coming up with total allowed gross revenues of $2 billion.

These are the dollars that the regulators suggest this company should have been allowed to raise in the form of revenue during the hypothetical period. On an earnings-per-share basis, these gross revenues translate into $4.20 per share.

[Chart shown.]

Now, let's look what happens when this typical company, which is company A is compared with that unusual company (company B), and I think there may be only one in the entire country, whose shares are selling at market value.

Our typical company is selling about one-third below book value. It is selling at $20 per share. The unusual company, company B, has a market value the same as its book value.

Next chart, please.

[Chart shown.]

Now let's look what happens when each of these two companies have to raise $300 million in new stock. I ask you just to look quickly at company A.

To raise $300 million, company A has to sell 15 million shares at its market price of $20 per share. It winds up with 55 million shares and a new book value of $1.5 billion. Its book value per share has dropped to $27.27. Its potential earnings per share, because it now has $1.5 billion in total book value, is now $210 million. That translates, with 55 million shares, to $3.82 per share, a reduction in its potential earnings per share.

But, now look at company B. You see that it only needs to sell 10 million shares because its stock is selling at $30, the same as its book value. It winds up with the same $1.5 billion in new total book value, but it now only has 50 million shares outstanding.

It still has a book value per share of $30. There has been no dilution in earnings per share. Because it is allowed the same 14 percent on its total book value, $210 million, but with less shares outstanding it still has the same potential earnings of $4.20 per share.

As you look at those key figures, I think it is easy to realize the importance of the dilution in book value per share that comes about when you sell new issues of common equity at below book value. That diluation literally penalizes the existing investors.

It makes it nearly impossible in today's world, for utility managements to make the decisions to build the essential new construction programs that the previous speaker just identified.

Now, I realize that there is another way to get at an improvement in market value. Regulatory commissions could make utility shares more attractive by allowing a higher allowed return. Let's say 17 or 18 percent instead of today's more typical 13 to 14 percent. However, it is not easy for regulators to allow an adequate return during a period of rapidly rising costs. The consumer pressures are significant.

This leads us to search for other ways to make utility shares more attractive. One way is to give equity investors a higher aftertax return by allowing tax deferred treatment on their reinvested dividends.

This tax deferred treatment will attract and keep for utilities an entire new group of investors. Investors not interested in cash dividends, but investors interested in reinvesting their dividends and thus maximizing their aftertax investment returns.

In summary, we support S. 141 because it will do two things. It will increase the amount of new equity money raised through the reinvestment of dividends and two, it will increase the market value of utility shares making it possible to raise the large amounts of new equity needed to finance essential new construction.

Thank you, Mr. Chairman.

Senator CHAFEE. Thank you, Mr. Nichols for your presentation. I will have some questions when we finish.

Mr. Rodgers.

STATEMENT OF PAUL RODGERS, ADMINISTRATIVE DIRECTOR, NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

Mr. RODGERS. Thank you, Mr. Chairman. My name is Paul Rodgers. I am the administrative director of the National Association of Regulatory Utility Commissioners composed of the commissions of the 50 States engaged in the regulation of utilities and carriers.

I am accompanied, today, by Michael Foley, our director of financial analysis and Rose Ann Fraistat, our director of congressional relations.

The NARUC fully supports the enactment of S. 141, relating to tax deferral of reinvested dividends. During the past 5 years, the consumer price index has surged by nearly 50 percent while interest rates have peaked at record highs, causing considerable damage to both the investors of the public utilities and the firms themselves.

Often overlooked, however, is the financial burden which utility ratepayers have been forced to shoulder due to rapidly escalating utility expenses.

Consider, for example, that in its 1981 annual statiscal report, Electrical World magazine reports that in the 5-year period since the end of 1975, average residential usage of electricity has gone up less than 10 percent while the cost for kilowatt hour has increased over 50 percent. The average annual residential electric bill has jumped nearly 70 percent.

Thus, consumers of utilities services have responded to the call for increased energy conservation only to be rewarded with skyrocketing utility bills.

Electric rates, which for years have been on the decline due to technological and productivity improvements, are now at a 40-year high and climbing. Additional improvements will require utilities to raise huge sums of new capital. Moody's Investor Service reports that, during 1982 and 1983 alone, well over $4 billion of utility debentures are scheduled to mature. Refinancing these debt obligations at today's double-digit interest rates will place an enormous strain on an industry which is already experiencing financial difficulties.

In addition to this refinancing task, the industry will again have to market several billion dollars' worth of new equity in order to raise a portion of the prodigious amounts of new capital required annually.

Unfortunately, in view of the fact that the common stock of almost every major electric utility is selling below book value, these additional equity sales will actually dilute the ownership position of present shareholders. No rational investor will purchase a security without a reasonable expectation for fair return. Persistent sales in new common stock equity at depressed market prices have made it increasingly difficult for utilities to raise needed capital.

In an effort to placate existing shareholders and to attract new investors, utilities have been increasing dividends at a rapid clip. The most recent data from Solomon Bros. indicates that fully 80 percent of the 100 largest electric companies increased their dividends within the past 12 months. Six of these firms actually raised their dividends twice within the last year. However, maintaining dividend yields, which now average in excess of 12 percent, places a serious cash drain on the industry.

State utility regulators, fully aware of the financial plight of the industry, have responded by granting record setting rate increases.

During 1980 alone, the State regulatory commissions granted almost $6 billion in rate hikes, nearly twice the level granted during 1979.

Rates of return on common equity currently being approved by the State commissions have been even higher. Yet, the actual rates of return which utilities have managed to earn have shown only marginal improvement. In a word, the culprit is inflation.

Passage of this legislation will amend the Tax Code by allowing shareholders to defer taxation on dividends which have been reinvested into qualified dividend reinvestment plans, thus enabling utilities more readily to raise needed capital while providing investors with a fair return.

Though there is no regulatory cure for inflation, it is the position of the NARUC that the amendments to the Tax Code included in this important legislation would provide an important first step in moderating the adverse effects of inflation on utility companies, their shareholders, and their ratepayers.

Mr. Chairman, I have here a letter fully supporting this legislation from the NARUC first vice president, who is chairman of the Public Utilities Commission of the great State of Rhode Island in Providence Plantation, Mr. Edward F. Burke.

If I may, I would like to offer this letter for insertion in the record.

Senator CHAFEE. Well, I certainly would appreciate that.

Mr. RODGERS. Thank you.

Senator CHAFEE. Thank you for that testimony.

Professor Wilson.

[Statement of Edward F. Burke, chairman, Rhode Island Public Utilities Commission follows:]

STATEMENT BY EDWARD F. BURKE, CHAIRMAN, RHODE ISLAND PUBLIC UTILITIES COMMISSION

My name is Edward F. Burke. I am Chairman of the Rhode Island Public Utilities Commission, First Vice President of the National Association of Regulatory Utility Commissioners, and Chariman of the Rhode Island Energy Coordinating Council. The Subcommittee on Energy Conservation and Power is to be commended for convening this timely hearing on the subject of utility financing. It follows closely upon the extensive testimony of many noted financial experts, utility executives and lawyers and economists familiar with utility financing and regulatory procedures at the informal conference on electric utility financial issues on March 6, a conference in which Chairman Ottinger and I were privileged to participate.

Reference should also be made to the widely-circulated and heavily publicized "Corey Task Force" recommendations to President Reagan relative to "restoration of financial health" to the electric power industry.

I think it not necessary for me to repeat the major contentions made by representatives of the industry and the financial community. There is no question that many electric utilities are no longer regarded as attractive investments by prospective investors for a variety of reasons, and that as a result capital financing for needed new construction or conversion of generating facilities has become increasingly more expensive.

The recommendations submitted to correct the problem have been many and varied and some of the proposed techniques meet with my approval as I will shortly indicate. I think, however, that it is fair to say that the proposals may be summarized as recommending substantially increased rate relief granted by regulatory commissions in a much more prompt fashion than heretofore through a streamlining of procedures.

The Corey Task Force in fact was highly critical of state public utilities commissions saying, "Why are the PUC's (with only a few exceptions) so remiss in allowing the utilities an opportunity to realize reasonable earnings . . ." [1] This comment was echoed by witness after witness at the FERC Informal Public Conference on March 6.

I think that I speak for all my colleagues in saying that we are not unaware of the concerns being expressed by or on behalf of the utilities. We, however, have the difficult task of balancing our obligations both to the utilities and the ratepayers. We are obligated to allow regulated public utilities a fair rate of return which, with prudent management, will be adequate to allow the utility to attract sufficient capital in addition to earnings sufficient to operate and maintain its plant and to provide adequate service. We must also make sure that the rates charged are both just and reasonable.

In short, we regulators must carefully balance the interests of both the regulated utility and its ratepayers which do not always fully coincide. There is no question that inflation has contributed to the spiraling cost of electricity in the United States. It is also clear that despite an increase in rate approvals for electric utilities from $538 million in 1970 to $5.932 billion in 1980 (from applications totalling $797 million in 1970 and $10.871 billion in 1980 [2]) that earned return of electric utilities has declined since 1972 by 1.3 percent.[3]

On the other hand the escalation of prices faced by ratepayers has been rapid and alarming. For example, an analysis by my office shows that the rates currently being paid by residential customers of a well run Rhode Island utility for 1000 kilowatt hours of electricity now amounts to $96.00. In 1972 the same amount of electricity cost the ratepayer slightly less than $23.00. This increase is not unique. It is common to utilities in the Northeast, with the largest increases being experienced in almost direct proportion to the amount of oil fired generation used by the utility.

Little wonder that state regulators are beset by expressions of concern, some quite vehement and emphatic, from residential ratepayers who are having trouble coping with the high cost of living and more recently by businessmen and industrialists who are finding, especially in the Northeast, that increasing energy costs are seriously affecting the profitability of their enterprises. During hearings on proposed rate increases it is common for regulators to receive oral or written comments from mayors and other local government officials, state officials including legislators, and even from members of Congress, complaining of rising electric rates and urging us to deny the pending petitions.

Faced as we are with these constant pressures, it is understandable that there is a high turnover in the membership of state public utilities commissions. Some leave voluntarily—frustrated by the workload and the constant stream of criticism—others involuntarily because of the displeasure of the appointing authority over their decisions.

I think that, under the circumstances, my colleague commissioners are to be commended for the conscientious effort which they make to render fair decisions based on the evidence before them.

Is it possible then to improve the financial condition of the electric utilities while at the same time curbing rising costs? I think the answer is yes. I do not have any certified, guaranteed answers or magic formulas, but I do have some suggestions which I hope will contribute to our goal.

JUSTIFICATION OF PLANT EXPANSION

The late 1960's and most of the 1970's constituted a period in which the electric utility industry, armed with forecasts of large increases in demand, embarked upon ambitious programs of generating capacity expansion. While the forecasts were basically accurate in certain areas of the nation where business activity was expanding and population was increasing, they were much too optimistic in many sections of the country, especially in the Northeast.

The result was the construction of new plants which have not been fully utilized or which have yet to prove their dependability while older plants have been kept on line to provide reserve capacity. At the present time New England's power grid, NEPOOL, has 22,000 megawatts of generating capacity while demand has never exceeded 16,000 megawatts. Thus we in New England maintain a reserve capacity of over 40 percent above peak demand while expert opinion suggests that 20 percent would suffice. In the latter years of the 1970's particularly after President Carter's presentation of a national energy plan in 1977 and its subsequent implementation, there was a marked increase in energy conservation much of which can be attribut-

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[1] Recommendations for the Restoration of Financial Health to the U.S. Electric Power Industry Report on an Informal Task Force To The Energy Transition Team. Dec. 17, 1980, p. 12.
[2] Source: Comments by Edison Electric Institute before FERC, Mar. 6, 1981, table 13.
[3] Recommendations for the Restoration of Financial Health, supra, Note 1, p. 9.

ed to the effect of increasing price "signals" to the consumers. In any event this led to a marked downturn in all forms of energy consumption including electricity. Some segments of the electric utility industry were slow to react to these barometers of slowed growth of electrical demand. Ontario Hydro continued its ambitious capital expansion program unabated despite evidence of diminishing need. As a result they have an overbundance of generating capacity which fortunately may assist sister provinces and neighboring states, but which is clearly unneeded in Ontario.

Yet, despite these recent examples, far too much of the testimony which I have heard recently from certain industry and financial community spokesmen stresses growth requirements of the industry and gives little heed to the demand-diminishing effects of rising prices and the conservation ethic.

Under the circumstances, I suggest that the first responsibility of state regulators is to make any utility proposing new plant construction or generation conversion—and let us note that there is little argument about the need to convert oil-fired generation to either coal or perhaps gas—to prove conclusively that actual and projected demand forecasts justify the proposal. The utility should further prove that all potential alternatives have been carefully explored both as to cost effectiveness and environmental impacts and that use of such alternatives to construction as conservation, load management and cogeneration have been utilized to their maximum.

PREAPPROVAL OF CONSTRUCTION

I feel that it is in the best interest of the utility involved and its customers to determine the need for construction and the method of financing in advance of commencement of the project. In effect, I suggest that the state PUCs must become involved in a preapproval process. I do not suggest that rates treatment of the project can possibly be fully treated in advance of construction or completion of the project, but I do suggest that to delay basic determinations as to the need and advisability of construction until shortly before the plant is in service is far too late in the process. The results in certain circumstances have been unfortunate. Certainly at this time of escalating costs of construction, careful examination of construction proposals and preapproval must be utilized if both the viability of the industry and the economic well being of the retail ratepayer is to be protected. It is also essential that any new construction or even generation conversion should be part of an overall plan for the development and maintenance of generating capacity of the area's power planning and exchange entity.

Robert P. Wax, Counsel to the Northeast Utilities, in testifying at the FERC hearing cited Edison Electric Institute projections of a need for 150,000 megawatts of essentially coal and nuclear energy during this decade and that non-investor owned utilities will require another 40,000 megawatts during the same period. Mr. Wax said that 94,000 megawatts is scheduled for construction by 1985. The decade forecast represents an increment equivalent to about 45 percent of 1980's peak load of 438,000 megawatts. Considering the anticipated effect of inflation on the costs of construction during the next decade, it is essential that all possible alternatives to new construction must be exhaustively explored.

ALTERNATIVES TO NEW CONSTRUCTION

1. Improvement of interconnection between power exchanges

As I have indicated, NEPEX, which is the power exchange of NEPOOL, has at its disposal a reserve capacity over 40 percent larger than peak demand. However, if a neighboring power exchange system lost generating capacity, New England could at present wheel no more than 2,000 megawatts over present system interconnection ties to aid systems to the south or west. Conversely, New England's potential receipt of wheeled power would be limited by the capacity of the interconnection transmission lines.

There have been several studies by DOE and others which have advocated the upgrading and expansion of system interties in the United States and Canada. In fact, there are cogent arguments for a national grid system or a North American grid system or, with due regard for the Rocky Mountains, at least a grid system from the Atlantic to the Rockies.

Basically the concept is that by increasing wheeling capability—by making electrical generation more mobile—it will be possible to significantly reduce base load reserve capacity in all systems. I think the concept is sound and should be implemented.

The Northeast Power Coordinating Council has already shown the benefits of international cooperation. It consists of over 20 full member electric systems which provide 98 percent of the electric generation in New England, New York and in the Canadian Provinces of New Brunswick and Ontario. This organization has already made significant progress in developing probability methods in system reliability evaluation. They are also working closely on load and capacity problems with reliability councils to the south and west such as MACC and ECAR. I feel that these organizations may be the forerunner of the development of an efficient national elecrical grid system.

One further note. We in New York, New Jersey, Pennsylvania and New England are actually aware of the potential for developing the massive hydro-electric power potential of Eastern Canada for the mutual benefit of the Canadians and the Northeast region. Interconnection capability between New York and Quebec and Ontario is being upgraded in a major way. NEPOOL and Hydro-Quebec are hard at work on engineering studies which could result in system interconnection capability of up to 2,000 megawatts by 1990.

Governors Garrahy, King, Snelling and others are busy exploring with their Canadian counterparts ways in which hydro power sites could be built under joint, though Canadian controlled, ventures to supply power on a long term basis to American utilities and which will be developed far in advance of the need for full Canadian utilization. These activities have prompted the Memphis Commercial Appeal to say, ". . . It may be unlikely that hydroelectric power from Quebec alone will cause the reindustrialization of New England in the next few years. But that water power could be the start of such a movement, even as hydro power was the start of industrialization in the TVA region." [4] At least the hydro power will help New England to end its dependency on OPEC oil.

CONSERVATION AND LOAD MANAGEMENT

We are proud in New England of the justly celebrated NEESPLAN developed by the New England Electric System in 1979 and subsequently upgraded. This plan substitutes an aggressive and imaginative conservation and load management program together with planned conversion of oil-fired generating units to coal as a substitute for nuclear or other possible new generation construction between 1980 and 1995. I think the plan is feasible and I think it is going to succeed due to intelligent leadership of Guy Nichols and his staff who communicate effectively with regulators, customers, Governors, and the media and who seek and take careful note of constructive criticism and affirmative suggestions.

I will again note parenthetically that New England has just witnessed an outstanding example of utility-government cooperation. On April 1 New England Power Company, a NEES affiliate, filed a proposal with the FERC providing for the conversion from oil to coal of three generating units at Salem Harbor, Massachusetts. The filing contains a proposal for an oil conversion adjustment ("OCA"). This is a financing mechanism under which NEP's customers will receive one-third of the savings of the difference between coal and oil costs with the balance of savings being used to defray the costs of conversion until the amortization process is completed in 1985. What is noteworthy is that this filing was submitted with the prior approval of Governors Gallen, King and Garrahy and all responsible energy officials in New Hampshire, Massachusetts and Rhode Island where retail affiliates of NEPCO operate. Governor Gerrahy further obtained written confirmation from NEPCO that subsequent savings to the company from passage of proposed oil backout or tax credit legislation will be passed on directly to retail customers.

As a corollary, we in Rhode Island are proud that our Congressman St Germain, with the co-sponsorship of Congresswoman Schneider and others, has reintroduced (H.R. 1031) last year's oil backout bill which passed in the Senate, but not in the House, which provides grants and loans to expedite the conversion of existing electric power plants from oil to coal.

We happen to think that these are the right kind of Federal grants, at a time when "grant" is an unpopular word, as it will help a region that is willing to make sacrifices to become more energy efficient and produce the kind of industrial climate that will reduce the need for federal unemployment and welfare assistance.

A passing word about the cooperation and enthusiasm of Senators Pell and Chafee. They are working hard also to develop legislative initiatives that will help New England electric utilities shed their oil dependency. Under Governor Garrahy's leadership we in Rhode Island have developed a bi-partisan approach to energy problem solving. It is fun and it seems to be working—I hope the approach is infectious.

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[4] Editorial, Memphis Commercial Appeal, Aug. 26, 1980.

COGENERATION

The potential of cogeneration has only begun to be realized in this country, though in Europe it has long been recognized as an important source of electrical generation. Implementation of Section 210 of the Public Utilities Regulatory Policies Act, which requires public utility commissions to establish the rate at which cogenerated electricity is purchased by utilities at the cost avoided by the utility in not having to generate power or add capacity, is expected to encourage greatly increased production of electricity by this means. The purchase of power generated by industry and institutions has several advantageous impacts. By not having to finance high-cost plants, with today's high interest rates and widespread regulatory lag, utilities can avoid dilution of earnings due to heavy construction programs. In an era of demand uncertainty, there is less risk of over-investment. The dispersion of cogeneration means easier siting, short lead times, less environmental hassle, and use of cheaper alternative fuels. Utilities must adjust to an altered role from that that has been traditional, and learn that distribution of cogenerated power can be both profitable and less expensive.

At this point I must abandon my efforts to develop a number of thoughts which I would have liked to express if this document is to make the night train to Washington and your already extended deadline. Such are the shortcomings of a small-state regulator who must write his own testimony.

I must, however, mention several additional thoughts.

I favor H.R. 654 which is a bill relating to tax treatment of qualified dividend reinvestment plans. This would encourage reinvestment of earnings and provide a vehicle which will assist the utility industry in increasing cash flow without having any significant effect upon retail rates.

I support the concept of a one year limitation on rate case decisions before the FERC provided FERC is given sufficient staff to effectively review filings. I further favor hearings in regions affected by FERC wholesale rate decisions.

I also favor former Chairman Ferris' concept of Federal-State Joint Boards to handle wholesale rate filings of such multi-state utility conglomerate as Eastern Utilities Associates and New England Electric System. I will be pleased to elaborate these views during the panel discussion.

STATEMENT OF BRENT D. WILSON, ASSISTANT PROFESSOR, COLGATE DARDEN GRADUATE SCHOOL OF BUSINESS ADMINISTRATION, UNIVERSITY OF VIRGINIA

Dr. WILSON. My name is Brent D. Wilson. I am an assistant professor at the Colgate Darden Graduate School of Business Administration at the University of Virginia.

My research, as well as that of many others, has shown that over the past two decades the capital structures of U.S. companies have been seriously weakened.

This deterioration has occurred because of the increasingly heavy use of debt capital in financing these companies.

For example, interest expense as a percent of net corporate profits has increased from 14 percent in 1960 to 45 percent in 1980.

This problem has been especially severe in all capital intensive industries, those industries which are basic to our economic interest structure, and is not limited to the well publicized afflictions of the regulated utilities about which the three previous witnesses have spoken.

These critical basic industries have been experiencing increased difficulty in raising needed capital because of the risks which investors see in their weakened capital positions.

I believe that dividend reinvestment plans, DRP's, are an effective financing vehicle which will assist in resolving this problem of raising equity capital.

Companies have several methods of raising needed equity to offset the increased debt ratios in their capital structures.

These methods include increased profitability, accelerated depreciation, dividend reductions, direct public equity offerings, rights offerings, and stock dividends.

Each of these alternatives, however, has some factors which have restricted or limited their appeal to potential investors or to the company.

Because of the continuing need for additional equity capital and the limited usefulness of the existing alternatives, companies have developed dividend reinvestment plans.

DRP's have grown in popularity as their usefulness in raising equity capital has been demonstrated. There are currently approximately 200 plans which utilize DRP's to issue new equity with about $2 billion in new equity capital raised through these plans in 1979.

Senator CHAFEE. Is a plan 1 company?

Dr. WILSON. One company, sir.

Senator CHAFEE. You mean there are only 200 companies in the Nation that have dividend reinvestment?

Dr. WILSON. These are for new issues of equity. There are somewhere over 1,000 companies which are utilizing plans which are purchasing equity from the markets and then would reissue those to shareholders. There are approximately 200 companies which are issuing new equity through these plans.

Senator CHAFEE. I don't understand how new issue and new equity works with dividend reinvestment.

Dr. WILSON. This would be essentially equity which has not been previously been issued or traded in the market. So a company which would be using one of these plans would be issuing new shares of stock similar to a direct——

Senator CHAFEE. You mean every quarter?

Dr. WILSON. Yes sir.

Senator CHAFEE. It would not be a once a year issue. The shares they are selling to their shareholders through the dividend reinvestment plans are not bought in the market. They are new shares.

Dr. WILSON. That is correct.

I might indicate that for the typical plan, approximately 75 percent of the participants hold fewer than 200 shares in the company.

I believe the DRP's are attractive because they provide benefits to the individual shareholder, the economy, and the issuing company.

Shareholders benefit because the plans provide for issuance of a small number or even fractional shares. Thus, the DRP's allow the investor to invest small amounts of capital. The shareholder also benefits through the opportunity to choose whether to receive cash or stock dividends.

The economy benefits from the anti-inflationary affect of having the dividends invested into productive assets instead of consumed.

Because of the small amounts involved and the high transaction costs otherwise incurred in small investments, it is likely that in absence of the DRP's, new dividend payments of small investors would be reinvested.

These plans also encourage individuals to save which helps reduce the savings gap between the United States and other industrialized countries.

The issuing company benefits by conserving the cash otherwise issued in cash dividend payments and not recovered through equity channels. This results in strengthened equity positions for the companies and improved capital structures.

This improvement has been noted by credit rating agencies who have stated that increased use of DRP's would likely to lead to improved credit ratings for the companies. The companies also benefit from lower administrative costs and in most plans pass this benefit to the shareholders by issuing the stock at a discount and by absorbing the issuance cost.

Let me just summarize by indicating, as represented by this panel, that the proposal has broad scale support with the pressing need for the formation of additional equity capital. I believe that the proposed changes to DRP's are vital and I strongly recommend approval of S. 141.

Senator CHAFEE. Thank you.

Mr. Hollister.

STATEMENT OF KENNETH HOLLISTER, FIRST VICE PRESIDENT, DEAN WITTER REYNOLDS, INC.

Mr. HOLLISTER. Thank you, sir. My name is Kenneth Hollister. I am first vice president of the utility finance department of Dean Witter Reynolds.

Dean Witter Reynolds supports the deferral of taxes and qualified dividend reinvestment plans, such as S. 141. We believe tax deferral and greater participation in dividend reinvestment plans would strengthen the capital structure of U.S. corporations and provide a base for necessary capital expenditures.

In my testimony, I have concentrated on the regulated industries as that is where I have my greatest familiarity. I recognize the same principles apply to other industries, such as steel, automobiles, and building.

The utility industry, however, including the electricity and telecommunications companies, represent the largest single requirement of equity capital in this country.

To put electric utility financing in perspective, over the past 5 years some $22 billion worth of common stock has been sold by the industry and another $5 to $6 billion by the telecommunications industry in order to provide necessary service.

According to our records where we have been an underwriter, over 75 percent of this approximately $27 to $28 billion was placed in what we call retain accounts. Those persons purchasing 200 shares or less and having an aggregate purchasing amount of $5,000 or less. I believe this can fairly be described as the individual owner.

As a corollary, there has been a significant decline in the common stock investment in regulated industries by fiduciaries and these larger pools of capital have been directed elsewhere.

While the investor was placing his funds in these industries, however, they have increasingly lowered the price they were willing to pay for a specific level of dividend because of the presumed reduction and opportunity for capital gains or inflation brought on by regulatory and economic constraints.

The result has been a continuing steady deterioration in the market price and an increase in the discount from book value. The latter having the effect of diluting the value of the equity investment of the prior common stock investor.

Stated in another way, the investor in order to obtain a satisfactory income return on his capital is insisting that earlier investment be marked down to current depreciated levels before he is willing to use his savings to buy new common stock.

Mr. HOLLISTER. Construction expenditures for the period 1980 to 1984 are estimated at $155 billion of which $95 billion will be obtained from savings. This must be accomplished in the face of an industry that has a serious health problem.

The primary advantages that I see to dividend reinvestment plans for the shareholders are, one, no commission or brokerage fees on reinvestment of dividends, automatic conversion of dividends into new productive facilities with further potential for growth in value of the investment.

As it is currently estimated that in the 5 years just passed, approximately $4.8 billion was reinvested through dividend reinvestment plans which is in addition to the $22 billion of other new equity.

The situation is that in the next 5 years $95 billion will be required and we need more than $4.8 billion of additional dividend reinvestment.

Under S. 141 investment not only would be directed toward business with the prospect for innovation, but also the rebuilding and modernization of existing facilities.

As a sidenote, it may be noted that the investment could aid the utility ratepayer and may also benefit them as they will not have to put up the dollars required for the double taxation of corporate earnings and personal dividends to meet the financial requirements of the industry.

Dean Witter Reynolds recommends that S. 141 be adopted.

Senator CHAFEE. Thank you very much, Mr. Hollister.

Mr. Goldberg.

STATEMENT OF SAM GOLDBERG, VICE PRESIDENT, INCO UNITED STATES, INC.

Mr. GOLDBERG. Thank you, Mr. Chairman. I am Sam Goldberg, vice president of Inco United States, an American subsidiary of Inco, Ltd., a Canadian corporation. Inco was formerly known as the International Nickel Co.

Accompanying me is Kurt Barnes, Financial Services Officer of Inco, Ltd.

You have my prepared statement, Mr. Chairman. I will summarize the main points of it in about 3 minutes here.

Like many companies incorporated abroad, Inco has substantial investments in this country.

Senator CHAFEE. Is Mr. Beard President of Inco?

Mr. GOLDBERG. That is right, sir. Not only are we the largest supplier of nickel in the United States, Inco also manufactures a variety of products in diverse enterprises across the country with operations in 26 States including advanced research and development facilities in New York, New Jersey, and North Carolina.

We support the basic policies of S. 141 with one important qualification. That is that the bill should extend eligibility to include certain parent companies which while incorporated outside the United States, have significant investments and operations within the United States.

It is clear that the objectives of S. 141 are first to promote capital formation and thus business expansion in this country and second, to give American shareholders an incentive to save by reinvesting their dividends in additional capital stock.

The benefits of business expansion in the United States do not arise solely from companies incorporated here. According to the Bureau of Economic Analysis, at the end of 1977 the assets of American affiliates of foreign corporations exceeded $130 billion.

These American affiliates employed over 1 million people in 1977. Inco, itself, has a $1 billion in assets in this country and employs over 15,000 people in some 26 different States.

Based on its U.S. activities alone, this would rank Inco 229 by asset size and 254 in employee size in the Fortune 500.

Corporations with such continuing and substantial commitment to the American economy should hardly be discouraged from this commitment simply because of the place of their incorporation.

Neither should a savings incentive be denied their U.S. shareholders. Inco, for example, has almost 20,000 American shareholders in all 50 States and the District of Columbia with a total of about 31 percent of Inco's shares worldwide.

Unless there be any misunderstanding, Mr. Chairman, let me emphasize that the savings incentive we propose will benefit only the American shareholders of foreign corporations, but will not confer unintended benefits on foreign shareholders.

It may interest the subcommittee to know that Canada currently has a system whereby shareholders may defer taxes by electing to receive new issue stock as dividends in lieu of cash irrespective of whether the corporation is Canadian or not.

For all of these reasons, it seems obvious that to exclude a sizeable segment of the American economy from the compass of this bill would be to deny important impetus to American investment and employment.

We, therefore, respectively urge that S. 141 be amended to include qualified foreign corporations. We are currently discussing, with members of the committee, the formulation of an acceptable eligibility test so that only those foreign corporations with important and continuing investments in the United States would be included.

This would ensure the objective of business expansion in this country which we all support.

Thank you, Mr. Chairman.

Senator CHAFEE. Thank you, Mr. Goldberg. That is an interesting point. The question, of course, is with the difficulty in determining what is eligible or qualified. I assume the word qualified means it is eligible.

Mr. GOLDBERG. Yes, sir. I have very interesting plans which I will be happy to discuss with you.

Senator CHAFEE. Gentlemen, Senator Dole regrets that he was unable to attend today's subcommittee hearing. He is deeply interested in the low personal savings rate in this country and recognizes that it is a very serious problem.

He has a statement for the record which I will include.

[Senator Dole's statement to follow Senator Chafee's:]

STATEMENT BY SENATOR JOHN H. CHAFEE

Good Morning. This is the second hearing we have scheduled this year for the purpose of analyzing individual savings and investment tax incentives. The first, on February 24, focused on proposals to expand the eligibility requirements for Individual Retirement Accounts, and to increase the contribution limit and purposes for which an IRA can be used.

In today's hearing, we will look at savings and investment incentives having a more general impact on individual taxpayers.

One of the most widely heard and widely accepted criticisms of our economy is that we have a capital shortage. There isn't enough money available for investing in new machinery and equipment to make our industries more productive. The home mortgage market has practically dried up. Interest rates are so high no one is buying cars, and the U.S. auto industry is on the ropes.

Part of the reason for the shortage of investment capital is that huge federal deficits are causing the government to borrow heavily from its citizens, usurping almost 30 percent of all loanable funds in the market this year.

Another basic reason for the shortage, however, is seen in the economic behavior of most U.S. taxpayers: we aren't saving much. Figures show that last year our savings rate dipped as low as 3.5 percent of personal income. That is down from 5.7 percent during the 1976–80 period, and 8.1 percent in the 1971–75 period.

A second widely heard and widely accepted criticism of our economy is that our tax system provides the wrong incentives or, at least, a bad balance between incentives. Taxpayers are rewarded with tens of billions of dollars in tax breaks for their every day habit of borrowing money, rather than saving it. Interest payments to lenders are deductible, whether they are from charging a pair of shoes or buying a house. On the other hand, interest and dividends earned by savers are taxed at the highest marginal rates.

The questions before us are these: Should Congress act to change this balance by creating more effective savings and investment incentives? If so, when should we act? What should we do?

President Reagan's economic package provides no specific tax incentive for individual saving and investment. It does, however, contain essential budget reductions, marginal tax rate cuts and business investment stimulus. It provides a good foundation for America's economic renewal.

We are told by the Administration that a second tax proposal will be made containing a savings incentive, a remedy for the marriage tax penalty and others. While I understand the Administration's legislative strategy, neither I nor many of my colleagues on the Finance Committee believe there will be two tax bills this year. We will have only one chance to enact a savings incentive and we must not let it pass.

The study I have done and the testimony we have heard so far this year has persuaded me that expanding Individual Retirement Accounts would give us the most efffective incentive for increasing total saving. To the witnesses, I can only say, I might be biased but I'm not close-minded. I remain open to your most persuasive arguments.

This morning's testimony will focus on four basic types of savings and investment incentives:

1. Reducing the capital gains tax rate;
2. Taxing investment income separately from salary and wage income to give it the benefit of a lower marginal rate;
3. Excluding large amounts or portions of interest and dividend income from taxation; and
4. Allowing tax deferrrals for reinvestmnent of dividends or capital gains.

We will also hear from two gentlemen who will discuss savings and investment incentives used in other industrial nations.

To begin, the Subcommittee welcomes Senator Schmitt followed by Senator Cranston, who will make statements on behalf of legislation they have introduced.

OPENING STATEMENT OF SENATOR DOLE

Mr. Chairman, today we have an opportunity to hear the views of members of the public on several bills intended to address a problem of vital concern to all Americans.

The problem is the appallingly low personal savings rate in this country—4.7 percent according to recent Commerce Department reports—lower than any of our major trading partners and competitors. This problem is important to *all* Americans because savings and investment not only provide financial security for the investor, but his investment provides the capital necessary to build homes and factories, to buy more efficient machines, and to provide jobs—to support the very foundation of our economic system.

It is not surprising, however, that fewer and fewer dollars are being saved. The rate of return on traditional small savings vehicles has not kept pace with inflation. Add that fact to the fact that the dollar that is saved, already taxed once when it is earned, earns income that is taxed again at the investor's highest marginal rate—so that the after-tax rate of return falls far short of the inflation rate—and it is no mystery why Americans are consuming rather than saving.

Two bills that I introduced earlier this Session on which this subcommittee has already held hearings, S. 12, which would make IRA's available for persons covered by employer pension plans, and S. 24, which would permit IRA—like savings accounts for persons saving to buy a home or for their children's education, specifically address this problem for the average citizen. We should keep an open mind, however, and consider seriously every measure which could improve savings.

The President's tax reduction package, by making a sizeable, *marginal* rate cut, is a significant step toward improving savings as, at the same time, it helps improve productivity. The bills to be discussed today, like S. 12 and S. 24, are even more precisely targeted at removing the tax disincentives for savings and investment.

The relative merit of each of these bills must not be viewed in the vacuum of classic revenue loss terms. Each is intended to spur new investment and new productive activity and thus will reduce significantly the amounts we forego by enacting such measures. For this reason, we should give particular attention to those proposals which would have an effect at the margin and would bring in new investment dollars rather than providing a windfall for those who already save.

In sum, Mr. Chairman, this hearing will provide us with information to evaluate different approaches to the problem of increasing savings and investment in this country—a problem we must resolve soon.

Senator CHAFEE. Now, gentlemen.

Why would this plan be of particular benefit to the utility industry? Would it not benefit everybody? Everybody would put their money into IBM, reinvest it, or leave it with banks if their stock holdings were in banks. I don't see why more people would flock into investing in the utility industry than presently are.

Mr. NICHOLS. I think they will flock into the utility common share market for the very simple reason that utility shares will suddenly become much more attractive from the viewpoint of after-tax return.

At the present time the tax law, you might use the word, discriminates against those companies that pay cash dividends. At the present time, using my own system that I work for as an example, we pay cash dividends that are roughly three-quarters of our total earnings.

We have about 15 percent of our shareholders that now participate in our dividend reinvestment program which is reinvested dollars in new shares.

If this Senate bill 141 is passed, I think we will suddenly attract a whole new host of potential investors. Investors that are not just interested in cash dividends or interested in reinvesting cash dividends on an after-tax basis, but investors that want to get the higher after-tax return that will be available to them if this bill is passed.

We desperately need to do that if we are going to raise the dollars that are essential and in the national interest. As the spokesman from the labor group indicated, the utility industry cannot raise the new equity dollars in the marketplace under existing tax legislation.

This bill will go a long way toward curing that particular problem and I think will be very helpful to tomorrow's customers.

Senator CHAFEE. Presently, utilities give a high yield in relation to the purchase price of the stock, correct?

Mr. NICHOLS. Yes; around 11 percent.

Senator CHAFEE. But, investors aren't attracted to the utility market because the paths of potential for growth are so limited.

Mr. NICHOLS. Every time a new issue of common shares is made, it further reduces that potential because the market price of those shares are less than book value.

Senator CHAFEE. Now, we pass this legislation which means that if the dividends are reinvested there is no tax on the dividend up to a modest point. You are not going to attract the big hitters because of the $3,000 limitation in this bill.

Mr. NICHOLS. Excuse me, I think you will attract that investment that will pay dividends of up to that amount from the big as well as the small. This suddenly becomes an attractive new market for those big investors up to a limited amount. You don't exclude them. They just don't go by the point.

Senator CHAFEE. You don't think they would overlook this?

Mr. NICHOLS. They rarely do. That is how they got there in the first place.

Senator CHAFEE. They would go for the utilities because of the large return which would be tax free. So then, you would probably cut back your dividends or least you wouldn't increase the dividends as substantially as you have been.

Mr. NICHOLS. No, they would go for the utilities because the utilities will meet two tests in tomorrow's world if this bill is passed—they do pay cash dividends of significant amounts, a very high percentage——

Senator CHAFEE. So does IBM.

Mr. NICHOLS. No, IBM does not pay that high cash dividend. They pay a modest cash dividend as a percentage of their earnings.

The typical utility company pays out about 75 percent of their earnings in the form of cash dividends. In tomorrow's world, the utilities——

Senator CHAFEE. But the investor is interested in what he can get, not what percentage is being paid out. As a matter of fact, if you pay 75 percent that doesn't look good because there is not much there for the future.

Mr. NICHOLS. He is interested in what he gets after Uncle Sam takes what he is going to take. That is what Senate 141 is going to help because it is going to permit that investor to reinvest his dividends and than get tax-deferred treatment, paying capital gains tax at the later date when he sells those new shares that he has purchased.

Senator CHAFEE. Well, let me ask Mr. Cohn. Mr. Chapoton opposed this proposal, in part, because it looked like the further locking of investment money. Thus, it inhibits the free choice of the investor. What do you say to that?

Mr. COHN. Well, sir, I have seen Mr. Chapoton's testimony since I came into the room and I notice that he did oppose the dividend reinvestment proposal for a number of reasons.

All of the reasons seem to me to come down to a rather single one. That is that the proposal would be quite attractive in persuading people to reinvest their dividends in these companies that have the new issue plans and that need common stock capital.

Now, we think that reinforces our proposal, that is, it suggests that we are right in urging that S. 141 will encourage people to reinvest their dividends.

The second thing, perhaps he is saying is that this is targeting the investment into a particular kind of company——

Senator CHAFEE. There is no——

Mr. COHN. Yes, sir. There isn't any question about that and there shouldn't be. That is one of the major points that we make in support of the proposal. It seems to us that it is highly desirable to encourage people to save and to invest their funds where it is urgently needed and where the funds will be reinvested in new productive facilities.

The point I would like to make, Mr. Chairman—and this is perhaps an enlargement of the response that was made by Mr. Nichols—is that this proposal, which is directed to companies having the new issue plans as referred to by Professor Wilson, deals with the highly capital intensive companies which need to go the market year after year for new common stock capital.

Where a company does not have a continuing need for new common stock capital, it does not have a dividend reinvestment plan for new issue stock. IBM does not have such a plan, nor does Dupont nor do the many other companies that do not have to go to the market year after year.

The reason they do not have a new issue plan today, and would not have one in the future, is because no company wants to sell common stock if it doesn't have to. The dividend reinvestment plan for new issue stock is a vehicle for raising common stock capital. It has proved to be a most effective one to date and it would be twice as effective if this legislation were adopted.

Senator CHAFEE. Now, what about the other legislation that was discussed here concerning the problem of a fifth year $2,500 for a joint return on taxes? That is, interest on these dividends being tax exempt. Now, that is not as targeted but that does the same thing.

Mr. COHN. Well, sir, I think perhaps you have answered the question. First of all, I would think there would be a great big question mark as to whether the numbers might go as high as the $1,500-$2,000 exemption for dividends and interest, because the revenue loss, I would think, would be very, very major.

Beyond that, our proposal is 100 percent targeted to creating new capital formation where it is urgently needed. I am all for anything that will encourage greater savings and investment and I think increased exclusion for dividends and interest would help. But, then the question arises, how much are we getting, how much help is the economy getting for the dollars of revenue lost.

We think our proposal will provide the biggest "bang for the buck" in terms of the increase in savings and productive investment, as compared with revenue loss.

Senator CHAFEE. Let me give you my problem. It seems to me that we have an industry here that has some very fundamental problems as far as attracting capital. The point that Mr. Brown, Mr. Nichols and others made are valid.

But, should we be in the business of targeting as specifically as this to help an industry whose problems have come about because the regulators have not recognized these problems apparently.

I don't blame the regulators. They are appointed by political figures. Elected officials are always anxious to hold down the rates of increase. Aren't you essentially in a regulated industry where the problems have not been recognized?

Mr. COHN. Well, sir, I would emphasize this point. The bill introduced by Senator Bentsen and the others, applies to any company which has a qualified plan and has a continuing need for common stock capital.

There are a significant number of nonutilities that are affected by this. That is an important point to get across.

It is true that the companies affected—the capital intensive companies having a continuing need for common stock capital—are primarily utilities, but by no means are they all utilities.

Mr. Goldberg spoke of the Inco problems. Inco is a company that has a continuing need for additional common stock capital and, of course, it is not a utility at all. It deals with natural resources. AMAX is another nonutility that is actively urging the adoption of this legislation.

The proposal is not targeted to a particular industry. It is targeted to companies that have a continuing need for common stock capital and many of them are not regulated.

Incidentally, there are about 30 or 40 bank holding companies that are using the dividend reinvestment plan as a vehicle to raise common stock capital which everybody agrees they urgently need.

Mr. NICHOLS. Senator, if I may add to that, there was previous targeting by our tax legislation that results in part in this request.

Let's assume that we run a major corporation and we are fortunate enough to have earnings for the corporation and we pay roughly a 46-percent tax on those earnings. That is the first tax. The after-tax earnings of the corporation are then available to you the management to either pay out in the form of cash dividends or to reinvest.

If you pay out those earnings in the form of cash dividends immediately, the recipients have to pay income taxes on them as they do today.

It you reinvest those earnings, the shareholders, at some later date, have the opportunity to sell their stock, hopefully, at a higher value at which time they will pay capital gains on that increased value.

That type of tax treatment, meaning when the corporation elects to reinvest immediately versus pay cash dividends, you could call that targeting under an earlier piece of tax legislation. We are only addressing that issue today. I don't think you can necesarily say this is a brand new piece of targeting.

Senator CHAFEE. Thank you, gentlemen.

Do the regulators want to respond?

Mr. RODGERS. Thank you, Mr. Chairman. I think you made the point which underscores the need for this legislation. The legislation is nondiscriminatory and it applies across the board to all industry and would be particularly beneficial to the electric utility industry.

I think the State commissioners have done an excellent job in balancing the interest between the ratepayers who are limited in what they can pay and the utility companies.

We are caught now in extremely difficult times with double-digit inflation and growing energy and environmental concerns. I think it is exceedingly important that we have this legislation because it is desperately needed and will provide great support to the electric utility industry and to the ratepayers.

The State commissioners have a very difficult job and, of course, I am surprised we don't have a faster turnover than we have. I don't think anybody could get elected to the Congress if during their term of office they had to raise electric utility rates. It is a very emotional issue.

I think the State commissioners have done as well as they can under a very onerous task.

Senator CHAFEE. Oh yes, I agree with that. Well, thank you all very much. We appreciate your testimony.

[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.141
BEFORE THE FINANCE SUBCOMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT POLICY
UNITED STATES SENATE
MAY 4, 1981

SUMMARY SHEET

A. Our Position - We urge the Subcommittee's favorable consideration of the dividend reinvestment legislative proposal incorporated in S.141, introduced by Senator Bentsen, on behalf of himself and Senator Baucus, and co-sponsored by Senators Packwood, Mathias, Boren, Leahy and Boschwitz.

This proposal -- by deferring the current tax on dividends reinvested in new issue stock under qualified dividend reinvestment plans and providing tax relief at the individual taxpayer level -- would reduce a tax disincentive for savings and investment, would substantially increase participation in such dividend reinvestment plans and would substantially increase savings, new capital formation and investment where it is urgently needed.

The proposal is complementary to -- and in no way conflicts with -- accelerated capital cost recovery. Accelerated capital cost recovery will reduce corporate taxes and increase internal generation of capital. The dividend reinvestment proposal is a reduction for the individual taxpayer which will increase external generation of capital for the capital-intensive companies which must rely primarily on external financing.

B. Economic Impact and Revenue Loss Estimate - It is estimated that adoption of the proposal would, in 1979 dollars and in the third full year after its adoption:

1. Increase dividend reinvestment to well in excess of \$4 billion a year (which would represent some 50% of the external common stock capital raised in public offerings, and provide the essential base for raising about twice as much, or well over \$8 billion, in bonds and preferred stock);

2. Increase national output by approximately \$2.7 billion annually;

3. Increase business fixed investment by about $1 billion annually;

4. Add about 50,000 jobs per year; and

5. After giving effect to the "feedback" associated with the increase in national output, business fixed investment and jobs, result in a net revenue loss of $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 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 and new capital investment where it is urgently needed.

2. Encourage stockholders (and participants in these plans are primarily the smaller stockholders) to increase current savings and provide for increased cash dividends when they are needed in the future as supplemental retirement income.

3. Reduce the double tax on dividend income by eliminating the current tax at the stockholder level when dividends are reinvested.

4. Be counter-inflationary in substituting capital formation for current consumption.

5. Be more equitable in treating receipt of stock under a qualified dividend reinvestment plan as the equivalent, for tax purposes, of a conventional stock dividend.

6. Help in financing essentially needed energy facilities since many of the companies having dividend reinvestment plans for new issue stock are suppliers of energy.

STATEMENT OF HERBERT B. COHN, CHAIRMAN
COMMITTEE FOR CAPITAL FORMATION THROUGH DIVIDEND REINVESTMENT
IN SUPPORT OF THE DIVIDEND REINVESTMENT PROPOSAL IN S.141
BEFORE THE FINANCE SUBCOMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT POLICY
UNITED STATES SENATE
May 4, 1981

My name is Herbert B. Cohn. I am associated with the law firm of Morgan, Lewis and Bockius in Washington, D.C. I appear here today as Chairman of the Committee for Capital Formation Through Dividend Reinvestment. Accompanying me are Robert R. Nathan, Chairman of Robert R. Nathan Associates, the Committee's economic consultant and Donald C. Alexander of the law firm of Morgan, Lewis & Bockius, the Committee's tax counsel.1/

We urge your favorable consideration of the dividend reinvestment legislative proposal incorporated in S.141, introduced by Senator Bentsen, on behalf of himself and Senator Baucus, and co-sponsored by Senators Packwood, Mathias, Boren, Leahy and Boschwitz.2/ Adoption of this proposal would reduce a tax disincentive for savings and investments, would substantially increase participation in dividend reinvestment plans for new issue stock; and substantially increase savings, new capital formation, and investment where it is urgently needed.

1/ The members of our Committee consist of the 59 companies listed in Appendix A.

2/ The companion bill in the House is H.R. 654, introduced by Congressman Pickle and sponsored by 156 members of the House, including 18 members of the Ways and Means Committee.

The essence of the proposal is also included in H.R. 488 introduced by Congressman Roe and in H.R. 1415 introduced by Congressman Minish.

The Provisions of the Dividend Reinvestment Proposal

Under current law, the stockholder who elects to reinvest his cash dividend and, instead, to take what is essentially a stock dividend, must pay a current tax on the value of the stock received. This is in contrast to the tax treatment of a conventional stock dividend, declared at the election of the company, where no current tax is imposed. The imposition of a current tax on reinvested dividends has been a substantial obstacle and a substantial disincentive in the way of increased participation in dividend reinvestment plans and a substantial limitation on the savings, new common stock capital and investment provided under such plans.

The proposal in S.141 would defer current taxes on dividends reinvested in original issue stock (with an annual limit of $1,500 for a single taxpayer and $3,000 for a joint return) of any company having a qualified dividend reinvestment plan. The stock received on such reinvestment would be regarded, for tax purposes, as essentially the equivalent of a conventional stock dividend with similar tax consequences. In essence, this would result in a downward adjustment of cost basis and, where the stock is later sold at a profit, in a capital gains tax. 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/]

This proposal, while providing tax relief at the individual taxpayer level -- and, primarily, for the smaller stockholder -- would stimulate a significant increase in individual savings and in external capital formation, capital investment and productivity and help to counter inflation.

It is important to note that the proposal is complementary to -- and in no way conflicts with -- proposals to increase internal generation of capital through increased 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

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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 S.141 includes 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.

It had also 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, S.141 provides 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.

or no effect on capital formation for those companies which cannot realize or retain the tax savings and they will have little or no effect in encouraging external capital formation for companies which are heavily dependent for their capital requirements on external financing.

Extent of New Capital Formation

We believe the dividend reinvestment proposal is one of the most direct, most closely targeted and most cost-effective proposals for increasing savings and investment and for encouraging new external capital formation where it is most urgently needed. It is most direct because the reinvestment in new issue stock represents instantaneous savings, investment and formation of new capital. It is most closely targeted because it represents a rifle-shot which is 100% effective in providing new capital to capital intensive companies having an urgent need for such common stock capital.4/ It is most cost-effective since it will provide a substantial increase in savings, investment and new capital formation, while involving a modest or nonexistent revenue loss.

For the stockholder who does not at the time need the cash dividend, the dividend reinvestment plans provide a simple, convenient and economical way to invest relatively small amounts and to build a larger nest egg for the future. They include the

4/ It is only the highly capital intensive companies having a continuing need for new common stock capital which have adopted -- or will adopt -- these dividend reinvestment plans for new issue stock. A company which does not need additional common capital will not want to sell additional shares and unnecessarily dilute the per share earnings and market price of its common stock.

advantages associated with "automatic savings"; and they employ the principles of "dollar averaging" and compounding to assist in building an investment which can provide larger cash dividends when the stockholder has need for such income.

There are about 185 companies which now have dividend reinvestment plans for new issue stock. About 2 million stockholders are participating in these plans. Such plans are now providing in excess of $2 billion a year in new common stock capital.[5/]

The potential for these plans is much greater. In the opinion of our economic consultants -- and in the opinion of those who are most familiar with the operations of these plans -- adoption of the proposed legislation will double this figure. This would be well in excess of $4 billion a year and would represent over 50% of the total external common stock capital raised in public offerings in 1979. Moreover, this common stock capital of well over $4 billion provides the essential base for raising about twice as much, or well over $8 billion, in bonds and preferred stock. The total of more than $12 billion a year represents a substantial portion of the total new capital which must be obtained through outside financing.

This would be of major help in assisting capital-intensive companies to obtain the common stock capital which is

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5/ To provide a concrete illustration of a plan in operation, Appendix B sets forth the figures for the dividend reinvestment plan of American Electric Power Company for 1977, 1978, 1979 and 1980. It indicates that, under this plan, American Electric Power is now obtaining common stock capital which, on the basis of the results for the fourth quarter of 1980, is in excess of $70 million a year. This represents more than 30% of AEP's annual external common stock capital requirements.

essential to finance their needs and to provide a cushion for required debt and preferred stock 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.

Economic Impact and Revenue Loss Estimates

Robert R. Nathan Associates, which has been the Committee's economic consultant, has concluded, after a detailed study, that adoption of the proposal (with the annual cap of $1,500/$3,000) would:

1. double dividend reinvestment in new issue stock;
2. increase national output by approximately $2.7 billion annually;
3. increase business fixed investment by about $1 billion annually; and
4. add about 50,000 jobs per year.

After giving effect to the "feedback" associated with the increase in national output, business fixed investment and jobs, Nathan Associates estimates that adoption of the proposal would result in a net revenue loss of $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 thereafter.

The Staff of the Joint Committee on Taxation which, as a matter of principle, does not take into account any "feedback" revenue gains, has estimated that the <u>gross</u> cash revenue loss in the first fiscal year would be some $240 million; and that the gross revenue loss would increase in succeeding years but would in no case exceed a little over $1 billion a year. These estimates are included in a letter dated October 24, 1979, from Bernard M. Shapiro, then Chief of Staff, to Congressman Pickle which is attached as Appendix C.

<u>Furtherance of Other Important National Policies</u>

In addition to providing direct, substantial and immediate help in the formation of new capital where it is urgently needed, adoption of the proposal would:

1. encourage stockholders to increase current savings and to provide for an increase in future cash dividends when they are needed as supplemental retirement income;
2. represent an important step in the direction of reducing the double tax on dividend income by eliminating the current tax at the stockholder level when dividends are reinvested under a qualified plan;
3. be counter-inflationary in financing increased productive facilities and in absorbing cash dividends which might otherwise be added to consumer demands;

4. be more equitable in treating the receipt of stock under a qualified dividend reinvestment plan as the equivalent, for tax purposes, of a conventional stock dividend; and

5. help in financing essentially needed energy facilities since many of the companies having dividend reinvestment plans for new issue stock are suppliers of energy.

Support for the Proposal

The proposal has been the subject of prior hearings before the Senate Finance Committee, one of its subcommittees, and the House Ways and Means Committee.[6/] At such hearings, it received strong support from a cross-section of individual companies,

6/ See, e.g., Hearings on "Miscellaneous Tax Bills" before the Senate Finance Subcommittee on Taxation and Debt Management Generally, 96th Cong. 1st Sess. (Oct. 1979); Hearings on "Tax Cut Proposals" before the Senate Finance Committee, 96th Cong., 2nd Sess. (July 1980); Hearings on "Tax Incentives for Savings" before the House Committee on Ways and Means, 96th Cong., 2nd Sess. (Jan. 1980); Hearings on "President's Proposal for Withholding on Interest and Dividends" before the House Committee on Ways and Means (April-May 1980); Hearings on "Advisability of a Tax Reduction in 1980 Effective for 1981" before the House Committee on Ways and Means, 96th Cong., 2nd Sess. (July-Sept. 1980); and Hearings before the House Committee on Ways and Means, 97th Cong., 1st Sess. (April 1981).

investment bankers, commercial bankers, labor, economists and academicians;[7] and it has been endorsed by a number of associations representing industry, stockholders and labor, including:

7/ See, e.g., in addition to Statements of individual companies and our Committee for Capital Formation Through Dividend Reinvestment, C. C. Hope, as President of the American Bankers Association, October, 1979, Sen. Finance Subcommittee Hearings, at p. 213; George H. Lawrence, President, The American Gas Association, October, 1979, Sen. Finance Subcommittee Hearings, at pp. 248-9; Margaret Cox Sullivan, President, Stockholders of America, Inc., October, 1979, Sen. Finance Subcommittee Hearings, at p. 249; Professor Ben Branch, University of Massachusetts, October, 1979, Sen. Finance Subcommittee Hearings, at pp. 584-95; Robert S. Salomon, Jr., General Partner, Salomon Brothers, July, 1980, Sen. Finance Committee Hearings, at pp. 167-201; Frank E. McGrath, on behalf of U.S. Independent Telephone Association, July, 1980, Sen. Finance Committee Hearings, at pp. 249-75; Robert H. B. Baldwin, President, Morgan Stanley & Co., January, 1980, House Hearings, at pp. 391-7, July-August, 1980, House Hearings, at pp. 919, 925, 939-40; Henry Kaufman, Partner and Member of the Executive Committee, Salomon Brothers, July-August, 1980, House Hearings, at p. 939; Donald T. Regan, then Chairman of the Board, Merrill Lynch & Company, July-August, 1980, House Hearings, at p. 450; Virgil E. Solso, Treasurer, The American Bankers Association, January, 1980, House Hearings, at p. 98; Thomas S. Johnson, Executive Vice President, Chemical Bank of New York, January, 1980, House Hearings, at pp. 514-32; Dean W. Harrison, Senior Vice President, State Street Bank & Trust Company, January, 1980, House Hearings, at pp. 533-4; Carl H. Stem, Dean, College of Business Administration, Texas Tech University, January, 1980, House Hearings, at pp. 325-9; Eugene Lerner, Professor of Finance, Northwestern University, January, 1980, House Hearings, at pp. 329-31, July-August, 1980, House Hearings, at pp. 2492-3, Professor Brent D. Wilson, Graduate School of Business Administration, University of Virginia, April, 1981, House Hearings, at pp. 53-7 of stenographic transcript (April 2, 1981); John Flynn, on behalf of International Union of Operating Engineers, International Brotherhood of Electrical Workers, International Union of Electrical, Radio and Machine Workers, Laborers' International Union of North America, Building and Construction Trades Department, April, 1981, House Hearings, at pp. 46-9 of stenographic transcript (April 2, 1981).

American Association of Retired Persons
American Bankers Association
American Council for Capital Formation
American Gas Association
American Society of Corporate Secretaries
Building and Construction Trades Department, AFL-CIO
Business Roundtable
Committee for Publicly Owned Companies
Edison Electric Institute
International Brotherhood of Electrical Workers
International Union of Electrical, Radio and Machine Workers
International Union of Operating Engineers
Laborers' International Union of North America
National Association of Regulatory Utility Commissioners
National Investor Relations Institute
Stockholders of America
U. S. Chamber of Commerce
U. S. Independent Telephone Association

In the only significant testimony critical of the dividend reinvestment proposal, it was 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. This argument is of doubtful relevance and its basic premise is contrary to the facts.

First, 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 it has any basis, it reinforces the proposal as a vehicle for capital formation.

Second, the factual premise is in error. The evidence is clear 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. As an illustration of this, Appendix D is a chart analyzing the participants in the General Telephone dividend reinvestment plan. That chart shows that 105,781, or over 92%, of the total 114,326 participants in the plan were the holders of less than 200 shares each. 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 (which is, typically not the kind of company adopting a dividend reinvestment plan for new issue stock).

Conclusion

In sum, adoption of the dividend reinvestment proposal embodied in S.141 would be counter-inflationary; would make a substantial contribution to increased savings, capital formation, capital investment and productivity; and would do so with a net revenue loss which, over a three-year period, would be either relatively modest or non-existent. We submit that the dividend reinvestment proposal clearly merits inclusion in any tax cut legislation directed to encouraging savings, new capital formation and investment where it is urgently needed.

COMMITTEE FOR CAPITAL FORMATION THROUGH DIVIDEND REINVESTMENT APPENDIX A

Members (as of April 16, 1981)

Alcan Aluminium
Allegheny Power System, Inc.
Amax, Inc.
American Electric Power Company
American Telephone & Telegraph Co.
Baltimore Gas and Electric Company
Bank of Hawaii
Brooklyn Union Gas Co.
Carolina Power & Light Company
Central and South West Corporation
Central Illinois Light Company
Central Telephone & Utilities
Cleveland Electric Illuminating Company
Commonwealth Edison Co.
Continental Telephone Corporation
Dayton Power and Light Company, The
Duke Power Company
Empire District Electric Company, The
First Jersey National Bank
General Telephone & Electronics Corp.
Hartford National Bank and Trust Company
Houston Industries
Illinois Power Company
Inco Limited
Iowa Electric Light & Power Co.
Iowa Resources, Inc.
Jamaica Water Supply Company
Kansas City Power & Light Company
Kansas Gas & Electric Company
Kansas-Nebraska Natural Gas Co., Inc.
Lincoln First Bank, N.A.
Long Island Lighting Co.
Manufacturers Hanover Corp.
Mercantile Texas Corp.
Minnesota Power & Light Company
Montana Power Company
New England Gas and Electric Association
Northeast Utilities
Orange and Rockland Utilities, Inc.
Otter Tail Power Company
Pacific Power & Light Co.
Pennsylvania Power & Light Co.
Philadelphia Electric Co.
Portland General Electric Company
Public Service Company of Colorado
Public Service Company of New Hampshire
Public Service Electric and Gas Company
Puget Sound Power & Light
Rochester Gas & Electric Corp.
Savannah Electric and Power Co.
TexasGulf Inc.
UGI Corporation
Union Carbide Corporation
United States Steel Corporation
Virginia Electric & Power Company
Virginia National Bankshares, Inc.
Washington Gas Light Co.
Wisconsin Electric Power Company
Wisconsin Power & Light Company

Results of AEP Dividend Reinvestment Plan for 1977, 1978, 1979 and 1980

APPENDIX B

	Shares (000)			$ (000)		
	Reinvested Dividends	Optional Payments	Total	Reinvested Dividends	Optional Payments	Total
1977						
1Q	107.4	115.5	222.9	$ 2,435.7	$ 2,756.2	$ 5,191.9
2Q	132.7	92.0	224.7	2,929.1	2,137.9	5,067.0
3Q	146.4	84.5	230.9	3,418.3	2,076.6	5,494.9
4Q	171.9	114.3	286.2	3,983.7	2,766.1	6,749.8
Total – 1977	558.5	406.3	964.8	$12,766.8	$ 9,736.8	$22,503.6
1978						
1Q	223.2	138.8	362.0	$ 4,840.2	$ 3,261.5	$ 8,101.8
2Q	232.4	162.1	394.5	5,030.7	3,693.2	8,723.9
3Q	232.7	120.1	352.8	5,197.7	2,824.6	8,022.3
4Q	278.6	165.0	443.6	5,865.6	3,630.5	9,496.1
Total – 1978	966.9	586.0	1,552.9	$20,934.2	$13,409.8	$34,344.1
1979						
1Q	314.8	164.7	479.5	$ 6,517.0	$ 3,614.9	$10,131.9
2Q	366.0	210.5	576.5	7,246.3	4,383.1	11,629.4
3Q	403.0	187.1	590.1	7,700.2	3,922.6	11,622.8
4Q	512.7	170.5	683.2	9,176.1	3,156.9	12,333.0
Total – 1979	1,596.5	732.8	2,329.3	$30,639.6	$15,077.5	$45,717.1
1980						
1Q	647.6	200.8	848.4	$ 9,951.0	$ 3,493.7	$13,444.7
2Q	652.4	186.6	839.0	11,411.4	3,343.7	14,755.1
3Q	700.6	259.8	960.4	11,897.2	4,785.1	16,682.3
4Q	890.5	268.6	1,159.1	13,515.1	4,526.2	18,041.3
Total – 1980	2,891.1	915.8	3,806.9	$46,774.7	$16,148.7	$62,923.4

% Participation	Number of Shareholders	Number of Shares
3/10/77	10.86	5.38
6/10/77	12.54	6.38
9/ 9/77	13.67	6.53
12/ 9/77	14.22	7.31
3/10/78	14.33	8.86
6/ 9/78	14.59	9.18
9/ 8/78	14.87	9.46
12/ 8/78	15.03	10.03
3/ 9/79	16.45	11.10
6/ 8/79	17.14	11.94
9/10/79	17.60	12.60
12/10/79	17.62	14.17
3/10/80	18.12	14.76
6/10/80	17.83	14.25
9/10/80	18.31	14.84
12/10/80	18.59	16.44

OCT 24 1979 APPENDIX C

The Honorable J. J. Pickle
U. S. House of Representatives
Washington, D.C. 20515

Dear Mr. Pickle:

We have completed the revenue estimate of H.R. 654, your bill relating to tax treatment of qualified dividend reinvestment plans, and the revenue effects for the next five years are shown below.

	1980	1981	1982	1983	1984
			(Millions of dollars)		
Calendar year liability	-640	-849	-1,050	-1,034	-1,038
Fiscal year receipts	-240	-718	-925	-1,044	-1,035

These figures take into account the additional revenue from capital gains tax as the stock acquired with reinvested dividends is sold and capital gains are realized. However, our estimates do not take into account any second order effects that the enactment of the bill might have on the economy.

Sincerely,

Bob Shapiro

Bernard M. Shapiro

APPENDIX D

As of January 1, 1981

GTE DIVIDEND REINVESTMENT PLAN SHAREHOLDER PARTICIPATION

Shareholders		Plan Participation	
Shares Held	Registered Shareholders	Participants	Percent Participation
1 - 50	223,039	76,070	34.1%
51 - 100	119,080	19,601	16.5
101 - 200	75,465	10,110	13.4
201 - 500	59,349	6,393	10.8
501 - 1,000	17,040	1,707	10.0
1,001 - Over	7,829	445	5.7
Total	501,802	114,326	22.8%

95,671

105,781

$\frac{95,671}{114,326} = 84\%$

$\frac{105,781}{114,326} = 92.5\%$

STATEMENT OF J.C. TURNER ON
S.141 BEFORE THE SENATE FINANCE
SUBCOMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT POLICY,
MAY 4, 1981.

Mr. Chairman and distinguished members of the Subcommittee; my name is J.C. Turner, General President for the International Union of Operating Engineers. I am appearing here today on behalf of the officers and members of the Operating Engineers Union. In addition, the views I will express at this hearing are endorsed by several other labor organization:

The International Brotherhood of Electrical Workers, AFL-CIO

The International Union of Electrical, Radio and Machine Workers, AFL-CIO

The Laborers' International Union of North America, AFL-CIO

The Building and Construction Trades Department, AFL-CIO representing 4 million construction workers

On behalf of those organizations, I am here today to speak in favor of the stock dividend reinvestment proposal that is contained in S.141 as introduced by 7 sponsors in the Senate and 157 sponsors in the House.

I want to make it clear that we are here today for the sole purpose of supporting that stock dividend reinvestment legislation.

As you might imagine, our over-riding concern is a healthy economy and jobs for our people.

The unions I represent are particularly active in the electric utility industry -- we help build and operate generating plants throughout the country.

As with most other sectors of the economy, inflation in the utility business has driven up the cost of new construction dramatically, and many utilities just have run out of the money necessary for badly needed construction projects. The utility commissions won't give the utilities high enough rates so that they can build from revenues, and they can't sell enough stocks and bonds to build their plants. So we are seeing cancellations of building programs all over the country, and more and more people out of work.

America runs on electricity -- without it, the economy stops. Yet we are cancelling new plants that will be essential in the years to come in order to supply power to new industry.

This problem of raising money is not unique to the utility industry -- but since about 50% of all new issues of common stock are utility stocks, you can see that this industry has a worse problem of raising money than any other industry.

Many of our members invest in utility stocks. Their holdings usually are small, but such investments give a real sense of participation in the industry in which we are involved.

However, when a cash dividend is issued, the current tax law provides a disincentive for reinvesting that money in the company's stock. Today that money is taxed even when it is plowed back into company stock under a dividend reinvestment plan.

The legislation now before your Committee would permit deferral of taxation on dividends reinvested in the stock of the company until the shareholder actually sells that stock.

For our members, this is one of the few ways they can be encouraged to invest in a growing economy while saving some of their earnings to plan for their retirement.

This is not a windfall to the rich because the bill limits such tax deferral benefits to a maximum of $1500 for a single taxpayer and $3000 for a joint return per year. The rich have many ways to shelter income, and some of them do nothing whatever for our economy. Here is a plan that puts the savings of small investors to work for the good of our economy.

We understand that a study by the Robert R. Nathan Associates indicates that this legislation, if passed, would add approximately 50,000 jobs per year. We favor creation of new jobs.

Another point that should be considered is that, especially in the utility plant construction field, we often are competing for jobs with Europe and Japan. Since both tax capital gains on a much more favorable basis than here in the United States, a bill such as the one before you helps put our country in a more advantageous position to complete for those new jobs.

This is not a labor issue or a management issue -- it is a national issue that unites both of us in a common effort.

It seems to us that the stock dividend reinvestment plan helps the economy, helps the consumer and helps the workers. As such, it has our full support -- and we respectfully suggest that it deserves the support of Congress.

SUMMARY OF PRINCIPAL POINTS INCLUDED IN THE STATEMENT OF GUY W. NICHOLS ON BEHALF OF EDISON ELECTRIC ISNTITUTE ON S. 141 BEFORE THE SUB-COMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT POLICY, SENATE FINANCE COMMITTEE ON MAY 4, 1981

1. We strongly support the tax deferred dividend reinvestment proposal in S. 141 because it will attract and keep for utilities an entire new group of investors, investors interested in maximizing their after tax investment returns and thereby will increase the market value of utility stock.

2. The capital requirements for utilities during the 1980's for new facilities to serve growing load, for conversion of existing facilities from insecure foreign fuels and for conservation and loal management are enormous.

3. When the market price of utility stock is less than book value, sale of additional stock dilutes both earnings per share and book value per share putting great pressure on utility management not to build needed facilities.

4. Studies show that tax-deferred treatment for reinvested dividends will increase the market price of utility stock and will result in significant additional capital funds existing shareholders through dividend reinvestment.

84-080 O—81——21

STATEMENT OF GUY W. NICHOLS, CHAIRMAN AND CHIEF EXECUTIVE OFFICER OF NEW ENGLAND ELECTRIC SYSTEM ON BEHALF OF NEW ENGLAND ELECTRIC SYSTEM AND EDISON ELECTRIC INSTITUTE CONCERNING S. 141 BEFORE THE SUBCOMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT POLICY, SENATE FINANCE COMMITTEE

MAY 4, 1981

Mr. Chairman and Senators:

My name is Guy W. Nichols. I am the Chairman and Chief Executive Officer of New England Electric System (NEES), a public utility holding company with subsidiaries serving over 1 million electric customers in the States of Massachusetts, New Hampshire and Rhode Island. I appear here today on behalf of NEES and the Edison Electric Institute (EEI). EEI is the national association of investor-owned electric power companies in the United States. Its' members comprise 99 percent of the investor-owned segment of the industry and serve 77 percent of all electricity users in the country.

First of all, I would like to state our industry's and our company's strong support for the tax-deferred dividend reinvestment proposal in Senate Bill S. 141. We advocate passage of S. 141 because (1) it will attract additional investors to an industry under severe economic pressures and (2) it will create significant additional capital investment by existing shareholders.

Industry's Financial Problems

There is great pressure on electric utilities to build new facilities to serve growing load and to spend new dollars to accomplish conversion from insecure foreign fuels to secure domestic fuels. There is also great pressure on electric utilities to spend dollars on conservation, load management, etc. Estimates of construction expenditures in the industry during the next five years are in excess of $150 billion. Many jobs and the health of our already weakened economy depend upon an adequate supply of electricity, and many jobs will be created in the construction of needed facilities. In fact, the electric power industry is the nation's largest employer of construction workers, providing about 250,000 construction jobs. The escalating costs of building new facilities, the unprecedented high costs of financing, the tremendous increase in the cost of fuels used in generating electricity and the fact that electric utility common stock is now selling at roughly 1/3 below book value, is putting great financial pressure on our industry. This pressure moves management not to build new plants because the construction of the new plants will require the utility to raise a great deal of money and some of this money has to be common equity money.

Without a strong equity base, it will be extremely difficult for our industry to fulfill its responsibilities of providing reliable service at reasonable prices.

Need for New Common Equity

During the next five years, our industry's needs for new common equity financing is expected to be $25 - 30 billion. Most of this capital is required to finance construction commitments already made. At NEES, we will need to raise $200 million of common equity over this period in order to meet our existing obligations for facilities under construction or in the planning stage and for the conversion of generating units from oil to coal. Without adequate capital, many companies in our industry will be forced to slow down or halt construction of these facilities.

Because of the public service obligation that utilities have, we are required to raise capital even in the worst markets in order to meet the demands of our customers. Common stock is the foundation of the capital structure of the investor-owned segment of our industry. To meet construction expenditures for new or converted facilities, common stock must often be sold under unfavorable market conditions. When a utility is forced to sell additional common stock at prices below book value, the value of the shares held by existing shareholders is diluted. Such dilution also has a further depressing effect on the market value of the stock and subsequent issues continue the dilution syndrome.

Problem of Dilution

The combination of utility stock selling below book value and selling additional shares in the market at a price below book value has a disasterous effect on the earnings potential of existing common shares.

I would like to use my very few minutes just to explain this point with a series of very simple charts. Let's start with a typical electric utility that has a book value of $30 per share. Book value, of course, is: Refer to Chart No. 1. If we assume the company has 40 million shares with the total book value of $1.2 billion, we have a book value per share of $30.00 per share.

In the next chart, I would like to describe very simply how the earnings of this particular utility are regulated. Refer to Chart No. 2. The typical regulatory commission has to determine what percentage return it will allow on the common equity investment of this particular company. Let's assume that this commission decided a 14% return was appropriate and 14% of $1.2 billion gives us the after tax earnings that they will allow - in this case $168 million. These earnings, added to the expenses that the commission considers appropriate, determine the total allowed gross revenues for the company in question. With earnings that are $168 million and 40 million shares outstanding, we have earnings per share of $4.20.

With this background, let's look at what happens if this company is allowed these revenues of $2 billion per year and let's make the further assumption, and this is almost never possible due to the pressures of inflation, that the company is able to hold the line on expenses and actually earns the $168 million per year which translates into $4.20 per share.

Now let's go to Chart 3 and compare two companies that have this identical background that I have just been describing, Company A and Company B. Refer to Chart No. 3. For our example, Company A is the typical electric utility whose common shares are selling in the marketplace at roughly 1/3 below book value - $20 instead of $30. But Company B is that rare exception, and I think there may be one or two utilities of this type in the country and they are only partial utilities and have considerable amounts of unregulated income; but let's assume we have a hypothetical Company B whose shares are selling in the market at its book value per share - $30 in each case.

Next, let's assume that both of these companies need to raise $300 million in new equity. Refer to Chart No. 4. As this chart shows, to raise $300 million in new equity, Company A will have to sell 15 million shares at $20 per share. Having done this, it will now have a total book value of $1.5 billion. It will have 55 million shares outstanding, and the new book value per share for Company A will be $27.27. Assuming the same regulatory commission allows the same 14% return on the total common share book value of Company A in its next rate case, that regulatory commission would allow earnings of 14% of $1.5 billion or $210 million. When you spread this $210 million over the 55 million shares as shown on the bottom line, you now have a new earnings per share for Company A of $3.82.

But look what happens to Company B when it needs the same $300 million. It only needs to sell 10 million share at $30 to raise the $300 million. It winds up with the same $1.5 billion worth of total book value of the common shares, but because there are only 50 million shares outstanding in Company B at this time, its book value has remained at $30 and once again because there has been no dilution in book value, the new earnings per share for this company remains at $4.20.

This final chart simply compares the key figures for Company A and Company B before and after the sale of the common issue that I have just described. Refer to Chart No. 5. Prior to the sale, Company A had earnings of $4.20 - those earnings have now fallen by $.38 per share and the book value of its stock has fallen by $2.73 per share. As you look at a chart of this type,it is easy to realize why electric utility company managements are reluctant to embark on capital intensive building programs if the shares of their common stock are selling below book value. It is simply not fair to the existing investors, and if done, it makes the utilities common shares increasingly less attractive to new investors.

It is true that if regulatory authorities allowed these companies a much higher rate of return, the market price of Company A's common stock might well be selling at or above book value. But, this is not happening in today's world. It is very difficult for regulatory commissions to allow an adequate rate of return during a period of rapidly rising costs.

Sources of Capital

The internal generation of funds which comes principally from retained earnings, depreciation and deferred taxes, provided for less than 30% of construction expenditures of electric utilities in 1980. In the mid-sixties, about two-thirds of utility construction expenditures were provided internally. NEES, which spent $170 million on construction expenditures in 1980, raised about 40% of that amount internally.

External funds come from the capital markets either in the form of debt or equity securities. Because of the common stock dilution problem previously discussed, increased emphasis has been placed in debt financings in recent years. This fact together with the generally poor earnings performances of many companies in the industry have resulted in the typical bond rating of utilities being downgraded from AA and A to A and BAA. Downgrading results in a one to two percent increase in cost of debt capital. Recent issues of longterm A rated utility bonds carry interest rates of above 16%.

<u>Benefits of Tax-Deferred Dividend Reinvestment</u>

In 1980, the electric utility industry raised about $4 billion by issuing common stock and about $5 billion is estimated to be raised by this means in 1981. Estimates have been made which indicate a substantial amount, perhaps as much as 50%, of the $5 billion could be raised through dividend reinvestment plans if S. 141 is enacted.

NEES has had a dividend reinvestment plan since 1977 and our shareholders have invested about $22 million in this manner. During 1980, NEES raised $12 million in common equity of which $8 million came from the dividend reinvestment plan even though the reinvested dividends were subject to tax as ordinary income. We expect that the amount raised through the NEES dividend reinvestment plan would at least double if the tax deferral feature becomes available.

Utility stocks are attractive to certain investors because of the relatively secure dividends they pay. As there is little prospect for capital appreciation of electric utility stocks, many other investors tend not to buy them. In fact, many individuals in higher tax brackets generally are not interested in utility investments because their return is taxable as ordinary income. However, the attractiveness of utility stocks would be greatly enhanced if shareholders had the option of either continuing to take their dividends in cash or having them reinvested in additional shares without incurring any current income tax liability and, if held for more than a year, possibly converting the ordinary dividend income into capital gains.

In a recent research report by Goldman Sachs, they indicated that electric utility stock prices could appreciate by approximately 20% if tax-deferred dividend reinvestment is adopted.

The higher market values for utility stocks resulting from enactment of S. 141 would substantially reduce the dilution problem and thereby facilitate the sale of additional common stock to the general public. A greater equity base, in turn, will support increased amount of debt securities.

Impact on Federal Revenues

In a report on the economic impact of tax-deferred dividend reinvestment, the economic consulting firm of Robert R. Nathan Associates, Inc. estimated a revenue loss to the Treasury of $350 million in the first year, a wash in the second year, and a net revenue gain of $600 million in the third year and thereafter. The Nathan study includes in its estimates, the "feedback" effect of growth in employment, wages and profits resulting from the proposal.

Conclusion

I urge favorable consideration of S. 141 because of its important and direct impact on capital formation for the electric utility industry.

This tax deferred treatment will attract and will keep for utilities an entire new group of investors, investors interested not just in current cash dividends, but interested in maximizing their after tax investment returns. This proposal will also make it less necessary for utilities to sell new issues in the open market as the reinvested dividends will make such issues on the open market less necessary.

Thank you for the opportunity to appear here today.

Chart No. 1

BOOK VALUE (B.V.) ÷ COMMON SHARES

B.V. = TOTAL $ INVESTED IN COMMON STOCK, SHOWN ON COMPANY BOOKS

$$\text{B.V./SHARE} = \frac{\text{TOTAL B.V. OF COMMON STOCK}}{\text{TOTAL \#'s OF COMMON SHARES}}$$

$$\text{B.V./SHARE} = \frac{\text{\$1.2 BILLION}}{\text{40 MILLION SHS.}} = \text{\$30.00/SHARE}$$

5/4/81

Chart No. 2

EXAMPLE

ALLOWED - AFTER TAX EARNINGS FOR COMMON STOCK - 14% of \$1.2 B	=	\$ 168 M
PLUS ALL EXPENSES, INCLUDING INTEREST, TAXES AND PREFERRED DIVIDENDS	=	\$1.832 B
ALLOWED GROSS REVENUES	=	\$2.000 B

$$\text{EARNINGS/SHARE} = \frac{\$168\ \text{M}}{40\ \text{M Shs.}} = \$4.20/\text{SHARE}$$

5/4/81

Chart No. 3

TWO REGULATED COMPANIES NEEDING $300 M IN NEW EQUITY

COMPANY A	COMPANY B
B.V. = $30.00/Sh.	B.V. = $30.00/Sh.
MARKET VALUE = $20.00/Sh.	MARKET VALUE = $30.00/Sh.
E.P.S. = $4.20	E.P.S. = $4.20

5/4/81

THE TWO COMPANIES RAISE \$300 M IN NEW EQUITY

COMPANY A		COMPANY B
40 M Shs. @ 30.00 = \$ 1.2 B	PRE SALE B.V.	40 M Shs. @ 30.00 = \$ 1.2 B
15 M Shs. @ 20.00 = \$ .3 B	SALE PROCEEDS	10 M Shs. @ 30.00 = \$ .3 B
55 M Shs. \$ 1.5 B	NEW B.V. TOTAL	50 M Shs. \$ 1.5 B
$\frac{\$1.5\text{ B}}{55\text{ M}}$ = \$27.27	NEW B.V./Sh.	$\frac{\$1.5\text{ B}}{50\text{ M}}$ = \$30.00
14% (1.5 B) = \$210 M	NEW TOTAL ALLOWED EARNINGS	14% (1.5 B) = \$210 M
$\frac{\$210\text{ M}}{55\text{ M}}$ = \$ 3.82	NEW E.P.S.	$\frac{\$210\text{ M}}{50\text{ M}}$ = \$ 4.20

5/4/81

Chart No. 5

COMPARISONS

COMPANY A		COMPANY B
$ 4.20	PRE SALE E.P.S.	$ 4.20
$ 3.82	POST SALE E.P.S.	$ 4.20
.38¢	DILUTION IN E.P.S.	NONE
$30.00	PRE SALE B.V.	$30.00
$27.27	POST SALE B.V.	$30.00
$ 2.73	DILUTION IN B.V.	NONE

5/4/81

UNITED STATES SENATE
COMMITTEE ON FINANCE
SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT POLICY

STATEMENT OF THE
NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

1102 INTERSTATE COMMERCE COMMISSION BUILDING
CONSTITUTION AVENUE AND TWELFTH STREET, N.W.
POST OFFICE BOX 684, WASHINGTON, D.C. 20044
TELEPHONE (202) 628-7324

ON

S. 141, A BILL RELATING TO
TAX TREATMENT OF QUALIFIED DIVIDEND REINVESTMENT PLANS

MAY 4, 1981

Summary of Remarks

- The five-year surge (1975-80) in the CPI, combined with record interest rates, has caused measureable damage to utility companies, their shareholders, and their ratepayers.
- Although consumption of electricity has increased less than 10% since 1975, the cost per kWh has increased over 50% while the average residential electric bill has jumped nearly 70%.
- New technological and productivity improvements in the utility industry will require vast sums of new capital. However, refinancing existing debt obligations as well as marketing new debt and equity will place a serious strain on shareholders and ratepayers.
- State Utility Regulators have granted record rate increases during 1980-81, and allowed rates of return on common equity have never been higher. Yet, due to inflation, the industry remains in a financial slump.
- Despite large dividend increases, utility shareholders have been unable to earn a fair return, due in part to current tax policy.
- S. 141 would enable utilities to raise large sums of new capital while providing shareholders with an opportunity to defer taxation on their investment returns.
- S. 141 would suppress the inflationary spiral by encouraging investment in our nation's industrial enterprises.
- S. 141 would be an important first step in returning utility companies to a position of financial stability.

Mr. Chairman and Members of the Committee:

My name is Paul Rodgers. I am Administrative Director and General Counsel for the National Association of Regulatory Utility Commissioners, commonly known as the "NARUC." Accompanying me today are Michael Foley, NARUC Director of Financial Analysis, and Rose Ann C. Fraistat, NARUC Director of Congressional Relations.

The NARUC is a quasi-governmental nonprofit organization whose members include the regulatory bodies of the fifty States, the District of Columbia, Puerto Rico, Guam, and the Virgin Islands. The mission of the NARUC is to improve the quality and effectiveness of regulation for the benefit of the American public.

The members of the NARUC appreciate your invitation to make their views known regarding S. 141, relating to tax deferral of reinvested dividends. In light of the current threatening financial environment in which our nation's privately owned utilities must operate, it is appropriate that the Congress examine legislative initiatives such as S. 141 which seek to suppress the inflationary spiral by encouraging and rewarding investment in our nation's industrial enterprises.

During the past five years the consumer price index (CPI) has surged by nearly 50% while interest rates have peaked at record highs, causing considerable damage to both the investors of public utilities and to the firms themselves. Often overlooked, however, is the financial burden which utility ratepayers have been forced to shoulder due to rapidly escalating utility expenses.

Consider, for example, that in its 1981 Annual Statistical Report, Electrical World magazine reports that in the five-year period since the end of 1975, average residential usage of electricity has gone up less than 10% while the cost per kWh has increased over 50% and the average annual residential electric bill has jumped nearly 70% (see Table 1). Thus, consumers of utility services have responded to the call for increased energy conservation only to be rewarded with skyrocketing utility bills.

Electric rates which for years had been on the decline, due to technological and productivity improvements, are now at a 40 year high and climbing. Additional improvements will require utilities to raise hugh sums of new capital. Moody's Investors Service reports that, during 1982 and 1983 alone, well over $4 billion of utility debentures are scheduled to mature (see Tables 2 and 3). Refinancing these debt obligations at today's double-digit interest rates will place an enormous strain on an industry which is already experiencing financial difficulties.

In addition to this refinancing task, the industry will again have to market several billion dollars worth of new equity in order to raise a portion of the prodigious amounts of new capital required annually.

Unfortunately, in view of the fact that the common stock of almost every major electric utility is selling below book value, these additional equity sales will actually dilute the ownership position of present shareholders. No rational investor will purchase a security without a reasonable expectation of a fair return, and persistent sales of new common stock equity at depressed market prices has made it increasingly difficult for utilities to raise needed capital.

In an effort to placate existing shareholders and to attract new investors, utilities have been increasing dividends at a rapid clip. The most recent data from Salomon Brothers indicates that fully 80% of the 100 largest electric companies increased their dividends within the past 12 months. Six of these firms actually raised their dividends twice within the past year (see Table 4). However, maintaining dividend yields which now average in excess of 12% places a serious cash drain on the industry.

State utility regulators, fully aware of the financial plight of the industry, have responded by granting record-setting rate increases. During 1980 alone, the State regulatory commissions granted almost $6 billion in rate hikes -- nearly twice the level granted during 1979. Rates of return on common equity currently being approved by the State commissioners have never been higher. Yet the actual rates of return which the utilities have managed to earn have shown only marginal improvement (see Tables 5 and 6). In a word, the culprit is inflation.

Passage of S. 141 would amend the tax code by allowing shareholders to defer taxation on dividends which have been reinvested into qualified dividend reinvestment plans, thus enabling utilities more readily to raise needed capital while providing investors with a fair return. Though there is no regulatory "cure" for inflation, it is the position of the NARUC that the amendments to the tax code included in this important legislation would provide an important first step in moderating the adverse effects of inflation on utility companies, their shareholders, and their ratepayers.

As such, S. 141 has the full support of the NARUC.

Table 1

Average Annual Use and Bill

	Av. use kWh	Residential Av. bill per kWh	Residential Av. bill per Annual
1975	8,176	3.21¢	$262.26
1976	8,360	3.45¢	$288.39
1977	8,693	3.78¢	$328.99
1978	8,849	4.03¢	$356.74
1979	8,828	4.33¢	$382.09
1980	8,973	4.93¢	$442.30

Source: Electrical World; April 1981, P. 96.

Table 2

Investor Owned Electric Utilities
Maturing Bonds, 1979-1983
(Amounts in millions)

-	Aaa	Aa	A	Baa	Total
1979	$159	$ 502	$ 304	$ 527	$1,492
1980	25	277	809	212	1,323
1981	12	565	864	535	1,976
1982	34	842	986	659	2,521
1983	9	641	628	555	1,833
	$239	$2,827	$3,591	$2,488	$9,145

Source: Moody's Investors Service as published by the Edison Electric Institute

Table 3

AVERAGE PRICE OF NEW CAPITAL

MOODY'S COMPOSITE AVERAGE OF YIELDS ON NEWLY ISSUED PUBLIC UTILITY BONDS (IN PERCENT)

Year	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
1980	12.09	14.26	15.04	13.23	11.81	11.80	12.06	12.74	...	...	...	...
1979	9.68	9.84	9.74	10.22	10.37	9.90	9.73	9.59	10.41	11.65	11.88	11.76
1978	9.05	9.21	9.01	9.08	9.40	9.30	9.62	8.80	8.90	9.38	9.47	9.29
1977	8.17	8.26	8.42	8.41	8.68	8.23	8.36	8.29	8.19	8.09	8.51	8.73
1976	9.06	8.96	8.84	8.60	9.32	9.16	9.38	8.58	8.57	8.53	8.44	8.23
1975	8.90	9.02	9.64	10.14	9.86	9.30	10.27	10.33	10.26	9.53	10.20	10.30
1974	8.46	8.16	8.66	9.08	9.23	9.60	10.41	10.12	10.39	10.74	9.61	9.65
1973	7.45	7.59	7.71	7.50	7.64	7.77	8.08	8.42	8.06	7.91	8.01	8.1[illegible]
1972	7.16	7.45	7.52	7.64	7.45	7.47	7.49	7.50	7.63	7.55	7.18	7.41
1971	7.47	7.34	7.75	7.70	8.23	7.97	8.12	7.88	7.90	7.56	7.51	7.40
1970	8.76	8.67	8.73	8.84	9.05	9.36	8.94	9.10	8.87	9.07	8.75	8.07
1969	7.07	7.07	7.59	7.42	7.46	7.85	7.93	7.88	8.41	8.36	8.70	9.10
1968	6.41	6.40	6.72	6.79	6.97	6.87	6.62	6.47	6.49	6.81	6.98	7.17
1967	5.15	5.29	5.51	5.64	5.90	6.05	6.00	6.12	6.17	6.46	6.72	[illegible]

Source: Moody's Public Utility Manual; 1980.

Table 4

Electric Utility Common Stock Dividend Increases Declared: April 1980 — March 1981

	Date Increase Declared	New Annual Rate	Old Annual Rate	Inc.		Date Increase Declared	New Annual Rate	Old Annual Rate	Inc.
American Electric Power	10/80	2.26	2.22	1.8%	Minnesota Power & Light	02/81	2.12	2.04	3.9%
# Allegheny Power	03/81	1.96	1.81	8.9	Missouri Public Service	04/80	a	a	2.0
Arizona Public Service	07/80	2.12	2.00	6.0	" " "	11/80	a	a	2.0
Atlantic City Electric	05/80	1.96	1.84	6.5	Montana Power	12/80	2.24	2.12	5.7
Baltimore Gas & Electric	08/80	2.56	2.44	4.9	" "	02/81	2.28	2.24	1.8
Boston Edison	11/80	2.80	2.72	2.9	Nevada Power	04/80	2.32	2.12	9.4
Carolina Power & Light	06/80	2.24	2.08	7.7	New England Electric System	11/80	2.50	2.36	5.9
Central Hudson G&E	09/80	2.24	2.16	3.7	New England Gas & Elec	06/80	1.72	1.60	7.5
# " " "	03/81	2.36	2.24	5.4	" " " "	03/81	1.88	1.72	9.3
Central Illinois Light	01/81	1.82	1.70	7.1	New York State Elec. & Gas	07/80	1.88	1.76	6.8
Central Illinois Pub. Svc.	04/80	1.40	1.36	2.9	Niagara Mohawk Pwr.	05/80	1.52	1.44	5.6
Central Maine Power	11/80	1.72	1.64	4.9	Northeast Utilities	01/81	1.18	1.10	7.3
Central & South West	01/81	1.58	1.50	5.3	Northern States Power	06/80	2.42	2.28	6.1
Central Vermont Pub. Svc	10/80	1.92	1.84	4.3	Northwestern Public Service	11/80	1.90	1.80	5.6
Cleveland Elec. Illum	01/81	2.08	2.00	4.0	Oklahoma Gas & Electric	12/80	1.68	1.60	5.0
Community Public Service	01/81	2.08	1.88	10.6	Orange & Rockland Utilities	06/80	1.60	1.56	2.6
Consolidated Edison	01/81	2.96	2.68	10.4	Otter Tail Power	01/81	2.28	2.20	3.6
Dayton Power & Light	01/81	1.82	1.74	4.6	Pacific Gas & Electric	01/81	2.72	2.60	4.6
Delmarva Power & Light	12/80	1.52	1.48	2.7	Pennsylvania Power & Light	02/81	2.24	2.12	5.7
Duke Power	10/80	2.04	1.92	6.3	Potomac Electric Power	07/80	1.52	1.40	8.6
El Paso Electric	07/80	1.16	1.10	5.5	# Public Service Colorado	03/81	1.68	1.60	5.0
" " "	02/81	1.22	1.16	5.2	Public Service Elec. & Gas	01/81	2.44	2.32	5.2
Florida Power Corp.	05/80	1.56	1.50	4.0	Public Service Indiana	04/80	2.48	2.32	6.9
" " "	11/80	1.64	1.56	5.1	Public Service New Mexico	01/81	2.68	2.08	28.8
Florida Power & Light	04/80	2.72	2.40	13.3	Rochester Gas & Electric	01/81	a	a	3.0
Gulf States Utilities	11/80	1.48	1.36	8.8	Rochester Gas & Electric	09/80	1.52	1.48	2.7
Hawaiian Electric	09/80	2.64	2.44	8.2	San Diego Gas & Electric	08/80	1.60	1.52	5.3
Houston Industries	01/81	2.96	2.68	10.4	South Carolina Elec. & Gas	01/81	1.82	1.74	4.6
Idaho Power	07/80	2.52	2.40	5.0	Southern Calif. Edison	09/80	2.96	2.72	8.8
Illinois Power	06/80	2.38	2.28	4.4	Southern Company	10/80	1.62	1.54	5.2
Indianapolis Power & Light	02/81	2.40	2.24	7.1	Southern Indiana G&E	01/81	1.88	1.68	11.9
Iowa Elec. Lt. & Pwr	11/80	1.66	1.60	3.8	Southwestern Public Service	10/80	1.38	1.28	7.6
Iowa-Illinois Gas & Elec	01/81	2.20	2.10	4.8	Tampa Electric	04/80	1.56	1.44	8.3
Iowa Resources	09/80	2.72	2.52	7.9	Texas Utilities	02/81	1.86	1.75	6.6
Iowa Public Service	01/81	2.40	2.20	9.1	# Toledo Edison	03/81	2.28	2.20	3.6
Iowa Southern Util.	01/81	2.48	2.38	4.2	Tucson Electric Pwr	02/81	1.72	1.52	13.2
Kansas City Power & Light	11/80	2.78	2.66	4.5	Union Electric	07/80	1.52	1.44	5.6
Kansas Gas & Electric	11/80	2.04	1.94	5.2	United Illuminating	02/81	2.76	2.68	3.0
Kansas Power & Light	01/81	2.20	2.04	7.8	Utah Power & Light	05/80	2.00	1.76	13.6
Long Island Lighting	06/80	1.86	1.78	4.5	Washington Water Power	02/81	2.24	2.16	3.7
Louisville Gas & Electric	09/80	2.14	2.06	3.9	Wisconsin Electric Power	04/80	2.52	2.38	5.9
Madison Gas & Electric	11/80	1.72	1.64	4.9	Wisconsin Pwr. & Lt.	01/81	2.00	1.92	4.2
Middle South Utilities	12/80	1.62	1.58	2.5	Wisconsin Public Service	07/80	1.82	1.72	5.8

Average	6.2%
Median	5.3%
(86 Increases)	
Average	6.6%
Median	5.7%
(80 Companies)	
Average	5.4%
Median	5.0%
(Industry)	

Notes: 80 electric utilities on the Salomon Brothers list of 100 have increased dividends 86 times since 4/1/80 (6 companies increased dividends twice).

Dividend changed during March 1981

a Stock dividend

Source: Salomon Brothers

Table 5

Electric Utility Rate Application Filings and Approvals
1974-1980
(Millions of Dollars)

Year	Applications Filed	Approvals
1975	3,973	3,094
1976	3,747	2,275
1977	3,953	2,311
1978	4,494	2,419
1979	5,736	2,853
1980	10,871	5,932

Source: EEI

Table 6

Comparison of Authorized Return on Common Equity
and Earned Return on Common Equity
Investor-Owned Electric Utility Industry
1974-1980

Year	Average Authorized Return	Earned Return
1974	12.5%	10.6%
1975	12.9	11.1
1976	12.8	11.5
1977	13.1	11.4
1978	13.2	11.3
1979	13.4	11.1
1980 Est.	14.2	11.0

Source: EEI

Based on rate decisions made during the year.

TESTIMONY BEFORE THE SUBCOMMITTEE ON
SAVINGS, PENSION, AND INVESTMENT POLICY
U.S. Senate
May 4, 1981

Brent D. Wilson
Assistant Professor
Colgate Darden Graduate School of Business Administration
University of Virginia

Summary of Major Points:

1. The capital structures of capital intensive industries have been severely weakened.

2. Dividend Reinvestment Plans have proven advantages over alternative methods of raising equity capital.

3. Dividend Reinvestment Plans benefit the shareholder, the economy, and the issuing company.

4. Changing the tax treatment of Dividend Reinvestment Plans will increase their utilization and result in strengthened capital structures.

My research, as well as that of many others, has shown that over the past two decades the capital structures of U.S. companies have been seriously weakened. This deterioration has occurred because of the increasingly heavy use of debt capital in financing these companies. For example: interest expense as a percent of net corporate profits has increased from 14% in 1960 to 45% in 1980. This problem has been especially severe in the capital intensive industries, those industries which are basic to our economic infrastructure, and is not limited to the well publicized afflictions of the regulated utilities. These critical basic industries have been experiencing increased difficulty in raising needed capital because of the risks which investors see in their weakened capital positions. I believe that dividend reinvestment plans, DRPs, are an effective financing vehicle which will assist in resolving this problem of raising additional equity capital.

Companies have several methods of raising needed equity to offset the increased debt ratios in their capital structures. These methods include:

1. Increased profitability
2. Accelerated depreciation
3. Dividend reductions
4. Direct public equity offerings
5. Rights offerings
6. Stock dividends

Each of these alternatives, however, has some factors which have restricted or limited their appeal to potential investors or to the companies. Because of the continuing need for additional equity capital and the limited usefulness of the existing alternatives, companies have developed Dividend Reinvestment Plans.

DRPs have grown in popularity as their usefulness in raising equity capital has been demonstrated. There are currently approximately 200 plans which utilize DRPs to issue new equity with about $2 billion in new equity capital raised through these plans in 1979. These plans have particularly appealed to the small investor with over 75% of the participants in the typical plan owning fewer than 200 shares in the company.

I believe that DRPs are attractive because they provide benefits to the individual shareholder, the economy, and the issuing company.

A. Shareholders benefit because the plans provide for issuance of a small number or even fractional shares. Thus, the DRPs allow the investor to invest small amounts of capital. The shareholder also benefits through the opportunity to choose whether to receive cash or stock dividends.

B. The economy benefits from the anti-inflationary effect of having the dividends invested into productive assets instead of consumed. Because of the small amounts involved and the high transaction costs otherwise incurred in small investments, it is likely that in absence of the DRPs few dividend payments to small investors would be reinvested. These plans also encourage individuals to save which helps reduce the savings gap between the U.S. and other industrialized countries.

C. The issuing company benefits by conserving the cash otherwise issued in cash dividend payments and not recovered through other equity channels. This results in strengthened equity positions for the companies and improved capital structures. This improvement has been noted by credit rating agencies who have stated that increased use of DRPs would likely lead to improved credit ratings for the companies. The companies also benefit from lower administrative costs and in most plans pass this benefit to the shareholders by issuing the stock at a discount and by absorbing the issuance costs.

Because of the current inequitable tax treatment with DRPs being taxed as ordinary income and stock dividends as capital gains, the appeal of DRPs may still be limited. Revising the tax regulations to allow for individuals to defer the taxes on stock provided through new issue DRPs would significantly increase their attractiveness. Analysts have suggested that the impact of this proposed change in the tax treatment would be significant. Based on current industry experience it is likely that the amount of new equity capital raised through the plans would double to more than $4 billion annually. Needless to say, this would be highly beneficial in resolving the problems which capital intensive companies are having in raising needed equity.

DRPs would provide these benefits without incurring any additional bureaucracy. The programs currently exist; nothing new needs to be created. The DRPs also are specifically targeted in that they provide the benefits to those industries which are in the most severe need, the capital intensive industries.

The DRP tax deferral proposal has broad scale support including investors, labor organizations, management, utility regulatory agencies, and academicians. With the pressing need for the formation of additional equity capital, the proposed tax changes regarding DRPs are vital. I strongly recommend approval of S.141 as a means of strengthening the capital structures of our basic industries which will result in a strengthening of our economy.

TESTIMONY OF KENNETH HOLLISTER

FIRST VICE PRESIDENT OF DEAN WITTER REYNOLDS INC.

ON TAX TREATMENT OF QUALIFIED DIVIDEND REINVESTMENT PLANS

BEFORE THE FINANCE SUBCOMMITTFE ON SAVINGS, PENSIONS, AND INVESTMENT POLICY

WASHINGTON, D.C., MONDAY, MAY 4, 1981

Mr. Chairman and members of this committee, my name is Kenneth Hollister. I am a First Vice President of the investment banking firm of Dean Witter Reynolds Inc. I appear before you on behalf of our corporate finance efforts and our utility clients.

Dean Witter Reynolds Inc. supports the deferral of taxes in qualified dividend reinvestment plans such as introduced in S.141. Tax deferral and the greater participation in dividend reinvestment plans would strengthen the capital structure of U.S. corporations and provide a base for necessary capital expenditures. In addition, as an incentive for increased savings, S.141 would aid in combatting inflation.

Dividend reinvestment plans have gained growing acceptance throughout the 1970's. According to latest available figures, over 900 corporations in the U.S. employ them. Their success is attributable to the advantages to corporations in providing a method of offering equity capital and an incentive to investors to direct their savings into corporate investment.

Corporate Investment And Its Relation To Dividend Reinvestment Plans

Industry in the United States and especially in the regulated sector is confronted continuously with the problem of acquiring new capital on a favorable basis for necessary investment over and above that portion which could be obtained from operations. In part the tax laws of the United States have worked contrary to this goal by putting the investor in common stocks at a disadvantage relative to a number of other alternative opportunities.

A dividend reinvestment plan provides one method of raising equity capital which has the simultaneous advantage of strengthening corporate capital structures, attracting new investment with savings that might otherwise be used for inflationary spending.

To place utility financing in perspective, over the past five years, over $22 billion worth of common stock has been sold by the electric utility industry and another $5-6 billion by the telecommunications industry in order to provide necessary service. According to our records over 75% of this amount was placed in so-called retail accounts, those purchasing 200 shares or less, and having a aggregate dollar purchase amount of $5,000 or less. I believe this may be described as the individual saver. As a corollary there has been a significant decline in common stock investment in regulated industries by fiduciaries, and these larger pools of capital have been directed elsewhere.

While the investor was placing his funds in these industries, however, they increasingly lowered the price they were willing to pay for a specific level of dividend because of the presumed reduction in opportunity for capital gains brought on by regulatory and economic constraints. The result, since 1975 has been, with the exception of 1977, (see (Exhibit 1, pps 12 & 13 & Exhibit 2, pps 14-15), a continuing steady deterioration in market price and increase in the discount from book value; the latter having the effect of diluting the value of the equity investment of prior common stock investors. Stated another way, the investor in order to obtain a satisfactory income return on his capital is insisting that earlier investment be marked down to current depreciated levels before he is willing to use his savings to buy new common stock.

The electric utility industry , as part of the regulated sector, is particularly capital intensive, and its capital requirements are significant. Marshall McDonald, Chairman of the Edison Electric Institute in a recent article in the Public Utilities Fortnightly (April 9, 1981, pp 19-21) cited construction expenditures for the period 1980-1984 totalling $155 billion of which over 60% ($95 billion) would be obtained from outside sources; he noted that about 30% of the external financing requirement is expected to be in the form of common equity. The aggregate external financing requirement breaks down for the years 1981-84 as follows: $17 billion in 1981; $19 billion in 1982; $20 billion in 1983; and $22 billion in 1984. This compares to $17 billion in 1980. This is a significant requirement facing an industry. whose financial health is deteriorating. Specifically: (1) interest coverage ratios are declining; in 1980, of the 115 electrics followed by our fixed income research only four issued had their bonds upgraded by the major rating agencies, while 28 issues suffered rating reductions on their bonds; The high level of interest rates experienced in financings by both the regulated and unregulated sector is a major contributor to declining interest coverages and a reason for the need for more equity capital; (2) average rates of return on common equity of the electric industry hovers around 11%, compared to interest rate requirements in the upper teens with regard to long term debt costs (Michigan Bell long term debt was offered recently at a 15.93% yield to maturity; Pacific Gas & Electric at 16.34%; General Telephone of Ohio at 16.70% and Alabama Power at 17½%). In this environment inducements are needed to attract necessary equity capital; (3) electric utility industry payout ratios average about 80% of earnings available for common and the annual compound growth rate for dividends is about 5%; coupled with a return on common of around 11%, continuation of this growth rate to attract the yield sensitive investors, upon whom the industry is dependent to sell common stock, is dependent upon yet higher payouts and/or higher rates of return; and (4), utility market to book ratios of around 75% lead to spiraling shareholder dilution with each public offering.

Factors such as these are currently contributing and will continue to contribute to financing difficulties. There is not one single remedy to these problems which are faced in differing degrees by other sectors of the regulated industries, as well as industry in general. However it is clear in the regulated sector that higher earned returns are necessary, accompanied by higher common equity ratios. The electric utility industry currently has debt ratios of around 52% with common equity ratios of around 36%. To improve financial integrity, the debt ratio must come down and common equity ratios need to move up to at least 40-45%, given the current high level of financing costs and their obvious impact on the financial position of the industry.

Indeed, the April 22 release by your subcommittee cites that Senator Chafee referred to Commerce Department data illustrating that the personal saving rate now stands at a near postwar low of 4.7%. "These figures underline the need to examine targeted proposals to provide incentives (or, more appropriately, to reduce disincentives), for capital formation." The ability of this class of investor to continue to place a slimming amount of savings into the capital intensive industries requires a greater potential for future gain than now exists. Dividend reinvestment, especially with a tax deferred feature, should go a long way toward remedying past inequities. In addition it would provide a basis for increasing individual savings especially if the prospect of paying lower total taxes on the investment are combined with a reasonable anticipation of greater long term capital gain.

Shareholder Considerations In Relation To Dividend Reinvestment Plans

The primary advantages of dividend reinvestment plans to shareholders are as follows:

1) No commission and brokerage fees on reinvesting dividends:
2) Possibility of purchasing fractional shares:
3) Automatic conversion of dividends into new productive facilities with the potential of further growth in value of the investment.

These benefits appeal most strongly to the small investor who cannot obtain volume discounts on securities transactions, or to the investor who may be tempted to spend cash dividends immediately. It is not surprising that small shareholders as a group have a much larger participation in dividend reinvestment plans than their proportional shareholding would indicate.[1] A recent illustration is the breakdwon of participation in the dividend reinvestment plan of General Telephone & Electronics Corporation, (Exhibit 3). Of the total participants in the plan, 79% owned 100 shares or less.

Yet it is these small shareholders who are penalized most severely by current taxation of reinvested cash dividends.

At present, participation in dividend reinvestment plans has no effect on the stockholder's tax obligation. Unlike a stock dividend where taxes are deferred until the shares are sold, (and probably taxed at capital gains rates), under a dividend reinvestment plan, the shareholder is taxed on the value of the new stock as if it were a cash dividend. Aside from the $100 deduction of dividends, an individual investor must come up with alternative sources of income to pay the tax on a dividend already taxed at the corporate level.

S. 141 by deferring taxes on dividends reinvested would not only make a contribution to corporate cash flow but would be a powerful incentive to the investor.

Inflation and certain aspects of economic policy have tended to discourage, and in fact reduce, the public's incentive to save. Recently, the personal savings rate in the United States, as noted above, has fallen below its long-run trend of 6-6½% as reflected below.[2]

84-080 O—81——23

1978 Actual				1979			
1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	1st Qtr. Actual	2nd Qtr. Actual	3rd Qtr. Actual	4th Qtr. Actual
5.3%	5.0%	4.8%	4.7%	5.0%	5.4%	4.3%	4.3%

The difference between the past long term trend and the current rate amounts to over $10 billion per year. Furthermore, the personal savings rate in the United States is the lowest of all the major industrialized countries including Canada, United Kingdom, West Germany, France and Japan. It is vitally necessary to restore value to savings for investment if the United States economy is to regain its strength.

Current Status of Dividend Reinvestment Plans

Recent reports have indicated that over the past five years 1975-1979, dividends of approximately $4.8 billion have been reinvested in the companies offering dividend reinvestment plans. This represents approximately 7% of all U.S. cash equity offerings in the same period.

An illustration of the success of these plans is the $4.8 billion estimated to have been raised by industry for the five years 1975-1979. Probably the largest participation was the $967 million collected by American Telephone and Telegraph from 25% of its shareholders in 1979. We believe the addition of a tax incentive would add considerably to the expansion of the plans to include more shareholders and potentially significant sums of necessary money to be reinvested in United States corporations. (See Exhibit 4).

Summary of the Benefits of S. 141

S. 141 would have the immediate effect of making reinvestment plans even more attractive to investors and would encourage more corporations to establish such plans for their shareholders. It would provide equitable tax treatment to investors in high cash dividend paying companies such as utilities, and those companies paying no dividends, low cash dividends, or stock dividends. In addition, it would serve as an incentive for shareholders to save.

Adoption of S. 141 also has broader implications for the economy as a whole. The increased equity investment brought about by greater participation in dividend reinvestment plans would strengthen American industry and produce increased output. This in turn would contribute to reduced inflation and allow the United States to compete in world markets in the future.

Dean Witter Reynolds Inc. recommends that S. 141 be adopted.

Footnotes

1- Dividend Reinvestment Programs, Patrick J. Davey, Conference Board Report No. 699, 1976, pp. 10-11.

2- "Economic Model: Data on the Expected Economic Outlook," Economic Research Department, Dean Witter Reynolds Inc., January 2, 1980. (See Exhibit 5 attached.)

EXHIBIT 1

CORPORATE FINANCE—UTILITY FINANCE DIVISION

SIXTH ANNUAL SURVEY OF THE 100 LARGEST UTILITY COMPANIES: COMPARATIVE FINANCIAL DATA FOR THE YEARS 1975-1979

1980 EDITION

Kenneth Hollister, CFA, First Vice President

A compilation of statistics prepared to show various measures of utility financial conditions over the recent several years.

A Publication of the Corporate Finance Department of Dean Witter Reynolds Inc.

DEAN WITTER REYNOLDS INC.

EXHIBIT 1-1

ONE HUNDRED LARGEST UTILITY COMPANIES
FOR THE YEARS 1975-1979
RATE OF RETURN EARNED ON AVERAGE COMMON STOCK EQUITY

	COMPANY	COMPANY TYPE	EARNINGS TYPE	RANK	1979	1978	1977	1976	1975
CEL	CENTRAL LOUISIANA ENERGY	C	N	1	25.73	15.51	15.92	17.25	17.57
NVP	NEVADA POWER CO	E	FT	2	15.98	9.77	16.12	10.50	9.76
PIN	PUBLIC SERVICE CO OF IND	E	N	3	15.59	12.60	15.43	15.48	13.19
SPS	SOUTHWESTERN PUBLIC SERV CO	E	N	4	15.28	17.33	21.67	19.62	16.35
IPL	INDIANAPOLIS POWER & LIGHT	E	N	5	15.09	10.54	16.30	13.71	12.39
OTTR	OTTER TAIL POWER CO	E	N	6	14.71	14.64	12.92	11.61	11.04
ELPA	EL PASO ELECTRIC CO	E	N	7	14.61	14.04	11.93	14.13	15.11
TEP	TUCSON ELECTRIC POWER	E	FT	8	14.48	14.63	14.46	13.53	14.45
HOU	HOUSTON INDS	E	N	9	14.25	13.37	15.19	15.22	10.79
WPS	WISCONSIN PUBLIC SERVICE	C	N	10	14.18	13.52	13.54	13.39	11.93
IOR	IOWA RESOURCES	C	N	11	13.76	14.25	12.48	13.34	14.41
CSR	CENTRAL & SOUTH WEST CORP	E	N	12	13.72	15.08	13.74	11.96	13.64
PNM	PUBLIC SERVICE CO OF N MEX	E	N	13	13.66	12.43	10.78	10.08	11.48
SCE	SOUTHERN CALIF EDISON CO	C	FT	14	13.66	9.45	11.88	11.03	10.43
MPL	MINNESOTA POWER & LIGHT	E	N	15	13.61	13.06	10.37	12.70	13.03
NES	NEW ENGLAND ELECTRIC SYSTEM	E	N	16	13.52	13.21	10.56	10.92	11.09
DUK	DUKE POWER CO	E	N	17	13.49	12.77	12.24	12.66	9.56
IWG	IOWA-ILLINOIS GAS & ELEC	C	N	18	13.38	12.99	12.73	12.91	11.93
NGE	NEW YORK STATE ELEC & GAS	C	FT	19	13.29	11.77	11.21	11.35	10.86
IPS	IOWA PUBLIC SERVICE CO	C	N	20	13.23	14.77	13.62	11.00	12.75
NSP	NORTHERN STATES POWER	C	N	21	13.19	13.33	11.76	12.57	13.03
UIL	UNITED ILLUMINATING CO	E	FT	22	13.15	10.24	12.99	10.53	14.70
NEG	NEW ENGLAND GAS & ELECTRIC	C	N	23	13.10	13.19	13.64	13.03	10.60
IUTL	IOWA SOUTHERN UTILITIES CO	C	N	24	12.95	12.74	12.99	11.33	13.47
CIN	CINCINNATI GAS & ELECTRIC	C	N	25	12.84	12.52	14.45	10.32	10.76
CPUB	CENTRAL VERMONT PUB SERV	E	FT	26	12.81	14.52	9.55	11.97	9.93
PPL	PENNSYLVANIA POWER & LIGHT	C	N	27	12.74	11.66	14.26	11.76	12.72
WPL	WISCONSIN POWER & LIGHT	C	N	28	12.73	11.29	12.46	12.70	10.32
MDK	MONTANA-DAKOTA UTILITIES	C	N	29	12.72	12.84	9.60	13.81	11.71
HE	HAWAIIAN ELECTRIC CO	E	N	30	12.70	12.24	11.69	11.60	11.49
SRP	SIERRA PACIFIC POWER CO	C	N	31	12.68	11.81	12.90	11.79	8.80
FPL	FLORIDA POWER & LIGHT	E	N	32	12.62	14.51	13.20	8.90	13.32
IPC	ILLINOIS POWER CO	C	N	33	12.46	12.78	12.70	11.30	13.23
WPC	WISCONSIN ELECTRIC POWER	C	N	34	12.40	12.11	12.15	11.61	10.04
AZP	ARIZONA PUBLIC SERVICE CO	C	FT	35	12.40	13.53	13.28	11.18	13.52
CIP	CENTRAL ILL PUBLIC SERVICE	C	N	36	12.36	11.51	11.93	11.33	13.11
CER	CENTRAL ILLINOIS LIGHT	C	N	37	12.32	10.10	8.01	10.46	8.82
CPL	CAROLINA POWER & LIGHT	E	N	38	12.31	12.62	11.27	11.86	11.94
IPW	INTERSTATE POWER CO	C	N	39	12.27	10.19	10.29	12.44	11.41
TXU	TEXAS UTILITIES CO	E	N	40	12.21	13.12	13.04	12.92	11.61
DEW	DELMARVA POWER & LIGHT	C	N	41	12.17	11.94	10.47	9.89	9.74
CNH	CENTRAL HUDSON GAS & ELEC	E	FT	42	12.15	12.10	11.48	11.05	10.41
LIL	LONG ISLAND LIGHTING	C	FT	43	12.15	12.32	13.96	14.21	13.36
PNH	PUBLIC SERVICE CO OF N H	E	N	44	12.11	14.35	9.37	10.76	12.95
CVX	CLEVELAND ELECTRIC ILLUM	E	N	45	12.04	11.24	15.51	13.67	13.06
BHPL	BLACK HILLS POWER & LIGHT C	E	N	46	12.00	14.77	10.08	11.60	12.45
CTP	CENTRAL MAINE POWER CO	E	FT	47	11.99	13.44	11.89	10.94	9.59
TE	TAMPA ELECTRIC CO	E	N	48	11.95	15.09	12.98	12.83	13.72
MSU	MIDDLE SOUTH UTILITIES	E	N	49	11.82	14.19	13.15	11.37	10.71
MPV	MISSOURI PUBLIC SERVICE CO	C	N	50	11.76	9.25	8.86	14.24	12.21

EXHIBIT 1-2

ONE HUNDRED LARGEST UTILITY COMPANIES
FOR THE YEARS 1975-1979
RATE OF RETURN EARNED ON AVERAGE COMMON STOCK EQUITY

	COMPANY	COMPANY TYPE	EARNINGS TYPE	RANK	1979	1978	1977	1976	1975
PPW	PACIFIC POWER & LIGHT	E	FT	51	11.71	12.00	11.23	12.52	12.82
ORU	ORANGE & ROCKLAND UTILITIES	C	FT	52	11.69	12.65	10.05	12.04	11.56
KAN	KANSAS POWER & LIGHT	C	N	53	11.61	12.12	12.63	13.19	12.11
OEC	OHIO EDISON CO	E	N	54	11.55	7.13	11.70	13.97	13.03
WWP	WASHINGTON WATER POWER	C	N	55	11.51	13.56	10.60	13.55	12.14
PCG	PACIFIC GAS & ELECTRIC	C	FT	56	11.46	10.87	10.58	10.09	9.56
BGE	BALTIMORE GAS & ELECTRIC	C	N	57	11.46	11.81	10.25	11.66	10.47
AYP	ALLEGHENY POWER SYSTEM	E	N	58	11.45	9.21	11.11	11.53	12.11
NMK	NIAGARA MOHAWK POWER	C	FT	59	11.43	11.06	10.38	9.67	12.24
ATE	ATLANTIC CITY ELECTRIC	E	N	60	11.40	10.50	10.05	12.76	12.74
FDP	FLORIDA POWER CORP	E	N	61	11.37	13.68	14.91	10.51	13.39
BSE	BOSTON EDISON CO	C	N	62	11.31	9.63	6.78	8.51	7.84
UTP	UTAH POWER & LIGHT	E	N	63	11.24	10.50	9.82	13.91	10.24
CMS	CONSUMERS POWER CO	C	N	64	11.20	11.34	10.47	12.09	8.80
TED	TOLEDO EDISON COMPANY	E	N	65	10.97	11.67	12.83	13.17	14.35
GSU	GULF STATES UTILITIES CO	E	N	66	10.91	10.93	11.53	11.43	11.77
COC	COLUMBUS & SOUTHERN OHIO	E	N	67	10.90	6.65	11.37	14.87	15.65
IEL	IOWA ELECTRIC LIGHT & PWR	C	N	68	10.84	11.43	11.48	11.12	7.69
DPL	DAYTON POWER & LIGHT	C	N	69	10.83	9.09	9.01	11.56	12.45
SIG	SOUTHERN INDIANA GAS & ELEC	C	N	70	10.74	15.08	15.14	14.72	13.18
MTP	MONTANA POWER CO	C	N	71	10.62	10.58	8.25	10.24	13.30
POM	POTOMAC ELECTRIC POWER	E	N	72	10.60	10.62	11.87	11.38	7.81
ED	CONSOLIDATED EDISON OF N.Y.	C	FT	73	10.52	10.51	11.74	11.58	11.11
AEP	AMERICAN ELECTRIC POWER	E	N	74	10.51	10.33	11.27	13.13	12.01
KU	KENTUCKY UTILITIES CO	E	N	75	10.39	7.51	7.96	10.62	12.42
SCG	SOUTH CAROLINA ELEC & GAS	C	N	76	10.39	12.81	13.17	12.17	12.64
CNM	COMMUNITY PUBLIC SERVICE	E	N	77	10.38	13.56	12.62	12.66	10.79
UEP	UNION ELECTRIC CO	E	FT	78	10.32	12.35	10.97	12.16	11.49
PEG	PUBLIC SERVICE ELEC & GAS	C	N	79	10.29	10.88	10.84	11.05	8.88
SDO	SAN DIEGO GAS & ELECTRIC	C	FT	80	10.28	11.35	12.99	12.92	5.93
DTE	DETROIT EDISON CO	E	N	81	9.99	9.13	10.28	8.69	7.81
MDSN	MADISON GAS & ELECTRIC CO	C	N	82	9.92	11.31	13.15	9.65	9.99
RGS	ROCHESTER GAS & ELECTRIC	C	FT	83	9.90	11.16	9.97	11.11	10.09
PE	PHILADELPHIA ELECTRIC CO	C	N	84	9.80	9.71	9.61	9.86	9.38
NI	NORTHERN INDIANA PUBLIC SER	C	N	85	9.77	8.43	11.00	14.00	11.96
DQU	DUQUESNE LIGHT CO	C	N	86	9.70	8.40	9.45	10.13	12.98
LOU	LOUISVILLE GAS & ELECTRIC	C	N	87	9.67	8.46	11.24	11.62	12.57
KLT	KANSAS CITY POWER & LIGHT	E	N	88	9.47	11.20	9.35	10.92	11.18
NU	NORTHEAST UTILITIES	E	FT	89	9.21	10.07	9.69	10.94	10.65
CWE	COMMONWEALTH EDISON	E	N	90	8.91	11.78	10.15	11.57	11.07
SO	SOUTHERN CO	E	N	91	8.90	8.43	11.26	10.07	13.61
PSD	PUGET SOUND POWER & LIGHT	E	N	92	8.55	11.24	9.86	11.36	13.31
VEL	VIRGINIA ELECTRIC & POWER	E	N	93	8.42	9.63	10.05	9.66	10.54
IDA	IDAHO POWER CO	E	N	94	8.29	10.21	7.70	10.57	8.70
KGE	KANSAS GAS & ELECTRIC	E	N	95	8.14	9.69	10.10	13.71	13.23
OGE	OKLAHOMA GAS & ELECTRIC	E	N	96	8.04	11.55	13.50	12.04	12.76
PSR	PUBLIC SERVICE CO OF COLO	C	N	97	7.89	9.05	8.59	11.15	12.65
GPU	GENERAL PUBLIC UTILITIES	E	N	98	6.94	10.41	11.50	10.47	9.29
PGN	PORTLAND GENERAL ELECTRIC C	E	FT	99	6.27	9.55	6.05	12.47	13.76
SAV	SAVANNAH ELEC & POWER	E	N	100	6.26	15.46	14.64	11.26	14.50
	AVERAGE FOR								
	100 COMPANIES				11.72	11.78	11.74	11.98	11.75
	20 FLOW THROUGH				11.74	11.67	11.52	11.59	11.31
	80 NORMALIZED				11.72	11.80	11.79	12.08	11.86
	AVERAGE FOR								
	53 STRAIGHT ELECTRIC COMPANIES				11.49	11.90	11.91	12.08	12.05
	10 FLOW THROUGH				11.81	11.87	11.44	11.66	11.76
	43 NORMALIZED				11.42	11.91	12.02	12.18	12.12
	AVERAGE FOR								
	47 COMBINATION COMPANIES				11.98	11.63	11.54	11.87	11.41
	10 FLOW THROUGH				11.68	11.47	11.60	11.52	10.87
	37 NORMALIZED				12.07	11.67	11.52	11.97	11.56

EXHIBIT 2

APRIL 1981

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Utility Trends is a monthly publication reviewing developments that could affect companies in the electric, natural gas and communications industries. We will also discuss market trends and price movements of the utility new issue markets. This publication is disseminated to utility corporate executives, associated accountants and attorneys, the regulatory community and its staffs.

HIGHLIGHTS

What Will The Utility Industry Look Like Ten Years From Now—It was a lively discussion.

A Leveraged Preferred Stock! The first issue is completed.

The Market for Electric Utility Common Stocks, Growing, Growing. . . .

Issues of Preferred Stocks in 1981.

DEAN WITTER REYNOLDS INC.

EXHIBIT 2-1

ELECTRIC UTILITIES

COMPANY	PRICE AS OF 04/22/81	BOOK VALUE PER SHARE	52 WEEK PRICE RANGE	EARNINGS PER SHARE 1978	EARNINGS PER SHARE 1979	EARNINGS PER SHARE 12 MOS 1980	MARKET PRICE/ BOOK VALUE	COMMON EQUITY RATIO
ALLEGHENY POWER(D)	$14	$21.05	$15 - $13	$1.90	$2.41	$2.09 (12)	.68	36.3%
AMERICAN ELEC POWER (D,O)	17	21.22	18 - 16	2.76	2.29	2.78 (3)	.79	32.5
ARIZONA PUBLIC SERVICE(D)	17	21.83	19 - 15	3.15	2.90	2.65 (3)	.77	44.3
ATLANTIC CITY ELECTRIC(D)	16	22.22	17 - 15	2.21	2.36	2.62 (12)	.70	38.0
BALTIMORE GAS & ELECTRIC	23	30.93	23 - 20	3.38	3.40	3.64 (12)	.73	39.6
BOSTON EDISON	20	30.76	22 - 20	2.96	3.52	3.75 (12)	.65	30.6
CAROLINA POWER & LIGHT(D)	18	24.09	19 - 17	3.10	3.06	3.13 (3)	.76	35.2
CENTRAL & SOUTHWEST(D)	14	17.13	14 - 12	2.25	2.27	2.45 (12)	.79	42.0
CENTRAL HUDSON G&E	17	26.49	18 - 16	3.04	3.27	3.56 (3)	.65	35.6
CENTRAL ILLINOIS LIGHT(D)	13	19.47	14 - 12	1.91	2.38	2.00 (12)	.69	34.7
CENTRAL ILLINOIS PUB SVC	11	14.19	12 - 10	1.63	1.80	1.52 (3)	.75	37.4
CENTRAL MAINE POWER	12	17.49	13 - 12	2.19	2.10	1.66 (9)	.67	34.1
CINCINNATI GAS & ELECTRIC	15	20.18	17 - 14	2.54	2.59	2.42 (3)	.72	34.5
CLEVELAND ELECTRIC ILLUM	15	19.06	16 - 14	2.20	2.42	2.24 (3)	.77	34.0
COMMONWEALTH EDISON (D,O)	19	27.98	19 - 18	3.30	2.51	2.97 (12)	.67	30.3
CONSOLIDATED EDISON(O)	28	45.66	29 - 23	4.29	4.51	4.67 (12)	.61	45.3
CONSUMERS POWER(D)	18	27.17	18 - 16	3.16	3.24	3.08 (12)	.66	32.3
DAYTON POWER & LIGHT(D)	13	18.17	14 - 12	1.73	2.01	2.27 (3)	.70	35.0
DELMARVA POWER	12	16.08	13 - 11	1.85	1.91	1.60 (12)	.72	35.3
DETROIT EDISON(D)	12	18.19	12 - 11	1.76	1.90	1.75 (12)	.63	32.5
DUKE POWER (D,O)	18	22.67	19 - 16	2.61	2.80	3.08 (12)	.80	36.2
DUQUESNE LIGHT(D)	12	17.29	13 - 12	1.49	1.75	1.73 (3)	.72	33.0
EASTERN UTILITIES ASSOC.	11	17.14	12 - 10	2.03	1.75	1.63 (12)	.66	30.3
FLORIDA POWER & LIGHT	28	36.65	28 - 24	4.54	4.22	2.21 (3)	.76	36.6
FLORIDA POWER(D)	14	18.05	14 - 12	2.37	2.07	3.06 (3)	.77	34.4
GULF STATES UTILITIES(D)	12	15.90	12 - 10	1.62	1.65	1.96 (12)	.72	31.7
HAWAIIAN ELECTRIC(D)	21	29.72	23 - 20	3.26	3.54	3.70 (12)	.72	33.0
HOUSTON INDUSTRIES(D)	27	35.69	29 - 25	4.21	4.04	4.71 (12)	.76	41.0
IDAHO POWER(D)	20	28.15	22 - 19	2.96	2.41	3.04 (12)	.71	36.5
ILLINOIS POWER(D)	18	22.00	19 - 17	2.74	2.70	2.87 (12)	.81	37.4
INDIANAPOLIS PWR & LT	19	25.07	20 - 18	2.30	3.46	3.60 (12)	.77	38.5
INTERSTATE POWER	11	17.05	13 - 11	1.60	2.01	1.75 (12)	.67	31.9
IOWA ELECTRIC L&P	12	18.34	13 - 11	2.04	2.06	2.07 (12)	.64	32.9
IOWA ILLINOIS G&E	17	21.55	17 - 16	2.74	2.86	2.69 (12)	.77	37.3
IOWA PUBLIC SERVICE	18	23.74	20 - 18	3.05	2.93	2.77 (12)	.77	36.6
IOWA RESOURCES	21	27.48	23 - 20	3.62	3.57	3.42 (12)	.75	36.9
IOWA SOUTHERN	20	30.44	21 - 18	3.47	3.65	3.75 (12)	.65	38.4
KANSAS CITY PWR & LT(D)	20	31.65	22 - 19	3.55	3.01	4.36 (12)	.64	36.0
KANSAS GAS & ELECTRIC	14	21.02	16 - 14	2.78	1.84	2.97 (12)	.68	35.2
KANSAS POWER & LIGHT(D)	17	24.03	18 - 16	2.74	2.8C	3.22 (12)	.72	39.6
KENTUCKY UTILITIES	15	22.82	17 - 15	1.88	2.60	1.69 (3)	.66	33.1
LONG ISLAND LIGHTING	14	18.98	16 - 14	2.44	2.41	2.55 (3)	.75	41.2
LOUISVILLE GAS & ELECTRIC	17	23.86	18 - 16	2.06	2.24	2.91 (12)	.71	35.3
MIDDLE SOUTH UTIL (D,O)	12	18.29	13 - 11	2.46	2.13	2.01 (12)	.64	28.7
MINNESOTA POWER & LIGHT	16	22.28	18 - 15	3.19	2.92	2.96 (3)	.73	32.7
MONTANA POWER(D)	28	24.85	32 - 25	2.71	2.81	3.24 (12)	1.14	38.0
N Y STATE ELEC & GAS(D)	15	21.95	16 - 13	2.46	2.83	2.76 (12)	.69	38.7
NEVADA POWER	19	21.29	21 - 18	1.96	3.37	1.58 (12)	.89	39.3
NEW ENGLAND ELEC SYSTEMS	21	26.66	22 - 19	3.21	3.45	3.75 (3)	.79	35.4
NIAGARA MOHAWK POWER	12	17.30	12 - 11	1.89	2.00	1.87 (12)	.67	38.7
NORTHEAST UTILITIES(D)	9	13.32	9 - 6	1.32	1.22	1.28 (12)	.70	30.1
NORTHERN IND PUB SVC(D)	11	17.39	12 - 11	1.58	1.82	1.67 (12)	.65	38.1
NORTHERN STATES POWER	22	28.12	22 - 20	3.39	3.51	3.23 (12)	.76	40.8
OHIO EDISON(D)	12	15.62	13 - 12	1.19	1.80	1.57 (3)	.78	30.6
OKLAHOMA GAS & ELEC(D)	13	16.71	14 - 13	1.97	1.36	1.73 (12)	.76	37.0
PACIFIC GAS & ELECTRIC(D)	21	30.31	22 - 20	3.20	3.55	3.60 (12)	.70	35.5
PACIFIC POWER & LIGHT(D)	20	20.71	22 - 19	2.51	2.46	2.64 (12)	.96	32.1
PENNSYLVANIA PWR & LT (D)	17	25.40	18 - 15	2.86	3.32	2.64 (12)	.66	31.4
PHILADELPHIA ELECTRIC(D)	13	18.04	14 - 12	1.87	1.85	2.00 (12)	.67	35.2
PORTLAND GENERAL ELEC(D)	13	17.21	13 - 12	1.72	1.86	2.03 (12)	.74	33.6
POTOMAC ELECTRIC PWR (D)	13	17.21	13 - 12	1.70	1.73	2.10 (12)	.76	37.8
PUB SVC OF NEW MEXICO (D)	22	23.36	22 - 19	2.83	2.97	3.36 (12)	.93	29.9
PUBLIC SVC ELEC & GAS(D)	18	27.11	19 - 17	2.95	2.85	3.38 (3)	.67	40.8
PUBLIC SVC NEW HAMPSHIRE	16	21.36	17 - 16	3.25	2.56	2.77 (12)	.74	35.5
PUBLIC SVC OF COLORADO(D)	15	16.66	15 - 14	1.66	1.35	2.06 (3)	.88	37.4
PUBLIC SVC OF INDIANA(D)	20	24.87	21 - 18	2.92	3.79	3.21 (12)	.81	37.8
PUGET SOUND PWR & LT(D)	13	16.98	14 - 11	2.17	1.67	1.60 (12)	.74	36.9
SAN DIEGO GAS & ELECTRIC	12	16.10	13 - 11	2.02	1.80	1.01 (12)	.72	34.4
SAVANNAH ELECTRIC(D)	10	20.05	11 - 9	2.75	1.24	1.22 (12)	.49	27.3
SIERRA PACIFIC POWER(D)	11	15.32	13 - 11	1.83	1.96	1.56 (12)	.74	34.8
SOUTH CAROLINA ELEC & GAS	14	18.80	15 - 13	2.26	1.90	1.91 (3)	.73	32.8
SOUTHERN CALIF EDISON(D)	26	34.09	26 - 23	3.38	4.38	3.08 (12)	.75	37.8
SOUTHERN COMPANY (D,O)	12	17.20	13 - 11	1.45	1.51	2.28 (12)	.71	29.6
SOUTHERN INDIANA G&E	18	23.37	19 - 16	3.04	2.29	3.43 (12)	.76	43.6
TAMPA ELECTRIC	20	19.70	21 - 16	2.53	2.12	3.12 (12)	1.02	41.8
TEXAS UTILITIES(D)	18	21.95	19 - 16	2.54	2.45	3.37 (3)	.84	38.3
TOLEDO EDISON	16	23.85	18 - 15	2.70	2.65	2.56 (12)	.68	31.9
TUCSON ELECTRIC POWER	16	15.96	16 - 13	1.95	2.11	2.37 (12)	.97	36.8
UNION ELECTRIC	11	15.90	11 - 10	2.01	1.73	1.90 (3)	.68	33.1
UTAH POWER & LIGHT(D)	16	18.57	17 - 15	1.93	2.06	2.51 (3)	.88	36.6
VIRGINIA ELEC & PWR (D,O)	12	18.63	12 - 10	1.88	1.63	1.98 (3)	.62	33.1
WASHINGTON WATER POWER	17	23.52	18 - 16	3.19	2.70	2.33 (12)	.71	40.0
WISCONSIN ELEC POWER(D)	23	31.69	24 - 20	3.90	3.75	3.52 (12)	.71	37.3
WISCONSIN POWER & LIGHT	17	20.42	18 - 15	2.15	2.50	2.04 (12)	.83	30.8
AVERAGES								
ARITHMETIC	16	22.23	17 - 15	2.51	2.54	2.61	.74	35.6
WEIGHTED	17	23.50	18 - 16	2.01	2.67	2.74	.74	35.7

EXHIBIT 2-2

ELECTRIC UTILITIES

TICKER SYMBOL	IND DIV	YIELD	CASH COVERAGE OF DIVIDEND	DIVIDEND PAYOUT IND RATE	DIVIDEND PAYOUT 1975-79 AVERAGE	TREND-LINE GROWTH RATE FIVE YEAR EPS	TREND-LINE GROWTH RATE FIVE YEAR DIV	RETURN ON COMMON EQUITY	MAJOR RATE INCREASES AMOUNT PENDING (MILLIONS)	MAJOR RATE INCREASES DATE DUE
AYP	$ 1.96 *	13.6%	2.3	75.7%	75.3%	2.0%	3.2%	10.6%		
AEP	2.26	13.5	1.8	99.1	88.3	-1.8	2.1	11.2	57.0	4/81
AZP	2.12	12.7	.9	80.0	56.2	5.3	7.4	11.4	142.0	20/81
ATE	1.96	12.5	2.4	74.8	70.6	-2.5	3.3	11.6	76.0	20/82
BGE	2.56	11.4	2.6	70.3	70.9	4.0	4.2	11.6		
BSE	2.80	14.1	2.6	74.7	92.0	5.6	.4	11.4		
CPL	2.24	12.3	1.2	71.6	65.2	7.1	4.8	10.3		
CSR	1.58	11.7	2.5	64.5	64.2	6.3	4.8	13.5	260v	20/81
CNP	2.36 *	13.7	1.2	66.3	63.5	7.5	3.2	3.7	35.7	7/81
CLR	1.82	13.6	2.5	91.0	86.7	3.5	.9	10.0	24.4	10/81
CIP	1.40	13.2	2.6	92.1	76.1	2.0	2.2	10.6		
CTP	1.72	14.6	2.0	103.6	75.6	8.0	2.9	9.4		
CIN	2.04	13.9	1.7	84.3	76.2	8.1	4.1	10.8		
CVX	2.06	14.2	1.3	92.9	74.7	.8	3.6	10.4	160.8	4/81
CWE	2.60	13.8	1.2	87.5	82.9	-1.3	2.3	8.6	441.8	6/81
ED	2.96	10.6	3.0	63.0	64.7	9.8	20.9	10.2		
CMS	2.36	13.2	.9	76.6	69.2	14.4	2.9	8.9	87.4	10/81
DPL	1.82	14.3	.9	80.2	86.9	-1.9	.5	9.5		
DQU	1.52	13.2	2.0	95.0	76.6	4.1	3.1	11.1		
DTE	1.60	13.9	1.6	91.4	85.2	5.7	1.6	9.0	554.5v	5/81
DUK	2.04	11.2	1.4	66.2	69.6	10.8	5.9	13.1	102.5	
BOU	1.80	14.5	1.6	104.0	95.0	-8.2	.3	9.7		
EUA	1.60	14.1	1.4	98.2	102.0	-.3	1.5	8.8		
FPL	3.04 *	10.9	3.0	137.6	49.8	9.7	10.9	10.7	375.0	80/81
FDP	1.64	11.8	3.5	42.5	81.7	-5.6	7.6	10.6		
GSU	1.48	12.9	2.0	75.5	74.6	.2	3.7	13.3		
HE	2.64	12.4	3.0	69.8	63.9	6.3	7.2	11.8	3.8	20/81
HOU	2.96	11.0	2.9	62.8	47.0	10.6	9.5	12.8		
IDA	2.52	12.7	2.0	82.9	83.9	-4.3	3.8	10.0		
IPC	2.38	13.4	1.8	82.9	84.6	2.9	.8	12.5	115.0	7/81
IPL	2.40	12.4	2.8	65.2	70.7	9.2	3.2	14.6		
IPW	1.56	13.7	2.7	89.1	82.5	1.5	1.7	9.6	14.4	20/81
IEL	1.66	14.1	2.7	80.2	77.8	22.2	3.5	11.3	33.2	20/81
IWG	2.20	13.3	2.2	81.8	70.1	6.4	6.7	10.2	21.4	6/81
IPS	2.40	13.1	2.1	88.6	67.0	6.8	6.5	11.1	12.2	20/81
IOR	2.72	13.2	2.6	79.5	64.9	5.6	7.0	13.3	55.4	30/81
IUTL	2.40	12.5	2.1	66.1	61.7	2.7	4.3	12.4	21.1	20/81
KLT	2.76	13.6	2.1	63.8	75.0	-.2	3.8	12.4	105.1	10/82
KGE	2.04	14.3	1.5	68.7	75.1	-4.1	4.1	16.0	13.9	20/81
KAN	2.20	12.8	2.9	68.3	62.9	6.0	5.5	13.3	37.3	20/81
KU	2.12	14.0	2.4	175.4	80.1	1.2	3.4	6.4	60.4	30/81
LIL	1.86	13.1	1.0	72.9	66.5	2.9	3.9	10.8	138.0	6/81
LOU	2.14	12.6	3.3	73.5	78.1	-1.6	2.1	11.2	55.1	20/81
MSU	1.62	13.8	.0	80.6	68.3	3.0	4.5	9.2	166.3	20/81
MPL	2.12	13.0	2.9	71.6	65.2	7.5	5.8	11.2	66.0	10/81
MTP	2.28	8.1	1.8	70.4	71.9	-2.6	2.5	9.8	726.	4/81
NGE	1.88	12.4	1.9	69.6	68.0	4.5	3.4	11.7	142.7	10/81
NVP	2.44 *	12.9	1.9	154.4	50.6	11.1	18.6	8.5	20.5	4/81
NES	2.50	11.8	2.6	66.7	71.4	8.4	4.5	12.0		
NMK	1.52	13.1	1.7	81.3	71.4	1.9	4.1	9.3		
NU	1.18	12.6	1.9	92.2	78.8	-2.3	.5	9.2		
NI	1.50	13.3	2.4	102.0	73.2	-4.0	2.3	7.7	108.2v	6/81
NSP	2.42	11.3	3.0	74.9	65.5	6.6	4.2	11.8	132.6v	
OEC	1.76	14.4	1.1	112.1	99.2	-3.5	1.5	10.6	110.1	7/81
OGE	1.60	13.3	2.2	97.1	84.3	-4.6	3.2	10.3	199.2	30/81
PCG	2.72	12.9	1.4	75.6	66.9	3.2	4.7	10.8	430.7	40/81
PPW	2.04	10.3	1.6	77.3	75.7	3.2	3.9	12.7		
PPL	2.24	13.3	.8	84.8	62.9	2.7	2.7	10.1	123.3	10/81
PE	1.80	14.3	1.0	80.0	91.1	-.6	1.9	8.5	304.0	20/81
PGN	1.70	13.3	.5	83.7	110.0	-15.6	2.3	11.8		
POM	1.52	11.7	3.7	72.4	79.0	8.3	3.8	12.2	47.1	30/81
PNM	2.68	12.4	1.3	79.8	61.4	7.6	9.4	14.0		
PEG	2.44	13.4	2.1	72.2	71.0	5.1	5.4	8.9	772.8	10/82
PNW	2.12	13.5	.2	76.5	72.9	3.0	4.7	11.8		
PSR	1.60	11.0	1.3	77.7	80.1	-5.1	6.3	10.7	123.3	3/81
PIN	2.60 *	12.9	2.0	81.0	66.3	8.0	6.5	11.9	118.6	6/81
PSD	1.76 *	14.1	1.3	110.0	66.7	-3.6	10.1	8.6	102.0	10/81
SDO	1.60	13.8	1.0	150.4	73.5	.9	11.2	10.5	232.0	12/81
SAV	1.20	12.1	3.7	90.4	64.4	2.7	8.3	6.1	12.9	20/81
SRP	1.66	12.5	2.3	93.6	64.2	7.2	7.4	9.5	5.5	30/81
SCG	1.82	13.2	1.6	96.3	75.5	4.7	2.6	10.4	106.0	30/81
SCE	2.96	11.6	1.0	86.1	58.3	8.8	9.5	10.1		
SO	1.62	13.2	2.8	71.1	86.7	-2.3	2.3	12.4		
SIG	1.80	10.6	3.6	54.0	51.0	5.7	6.6	12.0		
TE	1.72 *	8.5	2.9	56.1	56.6	7.6	8.1	11.5		
TXU	1.88	10.2	2.9	56.0	60.3	4.6	6.9	14.2		
TED	2.20	13.5	1.3	86.9	73.9	-2.4	1.7	10.3		
TEP	1.72	11.1	1.4	77.6	63.7	7.0	10.5	13.6	42.0	1/81
UEP	1.52	14.1	1.0	80.0	75.7	4.1	2.5	10.5	100.0	30/81
UTP	2.00	12.3	1.9	79.7	76.0	2.8	8.9	11.0	64.5	4/81
WEL	1.60	12.2	1.4	73.7	69.4	-2.0	3.1	9.9	98.3	80/81
WMP	2.24	13.4	1.4	96.1	65.5	9.6	7.8	9.2		
WPC	2.52	11.1	3.6	73.6	65.0	8.3	5.2	11.9	82.0	30/81
WPL	2.00	11.8	3.1	76.8	74.2	6.2	4.8	12.6		
	2.06	12.7	2.0	82.6	72.4	3.3	4.9	10.8		
	2.13	12.6	1.9	84.8	71.9	4.7	5.1	10.9		

EXHIBIT 3

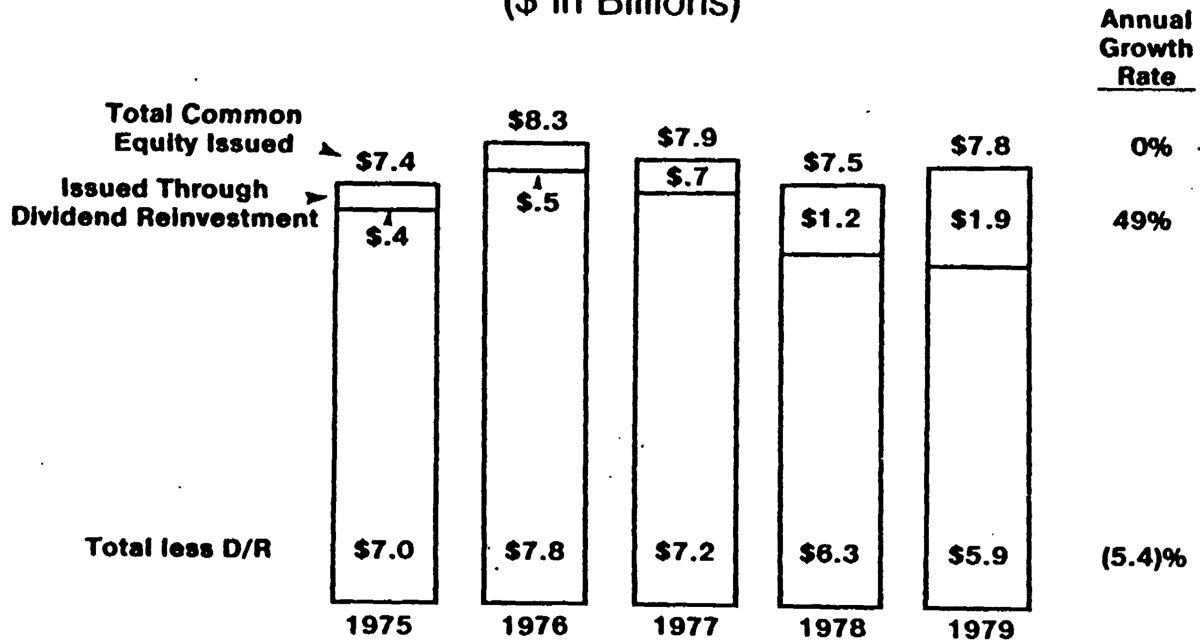
ILLUSTRATION OF PARTICIPATION BY SMALL SHAREOWNERS IN DIVIDEND REINVESTMENT PLANS

	Percent Of Plan Participants Owning 200 Shares Or Less
Central Telephone & Utilities Corporation	66%
American Telephone and Telegraph Company	80%
United Telecommunications, Inc.	81%
Continental Telephone Corporation	85%
General Telephone & Electronics Corporation	91%

Source: "Supplemental Statement of the United States Independent Telephone Associaton of S. 1543" submitted to the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance, November 23, 1979, Chart 6.

EXHIBIT 4

DIVIDEND REINVESTMENT
as a
SOURCE OF COMMON EQUITY CAPITAL
($ in Billions)



% From Dividend Reinvestment	5.4%	6.0%	8.9%	16.0%	24.4%

SOURCE: Federal Reserve Bulletin

ECONOMICS GROUP

EXHIBIT 5

An Institutional Service
ECONOMIC MEMORANDUM
January 2, 1980 RI 8/26-R
Arnold X. Moskowitz,
Vice President and Economist

INFLATION: NEAR TERM, UNFAVORABLE; INTERMEDIATE TERM, FAVORABLE

Summary and Conclusion

Our monthly model for gross national product indicates that for the final quarter of 1979 real growth is likely to range between +1.5% and -1.5%. We (and everyone) must still wonder whether the economy has actually entered a recession, but in our opinion the peak level of real GNP occurred in November, with an actual decline in December bringing the economy back to the October level. However, when the three months of the fourth quarter are averaged, that average may be—against our expectation—higher than the figure for the previous three months. Thus, on the basis of quarterly data, the economy may still be rising, even though the December drop appears to be decisive.

The first period of 1980 should be less equivocal. The expectation of weakness is supported by the 1.2% decline in durable goods orders in October, the 1.5% fall in industrial production in November, and the 100,000 additional people who made initial claims for unemployment insurance in the same month. The employment statistics are the first to reflect layoffs in the auto and steel industries.

GNP prices in the fourth quarter are expected to rise by 11.4%, and according to our forecast, double-digit inflation will continue through mid-1980. We continue to anticipate that approximately 40% oil price hikes by the Organization of Petroleum Exporting Countries will produce a $28 per barrel average price for all of 1980, after prices reach $29 early in the year; this should be the primary force behind the inflationary push over the next six months. With a 10.5% increase in unit labor costs next year, we look for a 1980 inflation rate of about 11.5% in the consumer price index.

But if we are decidedly bearish about the near-term inflation outlook, we are quite bullish about the longer-term cyclical inflation prospect. The four indicators of inflation—cumulative monetary base, M-2 (the broad money supply), unit labor costs, and commodity prices—support a double-digit inflation forecast for the next six months, but they also imply that the inflation rate will decline to 7.5-8.0% by mid-1981. (See our Monthly Money and Credit Memo for December 1979.) This cyclical drop in the inflation rate (politics will determine whether the downturn is more permanent) is a function of a recession of "average" severity. Implicitly, therefore, we reject a double-digit inflation forecast for 1980-81 that implies a mild recession.

Signs of Recession

November's new housing starts are reported down 14%, to 1.5 million, while permits, a leading indicator, fell to 1.267 million, the lowest level in three years. Sales of existing single-family homes also fell by 12%, the sharpest drop in 12 years, and the median price of a new one-family home fell by $4,700 in October, to $61,000—the reverse of the 1974-75 experience, when over the course of the recession the median price of homes that were selling actually rose.

In some respects, therefore, the exaggerated run-up in existing-home prices, a major result of trading up and buying ahead, has apparently produced an air pocket in demand for higher-price homes, given today's tight mortgage situation. Other signs of a December recession include weak car sales and rising initial unemployment claims—another "worst since" statistic, but in this case the bad news harks back only to January of 1979, when strikes affected this indicator.

Given last year's (and the previous year's) premature alarms about incipient economic weakness, we are of course in the position of the boy who cried "wolf" too often. Indeed, December's weakness is increasingly less likely to offset the strength exhibited in October/November, so that many expect the final quarter of 1979 to show positive real growth. Given tight money since the October Federal Reserve Board announcements, the consensus is that recession will start in the first period of 1980. But as our December Money and Credit Memo shows, in terms of the relevant indicator, M-3 adjusted for repurchase agreements and money-market funds, money growth has not yet begun to slow unmistakably. Thus, real estate and new cars are weak, and disintermediation has stripped the savings institutions of future mortgage lending ability, but the lingering boom is still evident in a few other areas.

For example, signs of recession remain elusive in the manufacturing sector. Shipments and trade sales were relatively strong at 0.9% in October, decelerating from 1.5% over the previous three months. But the inventory-to-sales ratio in October was 1.41, which is 7.2% below the 1.52 historical average. Moreover, given weak car sales, one might have expected a buildup in durables, but the gain was only $250 million, whereas in nondurables (where sales remained strong) the buildup was $1.2 billion. Clearly, therefore, inventories remain in reasonable balance, and a drop in final demand will not produce anything like the huge decumulation of 1974-75, which substantially deepened the last recession.

Nevertheless, first estimates of industrial production in November showed a decline of 0.5%, again centered in durables. There was a related drop in steel, and housing's weakness was reflected in lumber. With the economy's course in doubt, the probability of controls has risen to 50-50 as the political response to high inflation and high unemployment presses on the Carter candidacy. If a move toward controls occurs (which would be wrong), it will probably encompass controls on wages and prices, foreign exchange, and credit; legislation is in place for the last two of these.

Inflation

The present price structure for OPEC oil prices is shown in Table EO-1; the moderates (Saudi Arabia, Venezuela, Ecuador, and Kuwait) are expected to raise prices to about $26 a barrel after January. Assuming that the hawks would then maintain the current differential, we anticipated $30 a barrel from them—hence, an average of $28. Since we forecasted an average of $28 a barrel for imported oil for all of 1980, obviously we expected very little additional upward price pressure in 1980, owing to the recession. Actually, some hawks have now raised prices beyond $30 to $34 a barrel; however, we are not inclined to change our average price for 1980 since we expect some price cutting to appear, given present worldwide growth trends.

Table EO-2 shows OPEC oil price policy in real and nominal terms since 1972. With oil prices deflated by United States GNP prices to reflect deterioration in the dollar, which was the numeraire for oil pricing as well as the payment medium in the last cycle, members of OPEC did not suffer at all in real terms; indeed, there were gains throughout most of the 1975-78

Table E0-1

CURRENT AND PREVIOUS PRICES FOR OPEC MILD OIL
(Per Barrel)

Country	Previous Price	Current Price
Algeria	$21.56	$26.27
Ecuador	23.41	23.41
Gabon	22.00	22.00
Indonesia	24.50	26.50
Iraq	22.18	26.18
Iran	23.50	28.50
Kuwait	21.43	21.43
Libya	26.27	34.72
Nigeria	26.27	30.00
Qatar	21.42	28.26
Saudi Arabia	18.00	24.00
United Arab Emirates	21.56	27.56
Venezuela	20.00	24.00

Table E-02

NOMINAL AND REAL OPEC OIL PRICES

		Average Price per Barrel	Percent Change from Previous Price	Prices in Real Terms*	Percent Change from Previous Price
1972		$ 2.01		$ 2.00	
1973		3.25	61.7%	3.07	53.5%
1974		10.48	222.5	9.03	194.1
1975		10.34	-1.4	8.13	-11.1
1976		11.18	8.1	8.36	2.8
1977		12.02	7.5	8.48	1.4
1978		12.34	2.7	8.12	-4.4
1979:	1st Qtr.	13.18	6.8	8.23	1.4
	2nd Qtr.	16.14	22.5	9.85	19.7
	3rd Qtr.	19.51	20.9	11.67	18.5
	4th Qtr.	23.00E	17.9E	13.39E	14.7E
1980:	1st Qtr.	29.00E	26.1E	16.47E	23.0E

* Inflation adjusted by GNP prices: 1972=100.
E = Dean Witter Reynolds estimate.

cycle. Nevertheless, the Iranian crisis and a new willingness to forego production should enable OPEC to raise oil prices by 102.8% in real terms (versus 1978 prices), assuming our estimated average of $29 in the first quarter is correct and assuming a 10% rate of inflation in terms of GNP prices.

It seems to us that this huge jump, which amounts to a bonus in advance to offset inflation during the recession, will lead to another hiatus in real oil price increases in 1981—that is, the increases may be minor in real terms, as they were in 1976. If so, this supports our view that inflation will be in the 7.5% region in 1981, a sharp decrease from the current double-digit rate.

We will therefore have another opportunity to reduce the secular rate of inflation early in the next economic cycle, although the need to invest to make up for our present overdependence on foreign oil probably means that inflation will once again rebound. It is unlikely that any but a committed conservative administration will cut back on consumption to finance investment in the first year of a recovery, thereby reducing the imbedded long-term rate of inflation. This is our preliminary judgement, however; in fact, the issue will be settled in the next election.

Since energy accounts for 8.5% of the consumer price index and OPEC oil amounts to half of our consumption, 4.25% is added to the CPI for every 100% increase in OPEC prices; a 40% rise pushes prices up by 1.7% above what they otherwise would have been. This is one reason for expecting inflation to run in the 10-12% zone next year, up 1.7% from our forecast at midyear. Looking at inflation based on labor costs, we anticipate overall compensation gains to average 9.0-9.5%, and as the recession deepens, productivity increases should decline to a negative 1.2% as output slows faster than workers are laid off. Unit labor cost should therefore go up by 10.5%, which correlates with 70% of the consumer price index. As the economy weakens, corporate profit margins will suffer as well, but most of the labor cost increase will be passed along in the form of higher prices, so that for these reasons double-digit inflation may be expected early in 1980.

New Initiatives

Political responses also hinge on the near-term recession news. For example, the primary reason for delaying tax-cut proposals that would help business finance capital expenditures, thereby cushioning the recession, is the lingering boom. This makes proposals to reduce taxes one year hence seem irresponsible, even if the changes are made retroactive to the second or third quarter.

In general, however, the Administration is expected to propose tax cuts when it will do more good politically—that is, when signs of the recession are plain and when the Democratic primaries are in the offing. Moreover, Secretary of the Treasury G. William Miller, representing business, and Labor Secretary Ray Marshall, representing more liberal elements, are both reported to favor personal income-tax cuts through Social Security payroll tax reductions and a corporate tax cut through faster depreciation.

However, having given up on a gasoline tax of $0.50 a gallon owing to congressional opposition, the President may use his power to set import duties (which can be stripped from him only by two-thirds majorities in both houses) to tax imported crude at $21 a barrel. This would show "strong leadership," and leadership directed clearly at our overdependence on foreign oil is likely to go down well if the Iranian crisis continues. Since the $40 billion in estimated revenues (versus $50 billion for the gasoline tax) must be recycled, it would also allow the President to call for individual tax cuts plus rebates to lower-income families around primary time, assuming recession is by then unmistakable.

So far we have seen none of the unseemly haste to undo tight money policy that was in evidence on the part of the Administration or Congress in 1974-75, but the Presidential race has just begun. Proposals to reduce consumption by fiscal means by shifting the tax balance in favor of business may be unacceptable after recession deepens—especially if the Iranian crisis is settled, since in that case economic issues (with Kennedy to exploit them) will come to the fore. However, our forecast assumes:

- A recession lasting four quarters, although as indicated, the first period of the recession is increasingly in doubt. The drop in the first quarter is -1%; the progression thereafter is -3.3%, -3.9%, and -0.9%, with a slow recovery of 2.6% in the final three months of 1980. The peak-to-trough decline is 2.1% in terms of the quarterly figures for real GNP and 4.8% for industrial production. The year-over-year fall in 1980 in terms of real GNP is -1.4%, which compares to-1.1% for the consensus forecast of 40 economists reported by Eggert Economic Enterprises on December 3.

- We expect inflation in terms of consumer prices to be in the double-digit range in the first half, as do most forecasters, owing to a minimum 40% increase in imported oil prices, while domestic oil prices are also rising because of the gradual phase-out of controls. However, by the third quarter inflation decreases to 8.5% in terms of the consumer price index, and by the fourth quarter it is 7.8%, as productivity increases with recovery—a process that we expect to continue in 1981. Year-over-year we anticipate 1980 inflation to rise 11.6% in terms of consumer prices and 9.7% in terms of the implicit GNP deflator, which compares to 10.6% and 8.9% for GNP prices according to the Eggert survey--a full 1% higher than the consensus view. As for the present quarter, we look for 11.4% inflation in terms of GNP prices.

- Reported posttax profits are expected to decline 8.3% in 1980 versus a 17.1% rise in 1979. Our figure for 1980 is a bit worse than the consensus view of -6.3%, but we consider keep profits (retained earnings less an adjustment for inventory profits) to be a more significant indicator for the stock and bond markets. They are expected to decline 4.1% in 1980 after gaining 2% in 1979 and 4% in 1978—not a severe drop compared to the last cycle, when keep profit levels actually became negative in one quarter. This has positive implications for stock markets after the first period of 1980 and also, assuming continued monetary restraint, for the bond markets.

- We believe the peak in short-term interest rates was registered after the October 6 Federal Reserve announcements, although in terms of the quarterly forecast, 91-day Treasury bills are at 12% in both the last quarter of 1979 and the first quarter of 1980, and the other short rate proxy, the prime rate, actually edges up from 15% in the fourth quarter to 15.3% in the first. This difference is the result of the rapid rise from lower levels in the fourth quarter versus continued high rates in the first quarter. In short, a rapid decline is expected not in the first period of 1980 but in the second and third periods. By year-end we expect the prime rate to reach 10.8%—a 450-basis-point drop, which is exceptionally small in comparison with other cycles.

- As for long-term rates, they peak in the first quarter of 1980 at 11.9% (12.3% monthly) and decline 170 basis points to 10.2% in the fourth, which is also a small decline by historical standards. For a longer discussion of the hazards and opportunities of longer rate forecasting, see our soon-to-be published Economic Memorandum, "Forecasting the Bond Rate over the Next Nine Months."

* On balance we expect the Fed to remain fairly restrictive, which is reflected in these rate forecasts. However, as 1980 wears on and the recession deepens, and as Europe (where monetarism is strong) also enters recession, we can expect some wavering and stimulative monetary policies by all central banks by early 1981.

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Research assistance by Monica Spicker.
1/2/80

Reprinted from January 1980 issue of Monthly Investment Outlook.

84-080 O—81——24

Economic Model:

DATA ON THE EXPECTED ECONOMIC OUTLOOK

	1977 Year Est.	1977 Percent Change from 1976	1978 1st Qtr. Act.	1978 2nd Qtr. Act.	1978 3rd Qtr. Act.	1978 4th Qtr. Act.	1978 Year Act.	1978 Percent Change from 1977	1979 1st Qtr. Act.	1979 2nd Qtr. Act.	1979 3rd Qtr. Act.	1979 4th Qtr. Est.	1979 Year Est.	1979 Percent Change from 1978	1980 1st Qtr. Est.	1980 2nd Qtr. Est.	1980 3rd Qtr. Est.	1980 4th Qtr. Est.	1980 Year Est.	1980 Percent Change from 1979
KEY INDICATORS																				
GNP (Current $)	1,900	+11.6	2,011	2,104	2,180	2,235	2,128	+12.0	2,292	2,330	2,386	2,454	2,368	+11.3	2,492	2,575	2,577	2,846	2,580	+ 8.2
GNP Prices (Annual Rate, %)	–	+ 6.0	+6.3	+10.6	+7.2	+8.7	–	+ 7.3	+9.3	+9.3	+8.0	+11.4	–	+ 9.0	+10.1	+9.2	+8.7	+8.0	–	+ 9.7
GNP – Real Terms ($)	1,341	+ 5.3	1,360	1,396	1,407	1,427	1,390	+ 4.4	1,431	1,422	1,434	1,430	1,429	+ 2.0	1,418	1,406	1,404	1,413	1,410	– 1.4
GNP – Real Terms (Annual Rate, %)	+5.3	–	+1.9	+8.3	+3.6	+5.6	+4.4	–	+1.1	–2.3	+3.5	–1.0	+2.0	–	–3.3	–3.9	–0.9	+2.8	–1.4	–
Real Disposable Personal Income ($)	970	+ 4.2	957	966	970	987	973	+ 4.6	987	983	984	986	982	+ 1.9	982	980	975	980	979	– 1.3
Personal Saving Rate (%)	5.0	–	5.3	5.0	4.8	4.7	4.9	–	5.0	5.4	4.3	4.3	4.8	–	5.8	5.5	5.4	5.3	5.5	–
Unemployment Rate (%)	7.0	–	6.2	6.0	6.0	5.8	6.0	–	5.7	5.7	5.8	6.4	5.9	–	7.0	7.5	8.0	7.8	7.7	–
Consumer Prices (Annual Rate, %)	–	+ 6.5	8.8	10.8	9.8	8.3	–	+ 7.6	10.5	14.4	13.8	13.0	–	+11.3	12.0	10.1	8.5	7.8	–	+11.8
Reported Profits (Pretax $)	177	+13.5	177	207	212	227	208	+16.3	233	227	243	236	236	+14.1	226	213	204	216	214	– 9.8
Reported Profits (Post-Tax $)	106	+13.3	107	122	125	132	122	+16.3	142	139	146	143	143	+17.1	137	130	126	132	132	– 8.3
Inventory Profits ($)	15	+ 4.1	24	25	23	29	25	+66.8	40	37	44	41	41	+64.0	41	30	22	21	29	–29.3
Dividends ($)	42	+12.2	46	46	48	50	47	+12.1	52	52	53	54	53	+12.7	54	54	56	56	55	+ 3.3
Keep Profits ($)	47	+17.7	38	51	54	54	49	+ 4.0	51	51	51	46	50	+ 1.5	42	46	50	56	44	–12.0
Compensation per Man-Hour	–	+ 8.0	–	–	–	–	–	+ 8.8	–	–	–	–	–	+ 9.0	–	–	–	–	–	+ 9.3
Output per Man-Hour	–	+ 1.8	–	–	–	–	–	+ 0.5	–	–	–	–	–	– 0.7	–	–	–	–	–	– 1.2
Unit Labor Costs	–	+ 6.3	–	–	–	–	–	+ 8.0	–	–	–	–	–	+ 9.7	–	–	–	–	–	+10.5
Capital Spending ($)	138	+13.3	144	151	156	164	154	+13.3	166	173	173	179	173	+12.3	178	178	183	191	182	+ 5.2
Industrial Production Index	137	+ 5.4	140	144	147	150	145	+ 5.8	152	152	152	147	151	+ 4.0	148	146	145	147	147	– 3.0
Housing Starts (Annual Rate, Millions of Units)	2.0	+18.9	1.8	2.1	2.0	2.1	2.0	+ 2.1	1.8	1.8	1.8	1.7	1.7	–15.0	1.5	1.4	1.3	1.5	1.4	–17.6
New-Car Sales (Annual Rate, Millions of Units)	11.2	+10.5	10.7	12.1	11.3	11.1	11.2	0.0	11.6	10.5	10.7	9.3	10.5	– 6.7	9.1	8.8	9.3	9.5	9.2	–14.1
Domestic	9.1	+ 5.8	8.7	10.0	9.3	9.2	9.3	+ 1.9	9.3	8.0	8.6	7.4	8.3	–12.0	7.2	7.1	7.7	7.7	7.4	–12.1
Imported	2.1	+40.0	2.1	2.1	1.8	1.9	1.9	– 2.6	2.3	2.6	2.1	1.9	2.2	+15.8	1.9	1.8	1.6	1.8	1.8	–18.2
91-Day Treasury Bills (Qtrly. Avg., %)	5.3	–	6.4	6.5	7.3	8.8	7.2	–	9.4	9.4	9.7	12.0	10.2	–	12.0	10.4	9.3	8.3	10.0	–
Prime Rate (Qtrly. Avg., %)	6.8	–	8.0	8.3	9.1	10.6	9.1	–	11.7	11.7	12.1	16.0	12.8	–	15.2	12.7	11.3	10.8	12.8	–
Corporate Bonds – Seasoned AA (%)	8.2	–	8.6	8.8	9.0	9.2	8.9	–	9.5	9.8	9.6	11.6	10.1	–	11.9	11.0	10.5	10.2	10.9	–
Federal Deficit N.I.A. ($)	–46	–	–40	–26	–20	–16	–30	–	–12	–7	–24	–38	–21	–	–46	–60	–60	–56	–56	–
COMPONENTS OF GNP ($ Billions)																				
Consumer Spending	1,210	+11.0	1,287	1,331	1,360	1,416	1,361	+11.6	1,454	1,476	1,528	1,566	1,506	+11.5	1,603	1,632	1,687	1,740	1,662	+ 9.7
Durables	179	+13.6	186	200	204	212	200	+12.0	214	209	213	215	213	+ 6.5	213	213	218	224	218	+ 2.3
Autos & Related	82	+16.6	84	94	92	95	91	+11.8	98	89	90	88	91	0.0	88	87	93	96	92	+ 1.1
Other	97	+11.2	101	106	112	117	109	+12.2	116	120	124	126	122	+11.9	125	126	125	128	126	+ 3.3
Nondurables	481	+ 8.4	506	522	537	560	531	+10.2	571	581	604	620	594	+11.8	630	645	667	678	652	+11.6
Services	550	+12.5	595	609	629	646	620	+12.7	669	685	711	730	699	+12.7	750	774	792	802	780	+11.6
Housing Investment	92	+34.9	101	106	110	114	108	+17.5	111	113	116	118	114	+ 5.5	117	116	113	116	115	+ 0.9
Business Fixed Investment	189	+14.9	204	219	226	238	221	+16.7	243	249	262	268	256	+15.4	268	266	268	274	269	+ 5.1
Equipment	127	+17.6	137	144	146	152	145	+14.0	159	159	167	171	164	+13.1	170	169	173	178	172	+ 4.8
Structures	63	+ 9.2	67	75	80	84	77	+22.2	85	90	95	97	91	+18.2	98	97	95	96	96	+ 5.5
Inventories – Change	+22	–	+23	+26	+20	+21	+22	–	+19	+33	+15	+15	+20	–	+15	0	+10	+13	+9	–
Federal Spending	144	+11.3	151	148	152	159	153	+ 5.7	164	167	163	172	166	+ 8.0	176	179	182	187	180	+ 9.1
Defense	94	+ 8.4	98	98	99	101	99	+ 5.7	103	106	108	112	107	+ 8.1	113	116	118	122	116	+ 8.4
All Other	51	+16.9	53	50	53	58	54	+ 5.9	60	60	54	60	58	+ 7.4	63	63	64	65	64	+10.3
State & Local Spending	262	+ 8.9	269	280	289	295	283	+12.4	297	305	314	320	309	+ 9.2	326	333	340	348	336	+ 8.7
Net Exports	–10	–	–22	–8	–7	–4	–10	–	+4	–8	–6	–4	–4	–	–3	–2	–3	+1	–2	–

Prepared 1/2/80

Economic Research Department

DEAN WITTER REYNOLDS INC.

Assumptions: (1) A 40% OPEC oil-price increase, or $28 a barrel average price for 1980, therefore, a 120% annual OPEC increase measured from December 1978, and the U.S. oil-import bill rises from $42 billion in 1978 to a $73 billion rate at the end of 1979. (2) Tax cut of $25 billion in second quarter of 1980. (3) Domestic oil-price decontrol, raising oil prices by 30% per year starting in 1980. (4) Voluntary wage/price controls continuing.

Note: These projections represent the views of the Dean Witter Reynolds Economic Research Department alone and are not to be construed as necessarily reflecting the official corporate position of Dean Witter Reynolds Inc.

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DEAN WITTER REYNOLDS INC.

Table EO – 4

Economic Model:

SIMULATION OF A MONEY CRUNCH/$30-A-BARREL RECESSION

	1977		1978						1979						1980					
	Year Est.	Percent Change from 1976	1st Qtr. Act.	2nd Qtr. Act.	3rd Qtr. Act.	4th Qtr. Act.	Year Act.	Percent Change from 1977	1st Qtr. Act.	2nd Qtr. Act.	3rd Qtr. Act.	4th Qtr. Est.	Year Est.	Percent Change from 1978	1st Qtr. Est.	2nd Qtr. Est.	3rd Qtr. Est.	4th Qtr. Est.	Year Est.	Percent Change from 1979
KEY INDICATORS																				
GNP (Current $)	1,900	+11.6	2,011	2,104	2,160	2,236	2,128	+12.0	2,297	2,330	2,396	2,462	2,367	+11.1	2,472	2,480	2,500	2,567	2,507	+ 6.0
GNP Prices (Annual Rate, %)	–	+ 6.0	+6.3	+10.6	+7.2	+8.7	–	+ 7.3	+9.3	+9.3	+ 8.0	+ 11.2	.	+ 9.0	+ 10.0	+ 9.1	+ 8.8	+ 8.9	.	+ 9.4
GNP – Real Terms ($)	1,341	+ 5.3	1,365	1,396	1,407	1,427	1,399	+ 4.4	1,431	1,422	1,434	1,429	1,429	+ 2.0	1,408	1,382	1,368	1,371	1,382	3.4
GNP – Real Terms (Annual Rate, %)	+6.3	–	+1.9	+8.3	+3.5	+5.6	+4.4	–	+1.1	–2.3	+ 3.5	- 1.4	+ 2.0	.	- 5.8	- 7.2	- 4.0	+ 0.9	- 3.4	-
Real Disposable Personal Income ($)	970	+ 4.2	967	960	970	982	973	+ 4.8	987	980	984	991	980	+ 2.0	983	976	977	980	979	- 1.4
Personal Saving Rate (%)	5.0	–	5.3	5.0	4.8	4.7	4.9	–	5.0	5.4	4.3	4.5	4.8	–	4.6	5.0	5.6	6.0	5.4	-
Unemployment Rate (%)	7.0	–	6.2	6.0	6.0	5.8	6.0	–	5.7	5.7	6.1	6.4	6.0	–	7.0	7.6	8.4	8.3	7.8	-
Consumer Prices (Annual Rate, %)	–	+ 6.5	6.6	10.8	9.8	8.3	–	+ 7.6	10.5	14.4	13.8	12.0		+ 11.3	12.0	10.0	9.5	[illegible]		+ 12.0
Reported Profits (Pretax $)	177	+13.5	177	207	212	227	206	+16.3	233	227	243	236	236	+ 14.1	218	201	192	193	201	- 16.9
Reported Profits (Post-Tax $)	106	+13.3	107	122	126	132	122	+16.3	142	130	140	143	143	+ 17.2	133	122	117	117	122	- 16.4
Inventory Profits ($)	15	+ 4.1	24	25	23	20	25	+65.8	40	37	44	41	41	+ 62.0	41	37	28	24	12	– 22.0
Dividends ($)	42	+12.2	46	48	48	50	47	+12.1	52	52	53	54	53	+ 12.7	54	54	55	55	54	+ 1.9
Keep Profits ($)	47	+17.7	28	51	54	54	48	+ 4.0	51	50	51	48	50	+ 2.0	38	31	36	30	38	- 20.0
Compensation per Man-Hour (Nonfarm)	–	+ 8.3	–	–	–	–	–	+ 9.2	–	–	.	-	-	+ 9.0	-	-	-	-	-	+ 9.2
Output per Man-Hour	–	+ 1.5	–	–	–	–	–	+ 0.4	–	–	.	.	.	– 0.7		-	-	-	-	2.1
Unit Labor Costs	–	+ 6.7	–	–	–	–	–	+ 8.7	–	–	.	.	.	+ 9.7		-	-	-	-	+ 11.9
Capital Spending ($)	135	+13.3	144	151	156	164	154	+13.3	168	173	177	180	174	+ 13.0	177	177	175	173	176	+ 1.1
Industrial Production Index	137	+ 5.4	140	144	147	150	145	+ 5.8	152	152	152	150	152	+ 4.8	146	141	138	137	141	- 7.2
Housing Starts (Annual Rate, Millions of Units)	2.0	+18.9	1.8	2.1	2.0	2.1	2.0	+ 2.1	1.6	1.8	1.9	1.6	1.7	- 15.0	1.2	1.1	1.2	1.3	1.2	- 29.4
New-Car Sales (Annual Rate, Millions of Units)	11.2	+10.5	10.7	12.1	11.3	11.1	11.2	0.0	11.6	10.5	10.7	9.9	10.7	- 4.7	10.2	9.5	8.8	8.8	9.1	- 17.5
Domestic	9.1	+ 5.8	8.7	10.0	9.3	9.2	9.3	+ 1.9	9.3	8.0	8.6	8.0	8.5	- 9.4	8.5	7.9	7.3	6.3	7.5	- 14.7
Imported	2.1	+40.0	2.1	2.1	1.9	1.9	1.9	– 3.6	2.3	2.5	2.1	1.9	2.2	+ 15.8	1.7	1.6	1.5	1.7	1.6	- 27.2
91-Day Treasury Bills (Qtrly. Avg., %)	5.3	–	6.4	6.5	7.3	8.8	7.2	–	9.4	9.4	9.7	13.0	10.4	-	13.6	14.1	11.1	8.8	12.2	-
Prime Rate (Qtrly. Avg., %)	6.8	–	8.0	8.3	9.1	10.8	9.1	–	11.7	11.7	12.1	15.0	12.6	-	15.5	16.0	14.1	12.9	14.6	-
Corporate Bonds – Seasoned AA (%)	8.2	–	8.6	8.8	9.0	9.2	8.9	–	9.5	9.7	9.8	11.5	10.1	-	12.4	13.0	11.7	11.0	12.0	–
Federal Deficit N.I.A. ($)	–46	–	–49	–26	–20	–16	–30	–	–12	–8	24	38	- 21	-	- 46	70	- 80	- 86	- 70	-
COMPONENTS OF GNP ($ Billions)																				
Consumer Spending	1,210	+11.0	1,287	1,331	1,380	1,415	1,351	+11.6	1,454	1,476	1,520	1,573	1,500	+ 11.0	1,580	1,617	1,645	1,683	1,636	+ 8.5
Durables	179	+13.6	185	200	204	212	200	+12.0	214	209	213	217	214	+ 7.0	215	200	204	212	208	+ 2.8
Autos & Related	82	+16.6	84	94	92	95	91	+11.8	98	89	89	91	92	+ 1.1	89	85	87	91	88	4.3
Other	97	+11.2	101	106	112	117	109	+12.2	116	120	124	126	122	+ 11.9	126	115	117	121	120	1.6
Nondurables	481	+ 8.4	505	522	537	558	531	+10.2	571	581	604	623	594	+ 10.8	637	651	659	675	654	+ 10.1
Services	550	+12.5	596	609	639	645	620	+12.7	669	686	711	733	700	+ 12.9	751	766	782	796	774	+ 10.6
Housing Investment	92	+34.9	101	108	110	114	108	+17.5	111	113	116	114	113	+ 4.6	107	101	100	100	103	8.8
Business Fixed Investment	180	+14.9	204	219	226	236	221	+16.7	243	248	262	268	254	+ 14.9	265	260	258	256	260	+ 2.4
Equipment	117	+17.8	137	144	146	152	145	+14.0	158	158	167	171	163	+ 12.4	170	167	168	165	167	+ 2.5
Structures	63	+ 9.2	67	75	80	84	77	+22.2	85	90	95	97	91	+ 10.2	95	93	90	90	93	+ 2.1
Inventories – Change	+22	–	+23	+26	+20	+21	+22	–	+19	+33	+ 15	+ 14	+ 21		+ 12	0	8	5	0	
Federal Spending	144	+11.3	151	148	152	160	153	+ 5.7	164	162	163	174	165	+ 8.5	176	179	182	188	181	+ 9.0
Defense	94	+ 8.4	98	98	99	101	99	+ 5.7	103	106	109	112	108	+ 9.1	113	116	118	120	116	+ 7.4
All Other	51	+16.9	53	50	53	58	54	+ 5.9	60	56	54	62	58	+ 7.4	63	63	64	68	65	+ 12.1
State & Local Spending	252	+ 8.9	260	280	288	296	283	+17.4	297	305	314	318	309	+ 9.2	326	333	340	350	337	+ 9.1
Net Exports	–10	–	–22	–8	–7	–5	–10	–	+4	–8	3	4	3		12	10	10	10	10	

Prepared 1/2/80

Economic Research Department

DEAN WITTER REYNOLDS INC

Assumptions: (1) $30-a-barrel OPEC oil price in January 1979, with a money crunch. (2) 150% OPEC oil-price increase measured from December 1978; therefore, the U.S. oil import bill rises from $42 billion in 1978 to $67 billion in 1979 to $95 billion in 1980. (3) Tax cut in second quarter 1980, $25 billion. (4) Probability of wage/price controls dramatically rises. (5) Domestic oil-price decontrol, raising oil prices by 30% per year starting in 1980. (6) Dollar crisis in fourth quarter 1979 results in a money crunch in first quarter 1980. (7) Money growth as measured by M-3 quarterly for 1980 should be 7.0 7.5%.

Note: These projections represent the views of the Dean Witter Reynolds Economic Research Department alone and are not to be construed as necessarily reflecting the official corporate position of Dean Witter Reynolds Inc.

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Statement Before the
Subcommittee on Savings, Pensions and Investment Policy
Committee on Finance
U.S. Senate

97th Congress, 1st Session

By Samuel Goldberg
of
Inco United States, Inc.

May 4, 1981

Mr. Chairman and Members of the Subcommittee:

My name is Sam Goldberg. I am Vice President for Public Affairs of Inco U.S., a U.S. subsidiary of Inco Limited, a Canadian corporation. Inco was formerly the International Nickel Company. I appreciate this opportunity to appear before the Subcommittee. Accompanying me is Kurt Barnes, Financial Services Officer of Inco Limited.

Like many companies incorporated in other countries, Inco has substantial investments in the U.S. Inco is not only the largest supplier of nickel in the U.S., it also manufactures such products as high nickel alloys through its subsidiary Huntington Alloys, Inc. of Huntington, W. Va., automotive and industrial batteries through the Exide Corporation of Philadelphia, dry cell batteries through the Ray-O-Vac Corporation of Madison, Wisc., turbine blades through Turbo Products International of Ivoryton, Conn., electronic equipment through the Exide Electronics Corporation of Philadelphia, and maintains advanced research and development facilities in New York, New Jersey and North Carolina.

We support the basic policies of S.141, as introduced by Senator Bentsen, with one important qualification: that the bill should extend eligibility to include certain parent companies which, while incorporated outside the U.S., have significant investments and operations within the U.S.

It is clear that the objectives of S.141 are first, to promote capital formation and thus business expansion in the U.S., and second, to give American shareholders an incentive to save by reinvesting their dividends in additional capital stock. But the benefits of capital formation and business expansion in the U.S. do not arise solely from companies incorporated in the United States.

Like Inco, many foreign corporations have significant capital committed to U.S. activities. A survey by the U.S. Commerce Department's Bureau of Economic Analysis published in the July 1980 edition of the Survey of Current Business (copies are attached) provides an indication of the scope of this foreign commitment. At the end of 1977 the assets of the U.S. affiliates of foreign corporations exceeded $130 billion; 80 percent of this investment was held by enterprises involved in manufacturing, wholesale trade, petroleum and insurance. The compound annual growth rate of their total assets between 1974 and 1977 was 13 percent; the estimated growth rate since 1977, according to the Commerce Department, has been 15 percent.* These U.S. affiliates

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* Needless to say, not all of these companies have dividend reinvestment programs which would further the objectives of S.141.

employed over a million people in 1977. Inco itself has a billion dollars in assets* in the U.S. -- more than 20% of its assets worldwide -- and it employs over 15,000 people in some 26 states. Based on its U.S. activities alone, this would rank Inco 229th by asset size and 254th in employee size in Fortune's list of the top 500 U.S. industrial companies.**

Corporations with such continuing and substantial commitment to the U.S. economy should hardly be discouraged from this commitment simply because of the place of their incorporation. Neither should a savings incentive be denied their U.S. shareholders. Like many other foreign corporations, Inco has a significant number of U.S. shareholders -- on February 13, 1981 a total of almost 20,000 of them in all 50 states and the District of Columbia with a total of about 31% of Inco's shares worldwide.

Lest there be any misunderstandings, Mr. Chairman, let me emphasize that the savings incentive we propose will benefit only the U.S. shareholders of foreign corporations. Dividends of foreign corporations are subject to U.S. income tax only if the shares are owned by U.S. persons. So extending the benefits of the bill to qualified foreign corporations will prevent discrimination against their U.S. shareholders but will not confer unintended benefits on foreign shareholders. It may interest the Subcommittee to know that Canada

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* Assets include net fixed assets, investories and receivables located in the United States based on book value.

** The assets and employees of Inco Limited and the Fortune magazine list of the 500 largest U.S. industrial companies are figures for fiscal year-ended 1979.

currently has a system whereby shareholders may defer taxes by electing to receive new-issue stock as dividends, in lieu of cash, irrespective of whether the corporation is Canadian or not.

For all these reasons, it seems obvious that to exclude a sizeable segment of the American economy from the compass of this bill would be to deny important impetus to American investment and employment.

We therefore respectfully urge that S.141, as proposed, should be amended to include qualified foreign corporations. This will require careful legislative drafting. We are currently discussing with members of the Committee the formulation of an acceptable "eligibility" test, so that only those foreign corporations with important and continuing investments in the U.S. would be included. This would ensure and reinforce the policy of business expansion in the U.S. as envisioned by S.141.

Thank you, Mr. Chairman. My colleague and I welcome any questions the Subcommittee may have.

By NED G. HOWENSTINE

Selected Data on the Operations of U.S. Affiliates of Foreign Companies, 1977

THIS article presents data for 1977 from a new annual sample survey on the operations of U.S. affiliates of foreign companies.[1] The data cover affiliates' balance sheets and income statements, selected financial data by transactor, landownership, plant and equipment, employment and employee compensation, merchandise trade, and research and development expenditures. Estimates of growth for 1974–77 for a number of key items are also presented; 1974 data were from BEA's last benchmark survey of foreign direct investment in the United States.

These data supplement those on the foreign direct investment position and related international transactions that are published annually, usually in the August issue of the SURVEY OF CURRENT BUSINESS.[2] The August articles focus on the relationship between U.S. affiliates and their foreign parents and cover the foreign parents' transactions and positions with their U.S. affiliates. This article focuses on the operations of the U.S. affiliates themselves, including their transactions and positions with persons other than their foreign parents. For example, the direct investment position, as shown in the August articles, is equal to foreign parents' equity in and net outstanding loans to their U.S. affiliates; U.S. affiliates' total assets, as shown in this article, are equal to the sum of total owners' equity held by both foreign parents and all other persons and total liabilities owed to both foreign parents and all other persons.

Highlights of this article are:

- In terms of most measures, such as employment and landownership, U.S. affiliates accounted for a small share of the total U.S. economy. Their share of total U.S. merchandise trade, however, was relatively large.
- U.S. affiliates' assets were $131.5 billion at yearend 1977. Almost three-fourths of the total was accounted for by affiliates with parents in the Netherlands, Canada, the United Kingdom, Germany, and Japan. By industry, 80 percent was accounted for by affiliates in manufacturing, wholesale trade, petroleum, and insurance.
- U.S. affiliates' liabilities were $90.7 billion. Over 80 percent of both their current liabilities and long-term debt were to U.S. persons.
- The gross book value of affiliates' land was $7.9 billion. Affiliates owned 5.6 million acres and leased 28.8 million acres. By State, affiliates owned the largest number of acres in Tennessee, Nevada, Colorado, Wisconsin, and New Mexico. Land used for agricultural purposes accounted for 3.1 million of the acres owned and 1.6 million of the acres leased.
- Affiliates employed 1,122,207 persons. Their employment was largest in New York, California, and New Jersey. Manufacturing affiliates' employment was largest in the same three States.
- For manufacturing affiliates, the hourly wage rate of production workers was $5.81.
- There was considerable variation in growth in the key items examined. For example, employment of affiliates grew at an annual rate of about 3 percent, while employee compensation grew at an annual rate of 13.2 percent.

The article is organized as follows: The first section describes the sample and its relationship to the affiliate universe and to all U.S. businesses. The second briefly discusses the distribution of total assets by country of foreign parent and by industry of affiliate, and presents additional data for selected items by country of foreign parent. All of the remaining sections except the last focus on data disaggregated by industry of affiliate; three of these—those that cover landownership, plant and equipment, and employment—discuss data disaggregated by State and region as well. The last section briefly discusses growth for 1974–77 for a number of key items.

The Sample

The sample for the 1977 survey consists of affiliates—other than banks—that had total assets, sales, or net income greater than $5 million or that owned 200 or more acres of U.S. land in 1977.[3] For such affiliates, reporting was

NOTE.—The survey was conducted under the supervision of James L. Bomkamp, Chief, Direct Investment in the United States Branch, International Investment Division. Beverly A. Feeser was project leader for editing and processing the survey forms. Arnold Gilbert and Richard Mauery designed the computer programs for data retrieval and analysis.

1. A U.S. affiliate is a U.S. business enterprise in which a foreign person had a direct or indirect interest of 10 percent or more. Because foreign owners are usually business enterprises, they are referred to as "companies," although the legal term "person" also includes individuals, estates, trusts, governments, or other organizations.

2. See, for example, Gregory G. Fouch and L. A. Lupo, "Foreign Direct Investment in the United States in 1978," in the August 1979 issue of the SURVEY OF CURRENT BUSINESS.

3. Balance sheets and related financial data on U.S. bank affiliates are collected by the Federal Reserve System. See "Monthly Report of Conditions for U.S. Agencies, Branches, and Domestic Banking Subsidiaries of Foreign Banks." Board of Governors of the Federal Reserve System.

Table 1.—Total Assets of U.S. Affiliates at Yearend 1977 [1]

[Millions of dollars]

	All areas	Developed countries									Developing countries		
		Total	Canada	France	Germany	Netherlands	United Kingdom	Switzerland	Japan	Other	Total	Latin America	Other
All industries	131,530	118,364	19,630	6,728	10,430	30,434	19,060	7,400	16,512	7,772	13,173	11,807	1,366
Agriculture and forestry [2]	790	408	38	16	29	94	73	(D)	(D)	173	387	384	3
Mining	3,184	(D)	1,679	82	121	(D)	(D)	(D)	6	38	(D)	(D)	6
Petroleum	23,534	24,705	1,785	(D)	(D)	19,060	708	88	887	1,087	1,138	1,134	4
Manufacturing	27,986	23,997	6,285	2,679	6,036	4,989	6,408	3,972	1,671	1,785	4,178	3,908	271
Wholesale trade	27,708	25,617	1,384	2,190	2,678	2,036	2,073	1,033	12,049	2,315	2,091	1,897	194
Retail trade	3,074	2,634	(D)	(D)	(D)	(D)	(D)	(D)	87	165	440	(D)	(D)
Finance, except banking	7,283	6,876	780	(D)	386	256	1,080	78	41	(D)	407	196	211
Insurance	14,743	(D)	5,325	(D)	365	770	5,382	1,748	117	432	(D)	(D)	(D)
Real estate and combined offices	4,002	2,901	1,115	6	(D)	849	642	(D)	276	92	1,501	1,347	464
Other	2,725	2,194	(D)	(D)	75	374	(D)	233	(D)	(D)	531	363	169

D Suppressed to avoid disclosure of data of individual companies.
1. Excludes banks.
2. Fisheries are included in "other."

mandatory under the International Investment Survey Act of 1976. In BEA's surveys, U.S. affiliates are required to report on a consolidated basis; the consolidation for a given affiliate has to include all other affiliates owned more than 50 percent by that affiliate. Over 1,900 reports were filed with BEA; they cover approximately 5,500 U.S. affiliates.

The report of a consolidated enterprise may cover operations in more than one industry. Where this is the case, the enterprise is classified in the single industry in which its sales are largest. Thus, the industry classification of the enterprise is not necessarily indicative of the full range of activities it conducts.

Data in this article cover only affiliates in the sample, that is, the data have not been expanded to universe levels. However, data for affiliates in the sample accounted for almost all of the data for the universe of all U.S. affiliates. This is indicated by a comparison, based on BEA's 1974 benchmark survey of foreign direct investment in the United States, of 1974 data for the sample with 1974 data for the universe.[4] After adjustment for differences in coverage and definition between the 1974 and 1977 surveys, the data show that affiliates in the sample accounted for 93.5 percent of the total assets of the 1974 universe. The percentages were also high for other key items. (See technical note.)

Because the sample accounts for such a large portion of the affiliate universe, comparison of sample data with all-U.S. data for 1977 gives a good indication of the economic significance of U.S. affiliates relative to the total U.S. economy. By most measures, affiliates were small relative to the economy. For example, affiliates had 1.1 million employees, about 2 percent of the 67.8 million employees of all U.S. businesses (except banks); they owned 5.6 million acres of land, less than one-half of 1 percent of the 1,347.2 million privately owned acres in the United States. However, affiliates accounted for a relatively large share of total U.S. merchandise trade. Their exports, at $24.1 billion, were 20 percent of the $120.8 billion of total U.S. exports; their imports, at $42.5 billion, were 28 percent of the $151.7 billion of total U.S. imports.[5] Affiliates' share of exports was large because several wholesale trade companies that had large grain exports were U.S. affiliates. Their share of imports was large because affiliates were relatively heavily concentrated in two wholesale trade industries—motor vehicles and metals and minerals—that accounted for a substantial portion of total U.S. imports.

Country by Industry Distribution

Total assets of U.S. affiliates in the sample were $131.5 billion at yearend 1977 (table 1). Almost three-fourths of these assets were accounted for by affiliates with parents in five countries—the Netherlands, Canada, the United Kingdom, Germany, and Japan. Affiliates with parents in the Netherlands had the largest share—23 percent of the total.

Affiliates with parents in all developed countries combined accounted for 90 percent of total assets; those with parents in developing countries accounted for the remainder. For the developing countries, total assets were largely accounted for by affiliates with Latin American parents, particularly parents in the Netherlands Antilles, the Bahamas, Bermuda, and Panama (table 2).

4. Benchmark data were published in U.S. Department of Commerce, *Foreign Direct Investment in the United States: Report of the Secretary of Commerce to the Congress in Compliance with the Foreign Investment Study Act of 1974* (Public Law 93-479), Vol. 2, April 1976, and in "Benchmark Survey of Foreign Direct Investment in the United States, 1974," "Employment and Employee Compensation of U.S. Affiliates of Foreign Companies, 1974," and "Gross Product of U.S. Affiliates of Foreign Companies" in the May 1976, December 1978, and January 1979 issues of the SURVEY, respectively.

5. Employment for all U.S. businesses (except banks) is from national income and product account table 6.7 in the July 1979 SURVEY. For the above comparison of employment and for comparisons later in the article of employment and employee compensation, all U.S. employment (employee compensation) is equal to the U.S. total less employment (employee compensation) for households, governments, and government enterprises. To improve comparability, employment (employee compensation) for banks are excluded from the all-U.S. business total. All-U.S. landownership data are from table 1 in James A. Lewis, *Land Ownership in the United States, 1978*, Agriculture Information Bulletin No. 435, U.S. Department of Agriculture Economics, Statistics, and Cooperative Service, Washington, D.C., April 1980. Privately owned land consists of land owned by individuals, groups of individuals, or legal entities such as trusts, estates, and corporations. It excludes land owned by Federal, State and local governments, and Indian lands managed in trust by the Bureau of Indian Affairs. Total U.S. merchandise trade is from international transactions accounts table 1 in the June 1979 SURVEY.

In classifying data by country of foreign parent, BEA uses the country of the first company outside the United States in a foreign chain of ownership. In some instances, the country of the first company differs from that of the ultimate (beneficial) owner. In particular, a large portion of the total assets of affiliates with parents in the Netherlands Antilles, the Bahamas, Bermuda, and Panama, and a smaller portion of the total assets of affiliates with parents in the Netherlands and Switzerland, represent investments owned beneficially by residents of other countries.

Over 80 percent of total assets were accounted for by four of the ten major industries shown in table 1—manufacturing (29 percent), wholesale trade (21 percent), petroleum (20 percent), and insurance (13 percent). Within each of these industries, the distribution by country of foreign parent was highly concentrated, particularly in petroleum and insurance. In petroleum, affiliates with parents in the Netherlands accounted for almost three-fourths of total assets. In insurance, affiliates with parents in Canada, the United Kingdom, and Switzerland accounted for over three-fourths of the total. Five countries accounted for over three-fourths of total assets in both manufacturing and wholesale trade. In manufacturing, the five countries (ranked by size) were Germany, the United Kingdom, Canada, the Netherlands, and Switzerland. In wholesale trade, they were Japan, Germany, France, the United Kingdom, and the Netherlands. Japanese-owned affiliates alone accounted for 43 percent of total assets in wholesale trade.

Balance Sheet

The balance sheet for U.S. affiliates at yearend 1977 is presented in table 3. Of total assets of $131.5 billion, net fixed assets were $42.0 billion, or 32 percent. Trade accounts and notes receivable were 19 percent, inventories 17 percent, and investments 13 percent of the total. (Investments are mainly affiliates' security holdings and equity in unconsolidated businesses.)

Among industries, the composition of total assets largely reflects industry characteristics. For example, in goods-producing industries that require relatively large amounts of capital (such as petroleum, mining, and manufacturing), or in industries where landownership is significant (such as real estate and

Table 2.—Selected Data of U.S. Affiliates for 1977, by Country of Foreign Parent [1]

	Consolidated affiliates	Employment [2]	Employee compensation	Total assets	Fixed assets, net	Sales [3]	Merchandise exports [4]	Merchandise imports [4]	Land and mineral rights owned: Total	Land and mineral rights owned: Agricultural [5]	Land and mineral rights leased: Total	Land and mineral rights leased: Agricultural [5]
	Number		Millions of dollars						Thousands of acres			
All countries	1,927	1,122,297	17,458	131,539	42,018	181,773	34,136	42,641	5,590	2,063	30,047	1,627
Developed countries	1,649	969,867	15,282	118,364	37,676	167,346	31,774	40,556	5,002	2,006	37,083	1,312
Canada	264	159,326	2,490	19,839	6,237	17,001	736	3,436	1,408	782	9,309	(D)
Europe	1,065	742,304	11,813	83,064	29,467	101,546	18,696	20,000	2,504	1,833	18,121	(D)
European Communities (9)	708	634,204	10,117	72,121	27,419	88,708	9,738	17,098	2,096	1,613	17,780	(D)
Belgium and Luxembourg	62	18,560	315	2,494	1,061	2,488	144	1,347	(D)	(D)	(D)	(D)
France	108	68,771	1,019	5,728	1,305	14,632	(D)	1,044	83	30	(D)	4
Germany	129	121,189	1,836	10,439	2,417	14,439	644	4,673	166	53	(D)	(*)
Italy	17	2,980	46	806	107	397	(D)	60	(D)	(D)	1	0
Netherlands	132	127,866	2,412	28,634	17,340	28,287	1,374	6,947	736	(D)	12,674	2
Denmark and Ireland	34	7,732	96	261	94	648	(D)	297	(*)	(D)	(D)	0
United Kingdom	261	234,113	2,382	19,099	3,905	28,438	1,388	2,379	1,120	909	(D)	(D)
Other Europe	388	108,300	1,697	9,940	2,048	12,846	888	3,008	408	221	741	(D)
Sweden	66	24,388	394	1,980	354	2,033	182	1,167	5	4	(D)	0
Switzerland	140	80,512	1,241	7,400	1,487	9,126	720	1,691	211	31	(D)	(D)
Other	86	3,836	60	561	207	437	18	173	120	186	(D)	0
Japan	289	69,174	981	15,513	1,630	48,879	10,430	16,530	94	11	2	1
Australia, New Zealand and South Africa	19	4,663	56	991	27	417	1	141	3	2	(*)	0
Developing countries	278	152,300	2,176	13,175	4,348	14,427	2,361	1,983	578	474	564	326
Latin America	229	143,410	2,056	11,807	4,023	13,466	2,241	1,680	530	453	(D)	326
Panama	46	11,711	183	1,136	309	1,181	115	280	34	19	(D)	(D)
Bahamas	27	8,383	113	1,508	962	886	(D)	163	64	(D)	(D)	0
Bermuda and British Islands, Caribbean	44	28,965	400	2,807	732	2,709	108	125	20	28	(D)	(D)
Netherlands Antilles	78	88,348	1,230	4,977	1,979	7,974	(D)	408	400	384	204	306
Other	34	2,706	83	383	41	740	104	220	34	(D)	4	4
Other developing	60	8,940	120	1,368	326	966	120	304	38	21	(D)	0
Israel	8	515	(D)	368	(D)	181	(D)	(D)	(D)	0	(D)	0
Other Middle East	19	1,046	(D)	530	234	87	(D)	0	(D)	(D)	(D)	0
Other Africa, Asia, and Pacific	32	7,376	96	570	(D)	696	94	(D)	(D)	(D)	(D)	0
Addendum: OPEC [6]	28	4,225	64	718	256	310	(D)	(D)	25	5	4	4

*Less than 500 acres.
D Suppressed to avoid disclosure of data of individual companies.
1. Excludes banks.
2. Average number of full-time and part-time employees.
3. Excludes returns, discounts, allowances, and sales and excise taxes.
4. Exports are valued f.a.s. at the U.S. port of exportation; imports are valued f.a.s. at the foreign port of exportation. The data are classified by country of the U.S. affiliate's foreign parent, not by the destination of the exports or the origin of the imports, i.e., exports or imports shown for a particular country may not be destined for or have originated from that country.
5. Consists of land used for crops, pasture, timber production and other agricultural purposes.
6. Countries in the Organization of Petroleum Exporting Countries (OPEC) are: Algeria, Ecuador, Gabon, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, Venezuela, and United Arab Emirates.

agriculture and forestry), net fixed assets were large shares of total assets. In industries that provide services (such as finance, except banking, and insurance), net fixed asset shares were small.

Total claims on affiliates' assets consisted of liabilities of $90.7 billion (69 percent of the total) and owners' equity of $40.8 billion. Of total liabilities, long-term debt accounted for 36 percent and trade accounts and notes payable for 31 percent. As was the case for total assets, differences among industries in the composition of total claims partly reflected industry characteristics. For example, in the industries mentioned where fixed assets were large shares of total assets, at least 70 percent of total claims were accounted for by owners' equity and long-term debt, reflecting the fact that fixed assets require relatively long-term financing.

Income Statement

U.S. affiliates' total income was $183.6 billion (table 4). Almost all—99 percent—was sales (or gross operating revenues). Sales were largely accounted for by affiliates in wholesale trade and manufacturing. Within wholesale trade, the three largest industries—farm-product raw materials, metals and minerals, and motor vehicles—each accounted for 20 percent or more of total sales. Almost one-half of the sales in wholesale trade were attributable to affiliates of Japanese parents. These affiliates accounted for two-thirds of all sales in motor vehicles wholesale trade and three-fifths of all sales in metals and minerals wholesale trade. In manufacturing, 36 percent of total sales were by chemical affiliates.

Total costs and expenses were $179.8 billion. Almost 97 percent were operating expenses (costs of goods sold plus selling, general, and administrative expenses). U.S. income taxes, at $3.3 billion, were less than 2 percent. Net income after tax—total income less total costs and expenses—was $3.8 billion.

Selected Financial Data by Transactor

Data by transactor provide, for selected liabilities and current receivables, a breakdown showing to whom affiliates' liabilities are owed and from whom affiliates' receivables are due. Transactors are classified by whether they are U.S., affiliated foreign, or unaffiliated foreign persons. For liabilities, transactors are further cross-classified by whether they are banks or others.

Selected liabilities

Data by transactor are available for affiliates' current liabilities ("trade ac-

Table 3.—Balance Sheet of U.S. Affiliates at Yearend 1977 [1]

[Millions of dollars]

	Total assets = liabilities and owners' equity	Assets: Trade accounts and notes receivable	Assets: Other current receivables	Assets: Inventories	Assets: Other current assets	Assets: Investments [2]	Assets: Fixed assets, net	Assets: Other noncurrent assets	Liabilities: Total	Liabilities: Trade accounts and notes payable	Liabilities: Other current liabilities	Liabilities: Long-term debt	Liabilities: Other noncurrent liabilities	Owners' equity
All industries	131,530	26,370	2,227	22,340	12,494	17,619	42,918	8,300	90,748	28,412	20,165	32,630	9,536	40,796
Agriculture and forestry [3]	700	84	5	31	117	46	380	73	382	69	133	206	34	279
Mining	2,355	137	36	307	86	479	2,131	167	1,606	133	207	1,330	133	1,690
Petroleum	25,534	3,168	780	2,000	900	817	16,050	1,402	16,000	3,282	1,971	9,400	1,470	9,736
Manufacturing	37,985	6,020	722	8,146	2,330	2,438	14,000	2,340	22,240	6,612	4,700	9,061	1,677	14,745
Food and kindred products	4,868	687	66	1,487	268	238	1,388	100	2,782	1,148	686	642	300	2,016
Paper and allied products	1,357	157	27	170	84	(D)	743	(D)	798	101	230	373	90	668
Chemicals and allied products	14,234	1,941	201	2,626	686	867	6,320	1,394	7,530	1,686	1,185	4,361	307	6,363
Industrial	10,044	1,411	186	1,626	380	694	4,765	770	5,773	1,113	707	3,381	624	4,399
Drugs	2,077	238	(D)	488	(D)	101	666	266	951	130	(D)	388	(D)	1,146
Other	2,483	378	(D)	532	(D)	168	695	126	1,136	687	(D)	643	(D)	861
Primary metal industries	4,608	758	66	1,686	344	280	1,984	183	2,943	730	422	1,557	157	1,665
Fabricated metal products	1,066	144	21	330	61	308	322	36	666	260	(D)	216	(D)	388
Machinery, except electrical	3,307	616	41	1,048	233	135	668	76	1,604	580	646	666	71	1,153
Electric and electronic equipment	3,394	960	50	1,066	117	165	708	260	1,963	380	686	686	288	1,641
Other	5,060	1,136	300	1,234	633	(D)	1,661	(D)	3,418	866	(D)	1,466	(D)	2,638
Wholesale trade	27,702	9,308	866	8,130	2,746	1,638	2,304	1,363	21,985	12,386	6,465	2,798	467	5,780
Motor vehicles and automotive parts and supplies	5,345	1,254	136	2,146	633	713	636	234	4,300	2,686	1,046	466	301	1,046
Metals and minerals	7,673	2,324	230	1,947	464	348	486	380	5,162	2,327	1,516	705	80	1,530
Farm-product raw materials	5,304	1,778	144	1,611	708	321	317	382	4,410	2,000	1,466	382	161	894
Other	9,007	2,438	343	2,440	961	196	964	538	7,664	4,213	2,686	686	156	2,330
Retail trade	3,474	466	30	1,130	446	9	1,108	341	2,304	740	387	900	367	1,163
Finance, except banking	7,283	2,300	469	110	175	3,613	43	900	4,688	666	(D)	1,300	(D)	1,706
Insurance	14,743	1,382	102	(*)	4,000	8,133	304	1,130	12,904	4,731	1,734	2,461	4,078	2,732
Real estate and combined offices	4,603	300	52	113	800	371	2,900	167	3,830	300	306	2,848	104	763
Other	3,723	773	66	113	533	122	1,902	304	2,570	696	(D)	1,134	(D)	1,156

* Less than $500,000.
D Suppressed to avoid disclosure of data of individual companies.
1. Excludes banks.
2. Mainly security holdings and equity in unconsolidated businesses.
3. Fisheries are included in "other".

counts and notes payable" plus "other current liabilities") and long-term debt (table 5). These liabilities, which were $81.2 billion, accounted for 90 percent of affiliates' total liabilities.

Most of the affiliates' current liabilities and long-term debt—82 and 85 percent, respectively—were to U.S. persons. A large portion of affiliates' current liabilities resulted from purchases of goods, materials, and supplies on credit. The U.S. share of these liabilities was large because the purchases were mainly from U.S. persons.[6] The U.S. share of long-term debt was large probably because affiliates generally found borrowing in U.S. capital markets less expensive and more convenient than borrowing in foreign markets.

6. This statement is based on a comparison of affiliates' imports with affiliates' "costs and expenses relating to operations" after the latter were adjusted to exclude major cost items, such as employee compensation and depreciation, which are not for purchases of goods, materials, or supplies.

Virtually all of the U.S. liabilities were to unaffiliated persons.[7] Most of affiliates' liabilities to foreign persons were to affiliated companies (foreign parents and foreign affiliates of foreign parents).

Bank borrowing accounted for a significantly larger portion of affiliates' U.S. liabilities than of their foreign liabilities. Bank borrowing was almost 40 percent of affiliates' current liabilities and 27 percent of their long-term debt to U.S. persons, but only 15 percent of both their current liabilities and long-term debt to foreigners.

By industry, about two-thirds of affiliates' liabilities to U.S. persons were accounted for by affiliates in wholesale trade, manufacturing, and petroleum (table 6). Almost three-fourths of affiliates' liabilities to foreign persons were accounted for by affiliates in wholesale trade and manufacturing. In both industries, foreign liabilities were mainly to affiliated persons—in wholesale trade, 75 percent, and in manufacturing, 86 percent.

7. The breakdown of affiliates' U.S. liabilities between affiliated and unaffiliated U.S. persons is not shown in the table because reported liabilities to affiliated U.S. persons were negligible.

In most industries, the composition by maturity of affiliates' foreign and U.S. liabilities was about the same. For example, in wholesale trade, current liabilities were 88 percent of foreign liabilities and 87 percent of U.S. liabilities; in manufacturing, the shares were 48 percent and 52 percent, respectively. Exceptions were petroleum, where current liabilities were 64 percent of foreign liabilities but only 33 percent of U.S. liabilities, and retail trade, where current liabilities were 24 percent of foreign liabilities but 61 percent of U.S. liabilities.

Table 4.—Income Statement of U.S. Affiliates in 1977 [1]

[Millions of dollars]

	Income				Costs and expenses				Net income	Addenda	
	Total	Sales [2]	Equity in net income of unconsolidated businesses	Other	Total	Operating expenses [3]	U.S. income taxes	Other [4]		Depreciation charges for the year	Depletion charges for the year
All industries	183,587	181,773	687	1,127	179,791	174,064	3,303	2,424	3,796	2,831	231
Agriculture and forestry [5]	437	429	3	5	466	443	8	15	−29	15	(*)
Mining	1,239	1,178	(D)	(D)	1,237	1,159	17	61	2	72	4
Petroleum	26,615	26,317	138	160	25,267	23,740	1,100	427	1,348	998	112
Manufacturing	46,161	45,755	134	272	44,998	43,218	1,080	700	1,163	1,342	86
Food and kindred products	7,472	7,459	−12	25	7,382	7,267	97	18	90	83	(D)
Paper and allied products	1,657	1,651	2	4	1,596	1,516	46	34	61	51	(D)
Chemicals and allied products	14,627	14,491	50	86	14,141	13,386	346	410	486	564	(D)
Industrial	10,486	10,381	52	53	10,151	9,680	160	233	335	420	(D)
Drugs	1,997	1,987	−1	11	1,888	1,718	(D)	(D)	109	83	(D)
Other	2,140	2,123	(*)	18	2,097	2,097	(D)	(D)	44	74	(D)
Primary metal industries	5,457	5,417	22	18	5,320	5,156	115	50	138	121	2
Fabricated metal products	1,148	1,148	−7	7	1,188	1,147	33	8	−40	32	1
Machinery, except electrical	3,616	3,564	15	37	3,525	3,419	71	36	91	66	2
Electric and electronic equipment	4,718	4,675	16	27	4,582	4,430	120	33	136	90	(*)
Other	7,487	7,379	50	58	7,261	6,921	235	105	226	215	3
Wholesale trade	90,466	90,059	87	320	89,817	88,482	597	738	649	220	12
Motor vehicles and automotive parts and supplies	17,856	17,743	(*)	113	17,556	17,253	209	94	300	41	(*)
Metals and minerals	21,940	21,830	87	23	21,793	21,464	101	228	147	41	1
Farm-product raw materials	25,226	25,182	8	36	25,178	25,097	30	51	48	53	3
Other	25,443	25,283	10	150	25,161	24,536	287	338	282	94	8
Retail trade	7,640	7,599	1	40	7,486	7,221	161	104	154	112	(*)
Finance, except banking	1,319	1,105	184	30	1,117	1,009	40	68	202	4	(*)
Insurance	6,998	6,720	(D)	(D)	6,616	6,265	172	179	382	15	(*)
Real estate and combined offices	832	797	1	34	938	854	13	71	−106	72	3
Other	2,861	2,811	−2	52	2,775	2,629	73	73	86	128	(D)

* Less than $500,000 (±).
D Suppressed to avoid disclosure of data of individual companies.
1. Excludes banks.
2. Excludes returns, discounts, allowances, and sales and excise taxes.
3. Cost of goods sold plus selling, general, and administrative expenses.
4. Includes minority interests in net income of consolidated affiliates.
5. Fisheries are included in "other".

Current receivables

Current receivables ("trade accounts and notes receivable" plus "other current receivables") were $28.6 billion. Of this total, 84 percent were due from U.S. persons. The U.S. share was large because affiliates' sales, which generate most current receivables, were mainly to U.S. persons. (The ratio of affiliates' exports to affiliates' sales was 13 percent.)

Over 60 percent of affiliates' current receivables were accounted for by affiliates in wholesale trade and manufacturing. In wholesale trade, 74 percent of current receivables were due from U.S. persons and in manufacturing, 92 percent.

Landownership

Table 7 shows data on the gross book value of affiliates' land and on the number of acres of land and mineral rights owned and leased by affiliates (hereinafter referred to as acres owned and leased). The acreage data are further disaggregated to show separately the portion used for agricultural purposes, including timber production.[5]

For many industries in table 7, data on acres were suppressed to avoid disclosure of data for individual companies, as required by the confidentiality provisions of the International Investment Survey Act. The suppressions reflect the high degree of concentration of acres owned and leased among a few U.S. affiliates. The gross book values were less concentrated and, therefore, required fewer suppressions. The difference in concentration occurred because the gross book value of land owned by some affiliates was relatively small even though the number of acres owned was relatively large. For these affiliates, the cost per acre of land was low.

The gross book value of land held by affiliates at yearend 1977 was $7.9 billion; affiliates owned 5.6 million acres and leased 28.8 million acres. Land used for agricultural purposes accounted for 3.1 million of the acres owned and 1.6 million of the acres leased. More than one-half of the agricultural land owned and more than one-fifth of that leased was probably timberland.

By industry

The distribution of the gross book value of land and of acres owned differed among industries. This difference occurred because the value of a given acre of land may vary according to its use and location and, due to historical cost valuation in combination with rising land prices, the date purchased. Also, leased land that has been capitalized (primarily land with mineral rights) is reflected in gross book value but not in acres owned.

Over three-fourths of the gross book value of land was accounted for by affiliates in petroleum (with 39 percent), manufacturing (22 percent), and real estate (17 percent). Most of the gross book value in petroleum probably represents land devoted to oil and natural gas exploration and extraction. In manufacturing, more than one-half

5. The gross book value of land is its historical cost before deduction of accumulated depletion. It includes the value of leased land that has been capitalized. Acres owned and leased consist of surface rights and mineral rights to the land. Mineral rights are the right to extract the minerals located beneath the surface. They may be conveyed separately from surface rights and may be either developed or undeveloped. Acres of land and mineral rights owned or leased by an affiliate, as reported, reflect only the affiliate's interest in a particular tract of land when that interest is less than 100 percent.

Table 5.—Selected Financial Data of U.S. Affiliates at Yearend 1977, by Transactor[1]

[Millions of dollars]

	Total	Position with U.S. persons[1]	Position with foreign persons: All foreign persons	Position with foreign persons: Affiliated foreign persons[2]	Position with foreign persons: Unaffiliated foreign persons
Current liabilities and long-term debt, total	[illegible]	[illegible]	[illegible]	10,721	[illegible]
Current liabilities[3]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
To banks	17,944	15,744	[illegible]	[illegible]	[illegible]
To others	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Long-term debt	[illegible]	[illegible]	[illegible]	4,117	[illegible]
To banks	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
To others	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Current receivables[4]	[illegible]	[illegible]	4,747	[illegible]	[illegible]

1. Excludes banks.
2. Foreign parents and foreign affiliates of foreign parents.
3. Equals the sum of "trade accounts and notes payable" and "other current liabilities" in the balance sheet.
4. Equals the sum of "trade accounts and notes receivable" and "other current receivables" in the balance sheet.

Table 6.—Selected Financial Data of U.S. Affiliates at Yearend 1977, Major Industry by Transactor[1]

[Millions of dollars]

	Current liabilities[3] and long-term debt, total	Position with U.S. persons: Total	Position with U.S. persons: Current liabilities	Position with U.S. persons: Long-term debt	All foreign persons: Total	All foreign persons: Current liabilities	All foreign persons: Long-term debt	Affiliated foreign persons[2]: Total	Affiliated foreign persons[2]: Current liabilities	Affiliated foreign persons[2]: Long-term debt	Unaffiliated foreign persons: Total	Unaffiliated foreign persons: Current liabilities	Unaffiliated foreign persons: Long-term debt
All industries	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	10,721	[illegible]	4,117	[illegible]	[illegible]	[illegible]
Agriculture and forestry[4]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	17	[illegible]	[illegible]	(D)	(D)	[illegible]	(D)	(D)
Mining	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	(D)	(D)	(D)	(D)	[illegible]	(D)	(D)	(D)
Petroleum	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Manufacturing	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Wholesale trade	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	111
Retail trade	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	(D)	[illegible]	(D)	(D)	[illegible]	(D)
Finance, except banking	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Insurance	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	(D)	(D)	(D)	(D)	(D)	(D)	(D)	[illegible]
Real estate	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other	[illegible]	[illegible]	1,064	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

D Suppressed to avoid disclosure of data of individual companies.
1. Excludes banks.
2. Foreign parents and foreign affiliates of foreign parents.
3. Equals the sum of "trade accounts and notes payable" and "other current liabilities" in the balance sheet.
4. Fisheries are included in "other."

Table 7.—Land and Mineral Rights of U.S. Affiliates at Yearend 1977 [1]

	Gross book value [2]	Land and mineral rights owned		Land and mineral rights leased	
		Total	Agricultural [3]	Total	Agricultural [3]
	Millions of dollars	Thousands of acres			
All industries	7,926	5,396	2,662	28,847	1,637
Agriculture and forestry [4]	391	1,606	1,451	(D)	(D)
Mining	430	446	(D)	1,735	0
Petroleum	2,066	639	2	21,154	(*)
Manufacturing	1,708	1,619	1,188	4,333	690
Food and kindred products	279	84	7	(D)	(D)
Paper and allied products	(D)	1,004	996	(D)	(D)
Chemicals and allied products	871	282	(D)	(D)	4
Industrial	642	196	2	(D)	1
Drugs	33	(D)	1	(*)	(*)
Other	96	(D)	(D)	4	3
Primary metal industries	308	17	(D)	(D)	(D)
Fabricated metal products	22	4	(*)	(*)	(*)
Machinery, except electrical	38	(D)	(D)	(D)	(D)
Electric and electronic equipment	56	(D)	(*)	1	(*)
Other	(D)	184	134	4	(*)
Wholesale trade	430	309	(D)	38	(D)
Motor vehicles and automotive parts and supplies	83	6	(*)	1	0
Metals and minerals	51	(D)	(*)	(D)	(*)
Farm-product raw materials	140	(D)	(D)	(D)	(D)
Other	136	38	1	2	(*)
Retail trade	160	2	(*)	1	0
Finance, except banking	15	(D)	(D)	0	0
Insurance	65	2	1	1	1
Real estate and combined offices	1,314	294	182	(D)	(D)
Other	411	(D)	(*)	3	0

* Less than 500 acres.
D Suppressed to avoid disclosure of data of individual companies.
1. Excludes banks.
2. Gross book value of land carried in all balance sheet asset accounts.
3. Land used for crops, pasture, timber production, and other agricultural purposes.
4. Fisheries are included in "other".

of the gross book value was accounted for by affiliates in chemicals and food products. Because several of the largest of these affiliates had substantial secondary operations in petroleum, most of the gross book value probably represents land used for petroleum or natural gas extraction. The gross book value in real estate largely represents ownership of commercial land, such as office building sites.

Acres owned were primarily accounted for by affiliates in agriculture and forestry (30 percent), manufacturing (29 percent), and petroleum (12 percent). Within manufacturing, acres owned were mainly attributable to affiliates in paper products and "other" manufacturing.

Most of the land that was used for agricultural purposes was owned by affiliates in agriculture and forestry and in manufacturing. About two-thirds of the 1.5 million acres owned by agriculture and forestry affiliates were in agriculture and one-third were in forestry. Of the land owned by affiliates in agriculture, almost two-thirds was owned by affiliates whose major activity was livestock production and whose land was probably mainly pasture or range. Almost all of the remainder was owned by affiliates whose major activity was crop production.

In manufacturing, 84 percent of the 1.2 million agricultural acres owned were in paper products and 11 percent were in "other industries," mainly lumber and wood products. In both industries, land was probably largely timberland.

Of the 28.8 million acres leased by affiliates, most were devoted to the exploration for and extraction of fuels. Almost three-fourths of the total was leased by affiliates in petroleum, primarily for oil and natural gas extraction. Of the remainder, over 15 percent was leased by affiliates in manufacturing and 6 percent by those in mining. In manufacturing, where affiliates in food products and chemicals accounted for most of the total, the land was largely for exploration for and extraction of oil, natural gas, and coal. In mining, land was probably largely devoted to coal and uranium exploration and extraction.

Of the 1.6 million leased agricultural acres, over 45 percent were leased by affiliates in agriculture and forestry. The remainder was leased by affiliates in manufacturing and real estate. In agriculture and forestry, the affiliates that leased were mainly engaged in livestock production, and the land was probably largely pasture or range.

By State and region

Table 8 shows the gross book value of affiliates' land, acres owned, and acres leased classified by the State and region in which the land was located. (The regions shown in the table are the eight BEA regions). The total gross book value of land shown in table 8 is $0.3 billion less than that shown in table 7. The difference is the value of land carried in balance sheet accounts other than in "fixed assets" or "other current assets," which is included in table 7 but not in table 8.

The gross book value in "other territories and offshore," at $1.2 billion, was larger than that in any individual State. It was primarily accounted for by affiliates in petroleum and represented the value of leased offshore acreage devoted to oil and natural gas extraction. Among States, gross book value was largest in Texas ($0.9 billion), California ($0.8 billion), and Florida ($0.4 billion). Among regions, it was largest in the Southeast ($1.7 billion).

States in which affiliates owned the largest number of acres were (ranked by size) Tennessee, Nevada, Colorado, Wisconsin, and New Mexico. In Tennessee, over one-half of the 0.4 million acres were owned by affiliates manufacturing paper products and were probably largely timberland. Among regions, the number of acres owned by affiliates was largest in the Southeast (1.9 million acres).

States in which affiliates leased the largest number of acres were North Dakota, Montana, Texas, and Wyoming. By region, leased acreage was largest in the Rocky Mountains; the 9.4 million acres leased in this region accounted for almost one-third of total land leased by affiliates.

Table 8.—Land, Plant and Equipment at Yearend, and Employment of U.S. Affiliates for 1977, by State[1]

	Gross book value of land[2]	Land and mineral rights: Owned	Land and mineral rights: Leased	Gross book value of plant and equipment	Employment[3]
	Millions of dollars	Thousands of acres		Millions of dollars	Number
Total	7,[illegible]	[illegible]	[illegible]	[illegible]	1,1[illegible]
New England	1[illegible]	[illegible]	(*)	1,[illegible]	70,[illegible]
Connecticut	[illegible]	(D)	(D)	407	21,[illegible]
Maine	[illegible]	(D)	(D)	[illegible]	4,7[illegible]
Massachusetts	[illegible]	(D)	(D)	[illegible]	[illegible]
New Hampshire	[illegible]	(D)	(D)	[illegible]	[illegible]
Rhode Island	[illegible]	(D)	(D)	[illegible]	[illegible]
Vermont	[illegible]	40	3	111	4,[illegible]
Mideast	770	442	201	7,[illegible]	277,113
Delaware	[illegible]	(D)	(D)	[illegible]	4,[illegible]
District of Columbia	[illegible]	(D)	(D)	[illegible]	1,[illegible]
Maryland	[illegible]	10	(D)	717	[illegible]
New Jersey	[illegible]	[illegible]	1	2,[illegible]	[illegible]
New York	[illegible]	126	(*)	2,[illegible]	111,[illegible]
Pennsylvania	[illegible]	[illegible]	70	1,741	[illegible]
Great Lakes	[illegible]	454	2,445	7,[illegible]	[illegible]
Illinois	173	(D)	412	2,[illegible]	[illegible]
Indiana	[illegible]	15	(D)	773	[illegible]
Michigan	[illegible]	[illegible]	(D)	2,[illegible]	[illegible]
Ohio	214	[illegible]	(D)	2,[illegible]	[illegible]
Wisconsin	[illegible]	(D)	45	730	[illegible]
Plains	[illegible]	400	2,046	[illegible]	[illegible]
Iowa	[illegible]	11	(*)	[illegible]	[illegible]
Kansas	[illegible]	[illegible]	[illegible]	[illegible]	6,424
Minnesota	[illegible]	[illegible]	[illegible]	1,[illegible]	14,724
Missouri	[illegible]	64	(*)	[illegible]	[illegible]
Nebraska	11	(D)	40	[illegible]	[illegible]
North Dakota	44	[illegible]	2,[illegible]	132	1,[illegible]
South Dakota	4	(D)	[illegible]	[illegible]	[illegible]
Southeast	1,713	1,[illegible]	[illegible]	13,[illegible]	244,140
Alabama	[illegible]	[illegible]	[illegible]	1,[illegible]	14,[illegible]
Arkansas	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Florida	[illegible]	[illegible]	(*)	[illegible]	[illegible]
Georgia	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Kentucky	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Louisiana	[illegible]	[illegible]	1,[illegible]	[illegible]	17,[illegible]
Mississippi	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
North Carolina	[illegible]	[illegible]	(*)	[illegible]	[illegible]
South Carolina	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Tennessee	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Virginia	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
West Virginia	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Southwest	1,[illegible]	[illegible]	[illegible]	[illegible]	77,[illegible]
Arizona	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
New Mexico	[illegible]	[illegible]	1,[illegible]	[illegible]	[illegible]
Oklahoma	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Texas	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Rocky Mountains	[illegible]	[illegible]	[illegible]	1,[illegible]	[illegible]
Colorado	[illegible]	(D)	1,[illegible]	[illegible]	[illegible]
Idaho	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Montana	[illegible]	(D)	[illegible]	[illegible]	[illegible]
Utah	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Wyoming	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Far West	[illegible]	[illegible]	[illegible]	4,[illegible]	[illegible]
California	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Nevada	[illegible]	(D)	(D)	[illegible]	[illegible]
Oregon	[illegible]	(D)	(D)	[illegible]	[illegible]
Washington	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Alaska	(D)	(D)	(D)	(D)	[illegible]
Hawaii	[illegible]	(D)	[illegible]	[illegible]	[illegible]
Puerto Rico	[illegible]	(D)	(D)	(D)	[illegible]
Other territories and offshore	(D)	[illegible]	(D)	[illegible]	[illegible]
Foreign[4]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

*Less than 500 acres.

D Suppressed to avoid disclosure of data for individual companies.

1. Excludes banks.
2. Land carried as "fixed assets" or "other current assets" in the balance sheet.
3. Average number of full-time and part-time employees during the year.
4. Refers to land and plant and equipment carried on the books of U.S. affiliates but located abroad, and employees of U.S. affiliates working abroad.

Plant and Equipment

Table 9 shows the gross book value of U.S. affiliates' plant and equipment at yearend 1977, and affiliates' total plant and equipment expenditures and expenditures for new plant and equipment during 1977. Affiliates' petroleum and mining exploration and development expenditures are shown in table 10.[9]

9. The gross book value of plant and equipment is the historical cost of plant and equipment, before the deduction of accumulated depreciation. Plant and equipment expenditures are expenditures that are made to acquire, add to, or improve plant and equipment charged to fixed asset accounts, including capitalized mining and petroleum exploration and development costs. Expenditures are on a gross basis—sales and other dispositions are not netted against them. The value of plant and equipment belonging to a U.S. business enterprise that is acquired by a U.S. affiliate is not included in the affiliate's plant and equipment expenditures. The acquisition is considered to be the acquisition of equity in, rather than the purchase of the plant and equipment of, the enterprise by the affiliate. However, the 1977 expenditures of the acquired enterprise are included. Petroleum and mining exploration and development expenditures are expenditures, whether expensed or capitalized, that are made to find and extract oil, natural gas, minerals, and metals.

Table 9.—Plant and Equipment of U.S. Affiliates in 1977[1]

[Millions of dollars]

	Gross book value of plant and equipment at yearend	Expenditures for plant and equipment: Total	Expenditures for plant and equipment: New
All industries	[illegible]	[illegible]	[illegible]
Agriculture and forestry[2]	207	[illegible]	42
Mining	2,[illegible]	377	[illegible]
Petroleum	20,[illegible]	[illegible]	[illegible]
Manufacturing	[illegible]	2,[illegible]	2,[illegible]
Food and kindred products	1,7[illegible]	[illegible]	214
Paper and allied products	1,[illegible]	[illegible]	[illegible]
Chemicals and allied products	[illegible]	1,[illegible]	[illegible]
Industrial	7,[illegible]	[illegible]	[illegible]
Drugs	[illegible]	[illegible]	[illegible]
Other	1,173	[illegible]	[illegible]
Primary metal industries	2,7[illegible]	[illegible]	[illegible]
Fabricated metal products	444	[illegible]	[illegible]
Machinery, except electrical	1,[illegible]	[illegible]	177
Electric and electronic equipment	1,[illegible]	[illegible]	[illegible]
Other	2,912	[illegible]	[illegible]
Wholesale trade	2,[illegible]	[illegible]	[illegible]
Motor vehicles and automotive parts and supplies	[illegible]	[illegible]	[illegible]
Metals and minerals	574	[illegible]	[illegible]
Farm-product raw materials	719	[illegible]	[illegible]
Other	1,[illegible]	[illegible]	[illegible]
Retail trade	1,[illegible]	[illegible]	211
Finance, except banking	54	[illegible]	9
Insurance	[illegible]	[illegible]	17
Real estate and combined offices	2,[illegible]	[illegible]	[illegible]
Other	2,1[illegible]	[illegible]	[illegible]

1. Excludes banks.
2. Fisheries are included in "other."

By industry

The gross book value of affiliates' plant and equipment was $53.8 billion. Capital-intensive goods-producing industries accounted for most of the total; over three-fourths was in manufacturing and petroleum. Of the $20.7 billion in manufacturing, almost one-half was in chemicals (mainly industrial chemicals).

Affiliates' total plant and equipment expenditures during 1977 were $8.2 billion and were largely accounted for by affiliates in petroleum and manufacturing. Expenditures for new plant and equipment were $6.9 billion, or 84 percent of total expenditures. In most industries, such expenditures were at least 80 percent of the total. An exception was real estate, where expenditures for new plant and equipment were only 26 percent of total expenditures. In this industry, spending was largely for purchases of existing commercial structures, such as office buildings.

Petroleum and mining exploration and development expenditures were $1.6 billion. Petroleum affiliates' expenditures were 84 percent of the total. Manufacturing and mining affiliates accounted for most of the remainder.

Table 10.—Exploration and Development Expenditures of U.S. Affiliates in 1977

[Millions of dollars]

	Expenditures
Total	1,643
Mining	62
Petroleum	1,384
Manufacturing	179
Other	20

By State and region

Of the total gross book value of plant and equipment, over 20 percent was in Alaska and Texas combined (table 8). Petroleum affiliates' plant and equipment was also largest in these two States. In Alaska, over 95 percent of the total was owned by petroleum affiliates; their plant and equipment mainly consisted of facilities for extracting and transporting crude oil. In Texas, almost two-thirds of the total was owned by petroleum affiliates.

The gross book value of manufacturing affiliates' plant and equipment was largest in New Jersey and Texas. In both States, chemical affiliates accounted for most of the manufacturing total.

By region, the gross book value of affiliates' plant and equipment was largest in the Southeast ($12.8 billion). In this region, over one-half of the total was in manufacturing.

Table 11.—Employment and Employee Compensation of U.S. Affiliates in 1977 [1]

	Employment [2]	Employee compensation		
		Total	Wages and salaries	Employee benefits
	Number	Millions of dollars		
All industries	1,122,207	17,448	14,636	2,763
Agriculture and forestry [3]	7,060	101	84	17
Mining	14,868	306	223	83
Petroleum	101,360	2,054	1,660	396
Manufacturing	617,047	9,839	8,278	1,561
Food and kindred products	79,346	1,156	888	267
Paper and allied products	14,749	230	217	43
Chemicals and allied products	182,223	3,178	2,668	510
Industrial	135,844	2,256	1,888	367
Drugs	24,209	502	420	83
Other	22,210	419	330	86
Primary metal industries	61,630	1,109	915	194
Fabricated metal products	18,083	307	252	55
Machinery, except electrical	60,000	887	719	168
Electric and electronic equipment	81,290	1,116	985	131
Other	130,805	1,818	1,562	256
Wholesale trade	141,067	2,304	1,982	317
Motor vehicles and automotive parts and supplies	21,344	375	327	48
Metals and minerals	19,224	267	234	33
Farm-product raw materials	22,663	385	324	60
Other	77,836	1,154	998	156
Retail trade	128,980	1,308	1,118	188
Finance, except banking	6,411	142	126	16
Insurance	34,664	473	416	57
Real estate and combined offices	8,907	110	96	15
Other	60,813	827	713	114

1. Excludes banks.
2. Average number of full-time and part-time employees.
3. Fisheries are included in "other".

Employment and Employee Compensation

Table 11 shows employment and employee compensation of U.S. affiliates. Employment is the average number of full-time and part-time employees on affiliates' payrolls during 1977. Employee compensation consists of wages and salaries and employee benefits. Wages and salaries are the monetary remuneration of employees—including salaries of corporate officers, commissions, and bonuses—and payments in kind. Employee benefits consist of employer contributions to employees' social insurance, private pension plans, and welfare funds.

Employment

By industry.—Affiliates employed 1,122,207 persons in 1977. Over one-half of the total was in manufacturing, largely in chemicals. Other industries where employment was relatively large were wholesale trade (with 12 percent of the total), retail trade (11 percent), and petroleum (9 percent).

Differences among industries between the distribution of employment and of the gross book value of plant and equipment reflect differences in the capital intensity of production (measured as the amount of capital used per worker). For example, petroleum affiliates, whose production is highly capital-intensive, accounted for 38 percent of the gross book value of plant and equipment but only 9 percent of the employment. Similarly, within manufacturing, chemical affiliates, whose production is also highly capital-intensive, accounted for 46 percent of the plant and equipment but only 30 percent of the employment.

By State and region.—Affiliates' employment was largest in New York and California, each with 10 percent of the total, and New Jersey, with 7 percent. Manufacturing affiliates' employment was also largest in these three States. In New Jersey, 62 percent of total employment was in manufacturing; in California and New York, the percentages were 50 and 43, respectively. Wholesale trade affiliates' employment was largest in California. Employment of retail trade and petroleum affiliates was largest in New York and Texas, respectively.

By region, one-fourth of affiliates' employment was in the Mideast. Over one-half of the employees in this region were in manufacturing.

Compensation

Employee compensation was $17.5 billion. Wages and salaries were $14.7 billion, or 84 percent of compensation, and employee benefits were the remainder. Among industries, the wages and salaries share of total compensation ranged from 73 percent in mining to 90 percent in finance, except banking.

Annual compensation per employee was $15,577. Compensation rates were highest in finance, except banking ($22,156) and lowest in retail trade ($10,127). In manufacturing, annual compensation per employee was $15,929, ranging from $13,750 in electrical machinery to $18,087 in nonelectrical machinery. Differences in compensation rates may partly reflect differences among industries in the portion of total employment accounted for by part-time employees. Also, they may partly reflect differences among industries in the portion of total employment accounted for by production workers, because annual compensation rates of production workers differ considerably from those of nonproduction workers. One way to correct for these differences is to compare hourly wage rates of production workers alone.

Hourly wage rates

Table 12 shows employment and also wages and salaries of production and nonproduction workers for manufacturing affiliates only.[18] For production workers, data on hours worked and hourly wage rates are shown as well.

Production workers in manufacturing are the employees, up to and including working foremen, who are involved in the physical production, handling, and storage of goods and related services. Hours worked are annual hours per production worker. They exclude hours paid for holidays, vacations, sick leave, and other paid leave. Hourly wage rates of production workers were calculated by dividing annual wages and salaries by annual hours worked.

The hourly wage rate of production workers in manufacturing was $5.81. In chemicals, which had the largest number of production workers, the rate was $5.71. Wage rates were highest in nonelectrical machinery ($6.98) and lowest in electrical machinery ($4.54).

Differences among industries in hourly wage rates may partly reflect differences in the average skill levels of production workers. For example, in nonelectrical machinery, most production workers were probably employed in fabrication and milling of metals, operations that require relatively high skill levels. In electrical machinery, on the other hand, most production workers were probably employed in assembly of electronic components, an operation that requires somewhat lower skill levels. Differences among industries may also reflect differences in the degree to which production workers were unionized, the amount of overtime worked, and the geographic location of manufacturing operations.

18. Industries other than manufacturing are not shown in table 12 because of the uneven quality of the data reported to BEA for nonmanufacturing affiliates. Many of these affiliates do not normally distinguish between production workers and nonproduction workers in their own records. Also, some of these affiliates' employees, such as salesmen in wholesale and retail trade, who are classified as production workers receive annual salaries rather than hourly wages, so that their hours worked are not recorded.

Merchandise Trade

Data on U.S. affiliates' merchandise trade are presented in table 13. Affiliate trade refers to the physical movement of goods between the United States and foreign countries, rather than to changes in the ownership of goods. For example, if the title to goods is transferred by a U.S. affiliate to its foreign parent, but the goods remain in the United States, no export should be reported. Similarly, if a U.S. affiliate takes title to goods located outside the United States that are not actually shipped to the United States, no import should be reported. Exports and imports are valued free alongside ship (f.a.s.) at the port of exportation. The data are classified by industry of affiliate; trade data disaggregated by commodity were not collected in the sample survey.

Table 12.—Employment and Wages and Salaries of U.S. Manufacturing Affiliates in 1977

	Employment[1]			Wages and salaries			Addenda: for production workers	
	Total	Production workers	Nonproduction workers	Total	Production workers	Nonproduction workers	Annual hours per worker	Wages and salaries per hour
	Number			Millions of dollars			Hours	Dollars
Manufacturing, total	537,647	297,534	240,113	8,273	4,879	3,390	1,998	5.81
Food and kindred products	79,346	53,921	25,425	966	580	386	1,619	5.41
Paper and allied products	14,743	11,172	3,571	217	150	67	2,084	6.85
Chemicals	182,382	97,884	84,338	2,668	1,134	1,534	2,038	5.71
Industrial	126,944	78,484	57,360	1,898	891	997	2,037	5.57
Drugs	24,380	9,070	14,230	430	117	303	1,967	5.92
Other	22,309	9,530	12,670	350	126	224	1,900	6.80
Primary metal industries	61,530	44,124	17,415	915	577	338	1,941	6.74
Fabricated metal products	18,663	13,702	5,961	232	136	97	2,018	4.97
Machinery, except electrical	49,050	27,928	21,122	719	361	358	1,853	6.98
Electric and electronic equipment	81,260	45,526	35,734	988	384	604	1,856	4.54
Other	130,666	94,178	36,517	1,360	968	393	1,913	5.34

1. Average number of full-time and part-time employees.

Table 13.—Merchandise Trade of U.S. Affiliates in 1977, by Industry Affiliate [1]

[Millions of dollars]

	Exports [2]			Imports [2]		
	Total	To affiliated foreigners [3]	To unaffiliated foreigners	Total	From affiliated foreigners [3]	From unaffiliated foreigners
All industries	24,136	11,364	12,772	42,541	28,364	14,177
Agriculture and forestry [4]	27	(D)	(D)	1	1	(*)
Mining	236	(D)	(D)	129	(D)	(D)
Petroleum	912	658	254	6,126	2,128	3,998
Manufacturing	3,180	1,273	1,908	5,666	4,673	980
Food and kindred products	316	112	204	756	432	324
Paper and allied products	(D)	(D)	(D)	274	(D)	(D)
Chemicals and allied products	934	375	559	894	738	156
Industrial	653	193	460	961	876	85
Drugs	129	(D)	(D)	109	(D)	(D)
Other	152	(D)	(D)	134	(D)	(D)
Primary metal industries	(D)	(D)	179	716	592	124
Fabricated metal products	23	9	14	161	151	10
Machinery, except electrical	889	515	374	745	681	64
Electric and electronic equipment	336	141	195	942	826	116
Other	474	208	266	566	(D)	(D)
Wholesale trade	19,411	9,123	10,288	30,566	21,844	8,722
Motor vehicles and automotive parts and supplies	(D)	(D)	(D)	11,093	(D)	(D)
Metals and minerals	4,076	2,812	1,264	6,667	4,471	2,196
Farm-product raw materials	11,064	3,787	7,277	4,205	974	3,231
Other	(D)	(D)	(D)	8,602	(D)	(D)
Retail trade	196	(D)	(D)	283	128	155
Finance, except banking	(D)	0	(D)	(D)	3	(D)
Insurance	(*)	(*)	0	(*)	(*)	0
Real estate and combined offices	(D)	(D)	(D)	(D)	(D)	(D)
Other	29	11	18	(D)	45	(D)

* Less than $500,000.
D Suppressed to avoid disclosure of data of individual companies.
1. Excludes banks.
2. Exports are valued f.a.s. at the U.S. port of exportation; imports are valued f.a.s. at the foreign port of exportation.
3. Foreign parents and foreign affiliates of foreign parents.
4. Fisheries are included in "other".

U.S. affiliates had exports of $24.1 billion and imports of $42.5 billion in 1977. About one-half of the exports were to affiliated foreigners and two-thirds of the imports were from affiliated foreigners. Wholesale trade affiliates accounted for most of both exports and imports.

Wholesale trade affiliates' exports, at $19.4 billion, were 80 percent of total exports. Within wholesale trade, affiliates in farm-product raw materials and in metals and minerals accounted for 57 and 21 percent of the total, respectively. Almost two-thirds of the exports in farm-product raw materials were to unaffiliated foreigners, and were probably mainly grain shipments by French- and Japanese-owned affiliates; the former shipped over one-half and the latter over one-fourth of the total. In metals and minerals, exports were mainly to affiliated foreigners. Japanese-owned affiliates shipped four-fifths of the total.

Wholesale trade affiliates' imports, at $30.6 billion, were 72 percent of total imports. Within wholesale trade, 36 percent were accounted for by affiliates in motor vehicles and 22 percent by affiliates in metals and minerals. About four-fifths of the imports in motor vehicles were from affiliated foreigners. Japanese-owned affiliates accounted for two-thirds and German-owned affiliates for one-fourth of the industry total. Two-thirds of the imports in metals and minerals were from affiliated foreigners. About one-half of the imports in this industry were attributable to Japanese-owned affiliates.

Research and Development Expenditures

Expenditures by affiliates for research and development (R. & D.) consist of all costs incurred for R. & D., including depreciation, wages and salaries, taxes, costs of materials and supplies, and allocated overhead costs. R. & D. performed by others for affiliates is included; R. & D. performed by affiliates for others is excluded.

Affiliates' R. & D. expenditures were $898 million (table 14). Spending was mainly by affiliates in manufacturing (79 percent of the total) and petroleum (12 percent). In manufacturing, affiliates in chemicals accounted for 65 percent and those in machinery for 19 percent of expenditures.

By country, affiliates with parents in the developed countries accounted for over 83 percent of the total. Spending by affiliates with parents in the Netherlands, at $230 million, was particularly large.

Growth, 1974–77

Data similar to those presented in this article for 1977 were collected in BEA's 1974 benchmark survey of foreign direct investment in the United States. Differences in coverage and definitions between the 1974 benchmark survey and the 1977 sample survey, as well as revisions to the 1974 data made after publication, preclude direct comparison of published data from the two surveys. However, it is possible to adjust 1974 data to improve comparability. (See the technical note for a discussion of the differences between the 1974 and 1977 data and a description of the adjustments to the 1974 data.) The adjusted 1974 data and the 1977 data from the sample survey were used to calculate growth rates for a number of key items at the all-industry level. The resulting compound annual rates of growth for 1974–77 are shown in the accompanying tabulation.

	Percent
Total assets	[illegible]
Net fixed assets	[illegible]
Sales	[illegible]
Employee compensation	[illegible]
Employment	[illegible]
Acres of land and mineral rights owned	[illegible]

The considerable variation in annual rates of growth among the items reflected in part differential effects of inflation, changing industry mix, and cyclical economic developments. The lowest rate of growth—4.5 percent—was in employment. The next lowest—6 percent—was in acres of land owned. Because neither employment nor acres owned are measured in dollars, their growth rates were not directly affected by inflation. The growth rates of each of the other items—total assets, net fixed assets, sales, and employee compensation—were directly affected by inflation.

Growth in affiliate employment was slower than 4.5 percent if a rough adjustment is made to account for a difference in how employment was measured in the 1974 and 1977 surveys. (A more precise adjustment is not possible because necessary data are not available.) In the 1974 survey, employment was measured as the number of full-time equivalent (FTE) employees. FTE employment counts a part-time employee as a percentage of a full-time employee, with the percentage depending on the portion of a full-time schedule worked. In 1977, employment was measured as average full-time and part-time (FT-PT) employment; by this measure, part-time employees are counted on the same basis as full-time employees. As a result, employment in the 1974 survey is lower than it would have been if measured on the 1977 basis. Although FT-PT employment of affiliates in 1974 is not known, it can be roughly estimated using data for all U.S. businesses (except banks). Based on this rough estimate, growth in affiliate employment was about 3 percent.[11]

Growth in affiliate employment outpaced the 1.6-percent annual rate of growth in employment of all U.S. businesses (except banks) for the 1974-77 period. As a result, affiliates accounted for a slightly higher portion of employment for all U.S. businesses (except banks) in 1977 than in 1974.

Employee compensation of affiliates grew at an annual rate of 13.2 percent. In contrast, employee compensation for all U.S. businesses (except banks) grew at a 9.9-percent rate over the same period.[12]

Total assets grew at an annual rate of 12.9 percent; net fixed assets grew somewhat faster, 15.7 percent. Both rates reflect the impact of inflation. The higher rate for net fixed assets partly reflects the effect of major expansions by several existing affiliates. These affiliates had larger increases in net fixed assets than in other assets, such as inventories and receivables, because new production associated with these expansions was not yet fully underway by 1977. Also, relatively large purchases of land and other real estate would tend to raise net fixed assets relative to other asset categories.

Sales grew at an annual rate of 11.0 percent, somewhat slower than total assets and net fixed assets. Inflation would be expected to have a greater impact on sales, which are valued in current dollars, than on net fixed assets (and, therefore, on total assets), which are valued at historical cost. That sales grew more slowly than net fixed assets in part reflects the major expansion by existing affiliates mentioned above, which, by 1977, had not yet been accompanied by corresponding increases in sales. Similarly, affiliates newly established since 1974 may have added substantial net fixed assets to the affiliate total but may not have yet contributed significantly to sales. Finally, sales may have grown more slowly than net fixed assets because land and other real estate purchases directly increase net fixed assets but may have a limited impact on sales.

Table 14.—Research and Development Expenditures of U.S. Affiliates in 1977[1]

[Millions of dollars]

	Expenditures
Total	906
By industry	
Agriculture and forestry[2]	3
Mining	16
Petroleum	111
Manufacturing	709
Food and kindred products	27
Paper and allied products	1
Chemicals and allied products	461
Industrial	130
Drugs	(D)
Other	(D)
Primary metal industries	12
Fabricated metal products	26
Machinery, except electrical	51
Electric and electronic equipment	86
Other	43
Wholesale trade	28
Motor vehicles	(D)
Metals and minerals	(D)
Farm-product raw materials	2
Other	24
Retail trade	(D)
Finance, except banking	(*)
Insurance	6
Real estate and combined offices	2
Other	(D)
By country	
Developed countries	742
Canada	97
Belgium and Luxembourg	19
France	27
Germany	96
Netherlands	220
United Kingdom	123
Switzerland	154
Japan	19
Other	12
Developing countries	166
Latin America	158
Other	8

*Less than $500,000.
D Suppressed to avoid disclosure of data of individual companies.
1. Excludes banks.
2. Fisheries are included in "other".

Technical Note

The data in this article are for the sample of U.S. affiliates of foreign companies that reported in BEA's Interim Survey of Foreign Direct Investment in the United States, 1977. Similar and more detailed data for the universe of all U.S. affiliates were collected in BEA's 1974 benchmark survey of foreign direct investment in the United States. There are differences in coverage and definitions between the two surveys, in addition, revisions to the 1974 universe data were made after publication. This note discusses the differences and describes adjustments to the 1974 data that are needed to improve comparability. Estimates of the portion of the 1974 universe of all U.S. affiliates covered by the sample and of 1974-77 growth are provided, based on adjusted data for a number of key items.

11. FT-PT and FTE employment for all U.S. businesses (except banks) are from national income and product account tables 6.7 and 6.8, respectively, in the July 1979 SURVEY. The difference between FT-PT and FTE employment for all U.S. businesses (except banks) varied widely by industry. These differences were used in deriving the estimate of 1974 affiliate employment on an FT-PT basis. Comparison of the 1974 estimate and 1977 reported data for affiliate FT-PT employment results in the 3-percent growth rate noted above.

12. 1974-77 growth in employment and employee compensation for all U.S. businesses (except banks) are from national income and product account tables 6.7 and 6.5, respectively, in the July 1978 and July 1979 SURVEYS.

Table A.—Coverage of 1977 Sample and 1974–77 Growth

	Total assets	Fixed assets, net	Sales	Employee compensation	Employment	Land and mineral rights owned
	Millions of dollars				Number	Thousands of acres
1974 data for:						
1. Universe as published	174,273	3[illegible],300	146,771	13,[illegible]	1,083,432	4,[illegible]
2. Less: net effect of definitional and statistical revisions after publication	22,777	30	3,975	110	6,121	40
a. Change in consolidation rules	13,631		5,565			
b. Other	9,146	30	−1,590	110	6,121	40
3. Less: banks	34,788	200	4,327	2[illegible]	26,984	(*)
4. Less: deaths	6,900	3,073	4,770	[illegible]	88,263	676
5. Equals: affiliates that reported in 1974 survey that were potentially subject to reporting in 1977 survey	[illegible],743	2[illegible],9[illegible]	132,[illegible]	12,[illegible]	[illegible],073	4,1[illegible]
6. Less: affiliates that did not report in 1977 survey	5,873	1,[illegible]	4,[illegible]	772	80,341	169
7. Equals: affiliates that reported in both 1974 and 1977 surveys	[illegible],870	34,876	127,864	11,2[illegible]	913,1[illegible]	4,011
1977 data for:						
8. Affiliates that reported in both 1974 and 1977 surveys	¹116,2[illegible]	37,408	168,171	14,[illegible]	973,[illegible]	4,[illegible]
9. Plus: births	¹14,150	4,614	13,[illegible]	2,0[illegible]	148,[illegible]	1,077
10. Equals: all affiliates that reported in 1977 survey	¹130,544	42,0[illegible]	181,773	17,4[illegible]	1,122,[illegible]	5,[illegible]
Sample coverage:						
11. 1974 data for sample as percent of 1974 data for potential universe (line 7 ÷ line 5)	93.5	94.6	96.2	96.6	92.9	96.0
Growth from 1974 to 1977, including deaths in the data for 1974 and births in the data for 1977:						
12. Percent change $\left[\frac{\text{line 10}-(\text{line 4}+\text{line 7})}{\text{line 4}+\text{line 7}}\right]$	42.7	41.2	36.1	43.9	14.2	18.1
13. Compound annual rate of growth	12.9	12.0	10.8	12.9	²4.6	6.0

*Less than 500 acres.

1. To improve comparability with 1974 data, 1977 data for total assets are adjusted to eliminate current receivables due from U.S. parents and U.S. affiliates of foreign parents (see footnote 13 to text). The amount of the adjustment is $912 million in line 8, $73 million in line 9, and $985 million in line 10. The sum of the adjustment in line 10 and the total asset figure shown in line 10 ($130,544 million) equals the value of total assets shown in table 1 ($131,530 million).

2. If a rough adjustment is made to account for a difference in how employment was measured in the 1974 and 1977 surveys, annual growth in employment was about 3 percent. See text for discussion.

The first panel of table A (lines 1–7) shows 1974 benchmark survey data for the key items and the adjustments needed to improve comparability with 1977 sample data. Line 1 shows 1974 benchmark data, as published.[13] Line 2 is the net adjustment for definitional and statistical revisions made after publication of the 1974 data. It consists of two parts—adjustments to reflect a change in consolidation rules (line 2a) and other adjustments (line 2b).

In the 1974 benchmark survey, reporting on a consolidated basis was generally not permitted, i.e., a separate report was required from each U.S. affiliate. In the 1977 sample survey, U.S. affiliates were required to report on a consolidated basis; the consolidation for a given affiliate had to include all other affiliates owned more than 50 percent by that affiliate. The change in rules was made to eliminate duplication of interaffiliate transactions in certain items, as well as to reduce respondents' reporting burden.

Of the items shown, the change in consolidation rules affects only total assets and sales. The 1974 data for these items are adjusted by subtracting from the published totals available data on interaffiliate assets and sales that would have been largely eliminated in consolidation if the 1974 reports had been filed on a consolidated basis. For total assets, the adjustment of $13,631 million is the sum of (1) equity investment in other U.S. affiliates ($9,575 million) and (2) current receivables ($2,759 million) and noncurrent receivables and investments ($1,297 million) due from U.S. parents and U.S. affiliates of foreign parents. For sales, the adjustment of $5,565 million represents the sum, across all affiliates, of sales by each affiliate to other U.S. affiliates of its foreign parent.[14]

The change in consolidation rules also affected industry classification of affiliates. In both the 1974 benchmark and 1977 sample surveys, affiliates were classified by industry based on the distribution of their sales. In the 1977 sample survey, affiliates reporting as one consolidated entity would have been classified in the single industry in which that consolidated entity's sales were largest. In the 1974 benchmark survey, on the other hand, the same affiliates may have been classified in a number of different industries, determined by the industries in which the individual affiliates' sales were largest. Thus, data below the all-industries level are not comparable for 1974 and 1977.

Line 2b represents the net amount of all other definitional and statistical revisions made after publication of the 1974 benchmark data. Definitional changes include: (1) the removal from direct investment of U.S. branch stations, ticket offices, and port facilities of foreign airlines and ship operators that service only their foreign parent companies; and (2) the removal from foreign direct investment in the United

(Continued on page 56)

13. These data are as published in U.S. Department of Commerce, *Foreign Direct Investment in the United States: Report of the Secretary of Commerce to the Congress in Compliance with the Foreign Investment Study Act of 1974* (Public Law 93-479), Volume 2, April 1976.

14. Data used to adjust total assets are from tables O-2 and H-4 in the 1974 benchmark survey publication cited in footnote 13. Data used to adjust sales were collected in the 1974 benchmark survey but were not published.

Subtracting the full amount of interaffiliate assets and sales probably overadjusts the 1974 data because a portion may reflect transactions with unconsolidated U.S. affiliates that would not have been eliminated during consolidation. Overadjustment of the 1974 data would tend to overstate estimated 1974–77 growth in total assets and sales. For total assets, any such overadjustment is partly offset by subtracting from 1977 total assets 1977 current receivables due from U.S. parents and U.S. affiliates of foreign parents (see footnote 1 to table A). Data on equity investment in other U.S. affiliates and on noncurrent receivables and investments due from U.S. parents and U.S. affiliates of foreign parents were not collected in 1977. For sales, no adjustment to 1977 data is possible because data on interaffiliate sales were not collected. For both total assets and sales, the impact of overadjustment on the growth shown in lines 12 and 13 of table A is believed to be small.

(Continued from page 44)

States of data for a large U.S.-incorporated petroleum company operating in the Middle East. (For a discussion of the latter change, see the October 1977 SURVEY, p. 36.) Statistical revisions include corrections to the published 1974 data and inclusion of data from reports received after publication.

Line 3 shows 1974 data for U.S. affiliates in banking. Bank affiliates were not covered by the 1977 sample survey because similar data for them were collected by the Federal Reserve System.[14]

"Deaths," shown in line 4, represent 1974 data for U.S. companies that were affiliates (owned 10-percent or more by foreigners) in 1974 but were liquidated or sold, or those in which foreign ownership was reduced to less than 10 percent, by 1977. Because these companies would not have been part of the 1977 direct investment universe, their data were excluded from the 1974 benchmark data for purposes of estimating the coverage of the universe accounted for by the 1977 sample.

After all adjustments, the remainder, shown in line 5, represents revised 1974 data for all affiliates that potentially could have reported in 1977. Line 6 shows 1974 data for affiliates in this group that did not report in 1977, primarily because they were exempt[15] or were liquidated or sold after 1977, but before 1977 report forms were mailed out, so that a report could not be secured. 1974 data for U.S. affiliates that reported in both the 1974 and 1977 surveys are shown in line 7.

The second panel of table A (lines 8–10) shows 1977 sample survey data. Line 8 shows data for affiliates that reported in both the 1974 and 1977 surveys. Line 9, "births," shows data for affiliates that entered the direct investment universe after 1974. Line 10, the sum of lines 8 and 9, is total sample data as published in this article.

The portion of the universe covered by the 1977 sample is estimated by dividing 1974 data for affiliates that reported in both the 1974 and 1977 surveys (line 7) by 1974 data for all affiliates that were potentially subject to reporting in the 1977 survey (line 5). The results show that coverage of the sample was quite high—ranging from 92.9 percent for employment to 96.2 percent for sales. Thus, the sample data presented in this article, while not expanded to universe levels, are reasonable estimates of total foreign direct investment activity in the United States in 1977.

Growth from 1974 to 1977 is shown in line 12. For each item, it is calculated as the percent increase in 1977 data for affiliates that reported in the sample survey, including data for "births," over 1974 data for affiliates that reported in both the 1974 and 1977 surveys plus 1974 data for "deaths." Line 13 shows compound annual rates of growth.

14. See footnote 3.

15. In the 1977 survey, a U.S. affiliate, as consolidated, was exempt if:

a. Each of the following three items for the U.S. affiliate (not the foreign parent's share) was between −$5 million and +$5 million during 1977:

(1) Total assets,

(2) Net sales or gross operating revenues, excluding sales taxes, and

(3) Net income after provision for U.S. income taxes; and

b. The U.S. affiliate did not own 200 acres or more of U.S. land during 1977. (If the U.S. affiliate owned 200 acres or more of U.S. land, it was required to report regardless of the value of its assets, sales, or net income.)

Testimony of

JOHN S. BAIN

Vice President, Salomon Brothers

before the

SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT POLICY

of the

COMMITTEE ON FINANCE, UNITED STATES SENATE

May 4, 1981

CONTENTS

Tax Deferral for Reinvested Dividends

Introduction

I welcome the opportunity to testify on behalf of Salomon Brothers on the subject of a tax deferral for reinvested dividends. We believe that a properly structured deferral of income taxation on dividends reinvested in original issue shares will be of benefit to individuals, to business, and to the future health and well-being of the entire United States economy.

Salomon Brothers is a leading firm in the investment banking and brokerage industry. We have ten office locations, including establishments in London and Hong Kong. In addition to our activities as market makers and brokers of financial instruments, we have extensive investment banking relationships with many major corporations, both domestic and foreign. During our last fiscal year, we participated as manager or co-manager in financings by more than 150 domestic and foreign companies, aggregating in excess of $23 Billion.

As a result of these activities, we have become familiar with the problems businesses have had in raising money for new investment in recent years, particularly the very high cost of that money under current market conditions.

Qualifications

Regarding my qualifications, I received a Bachelor of Science Degree from Rensselaer Polytechnic Institute in 1963, and the degree of Master of Business Administration from the Wharton Graduate School in 1969. I am a member of the Financial Analysts Federation, the New York Society of Security Analysts, and the Fixed Income Analysts Society. I am a member of the adjunct faculty of the Stevens Institute of Technology. I am a Vice President in the Stock Research Department of Salomon Brothers.

Before joining Salomon Brothers in 1979, I was with the American Telephone and Telegraph Company for ten years, concentrating in the areas of financial planning and regulatory matters. In both my current and former positions, I undertook a number of studies relating to financing, investment planning, capital formation, and dividend policy. I have prepared, or assisted in the preparation of, several studies of dividend reinvestment plans. I participated, with Robert S. Salomon, General Partner of Salomon Brothers, in the presentation of testimony to the Senate Committee on Finance regarding earlier proposed legislation affecting dividend reinvestment plans.

Dividend Reinvestment Plans

Dividend Reinvestment Plans (DRPs) originated in September of 1968, when Allegheny Power Systems, Inc. offered its stockholders the opportunity to participate in such a plan to be managed by First National City Bank of New York (now Citibank). After the American Telephone and Telegraph Company adopted a similar plan in 1969, DRPs spread rapidly.

These early plans were viewed primarily as a service to share-owners, and merely acted as a purchasing medium, buying the shares in the marketplace. Because the plan administrator had the advantage of large volume purchasing, a significant reduction in transactions cost could be passed along to the participants.

In 1973 companies began to issue new or "original issue" shares to DRP participants. Today there are in excess of 175 companies having such plans. (Exhibit A lists those companies we know to be currently employing an original issue Dividend Reinvestment Plan.) The distinction is important, because only original issue plans can be said to generate new investible funds. The older "market" plans merely buy existing shares from existing owners, and therefore con-tribute nothing to corporate equity.

Market purchase plans will probably continue to be a valuable shareowner service in many cases, but the focus here is on original issue DRPs. Provisions of bill S. 141 apply only to Dividend Rein-vestment Plans that issue new shares, and it is these plans alone toward which this testimony is directed, unless otherwise indicated.

Savings and Investment Necessary for Economic Growth

Real economic progress of the sort that produces an increasing standard of living depends on an adequate rate of investment. Increases in per capita consumption of goods and services is possible only if per capita output, or productivity, also increases. Productivity growth, in turn, results from a number of factors, including increased worker skill and knowledge, improved business organization, technological progress, and increased investment in productive assets. All of these factors are necessary ingredients for real economic growth.

Over the past decade there has developed an increasing suspicion that the United States is lagging in overall economic progress. This is believed to result from an inadequate level of savings and investment, resulting in lower productivity growth.

U.S. Productivity Lags

In the January 1978 "Economic Report to the President," the Council of Economic Advisors termed the slowdown in U.S. productivity growth "one of the most significant economic problems in recent years." The continued productivity slowdown during 1978 and 1979 has greatly increased the public's awareness of this problem. Concern about the growth rate of productivity is well-founded, because productivity growth is the major source of increase in our standard of living and one of the keys to the reduction of inflation.

Charts 1 and 2 show two measures of productivity. Chart 1 shows real GNP divided by the quarterly average of civilian employment, while Chart 2 shows output per hour in the private business sector. In both cases, the productivity measure is shown from 1948 to the present in logarithmic form to indicate trends in growth. The downturn of the curves in recent years is obvious.

Productivity growth in the Seventies, particularly since 1973, has been extremely sluggish. From 1948 to early 1973, the trend rate of growth of real GNP per worker was 2.4% per year; since then the average rate of growth has been essentially zero. The same pattern appears in Chart 2 where the trend rate of growth was 3.0% per year until the first quarter of 1973, while the recent rate has been 0.5%. In both cases, productivity decreased sharply during 1973-74, and, despite the relatively rapid expansion of output and employment since 1975, the rate of productivity growth has remained extremely slow. Table 1 shows that this trend has been true for every major sector of the economy.

CHART 1

Real GNP Per Worker*

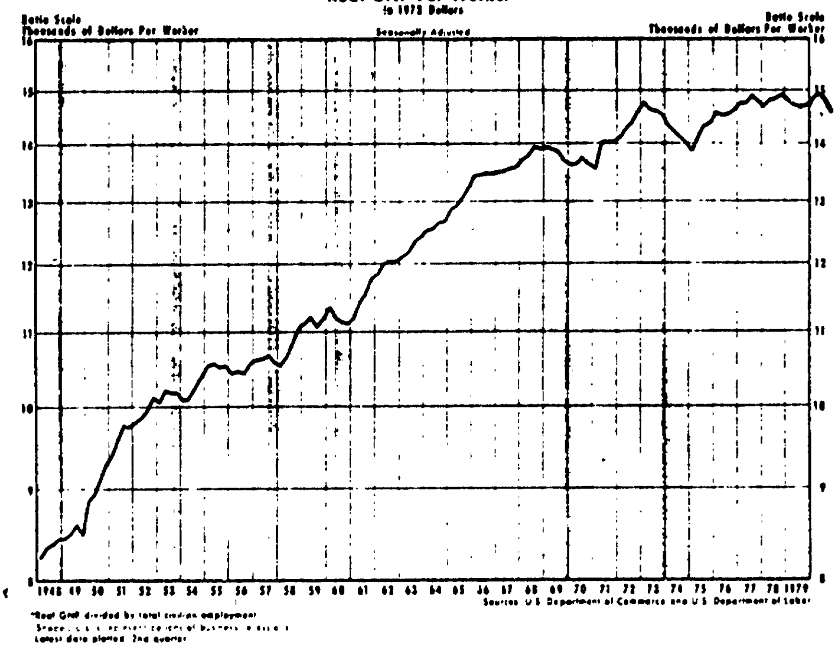
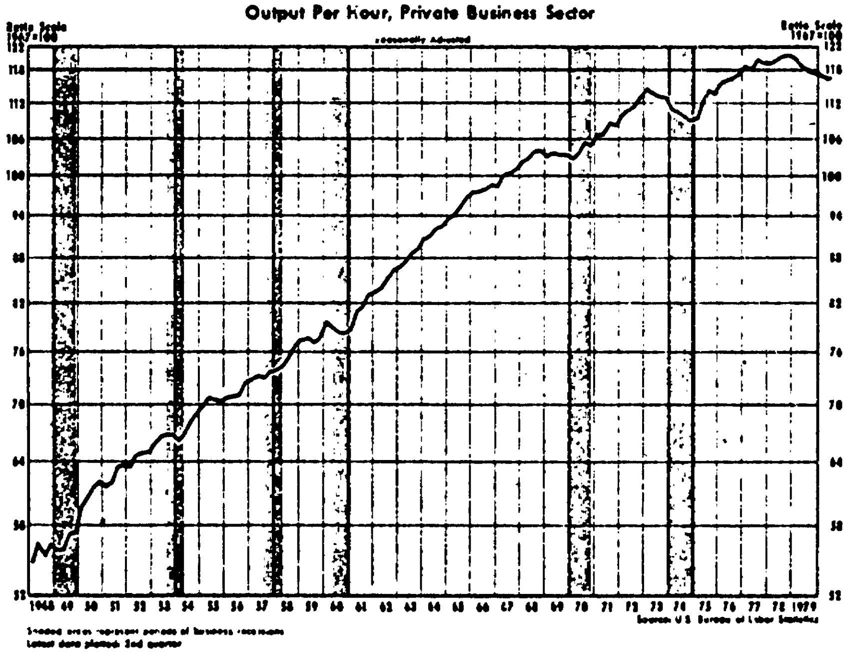


CHART 2

Output Per Hour, Private Business Sector



Source: Federal Reserve Bank of St. Louis
(Updated by Salomon Brothers.)

Table 1

Productivity Growth Rates for Major Sectors
(Annual Average Percentage Rates of Change)

Sector	1947-1967	1967-1972	1972-1978	1977:4 1979:2
Private Business	3.2	2.2	1.2	-0.3
Hours	0.5	1.1	1.8	3.5
Output	3.7	3.3	3.0	3.2
Nonfarm Business	2.6	1.9	1.9	-0.5
Farm	5.7	5.2	2.1	N.A.
Manufacturing	3.0	3.0	1.8	1.4
Durable	2.7	2.5	1.2	0.7
Nondurable	3.3	3.6	2.6	2.6
Nonfinancial Corporations	3.2	2.0	1.3	1.7

Source: Federal Reserve Bank of Kansas City

The paramount reasons, in my view, for the slowing of productivity growth are the decline in the pace of capital formation and the tremendous increases we have seen in energy prices.

Table 2 shows starkly that the growth rate of capital has declined markedly over the last thirty years, as has that of the capital to labor ratio.

Table 2

Annual Growth Rates of Productivity and Inputs Between Business Cycle Peaks (Per Cent Per Year)

	Output Per Hour	Capital Labor Ratio	Capital	Labor Hours
1948-53	3.65	4.21	4.59	0.36
1953-57	2.42	4.05	4.15	0.10
1957-60	2.45	2.91	2.68	-0.21
1960-69	3.07	3.29	4.65	1.32
1969-73	2.34	2.50	3.71	1.18
1973-78	1.11	1.32	2.69	1.35

Source: Bureau of Labor Statistics

The Federal Reserve Bank of St. Louis estimates that the level of capital per worker by mid-1979 was about 17% lower than that implied by the 1950-72 trend. The effect of this 17% loss would reduce private business output per hour by approximately 4.8%, and accounts for 39% of the decline of productivity growth between the periods 1952-1972 and mid-1972 to mid-1979. Thus capital formation has played a major part in the stagnation of productivity in the 1970's.

Inflation, of course, has tended to reduce business capital formation. Higher rates of inflation tend to reduce the purchasing power of fixed depreciation expenses which results in lower real cash returns in future periods. Also, the U.S. tax system treats interest payments made by firms as income to recipients and taxes them accordingly.

When interest rates rise to compensate investors for the loss in purchasing power of original sums lent to investors, these receipts - which are necessary to maintain the real wealth of investors - are treated as income. As a result, higher before-tax real rates of return are required to compensate for these taxes, further reducing incentives for firms to raise investment funds. And, since higher inflation rates also tend to increase uncertainty about the future, investors and firms view the cash flows that are expected from investment projects as riskier and are therefore more reluctant to invest.

Finally, the sharp rise in the relative price of energy since 1973 has been a major factor in the reduced rate of capital formation. It has created incentives to reduce energy, plant, and equipment usage per unit of output, by employing less energy per unit of capital and more labor-intensive methods of production. This has retarded the growth of plant and equipment.

The United States has been suffering from a relatively poor level of productivity. Table 3 shows that the United States has had the lowest growth rate from 1973-80 among major industrialized nations.

Table 3

Productivity Growth Rates for
7 Industrial Nations
(GNP/Employment)

	Total Economy, percentage changes, seasonally adjusted at annual rates, 1973-80(a)
West Germany	3.1
France	2.7
Japan	3.5
Italy	1.9
Canada	-0-
United States	-0-
United Kingdom	0.4

(a) Forecast values for 1980

Source: OECD Economic Outlook.

Furthermore, the 1979 Economic Report of the President reported that whereas in the U.S. 13.5% of Gross Domestic Product was devoted to investment, the corresponding figures for other major nations were: Japan 26.4%, Canada 17.2%, France 16.7%, West Germany 17.4% and the United Kingdom 14.9%. I therefore feel strongly that unless more incentives are created for capital formation in the United States, this country's relatively low productivity growth rate will continue and our position among worldwide economies will be eroded further.

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Equity Investment has Become Unattractive

During the past decade, corporations turned more and more to the debt markets to satisfy their needs for money. In part, this is attributable to the tax disadvantage that equity investment has at the corporate level. Because of the corporate income tax on net income, it is much more difficult to support a dollar of equity than a dollar of debt. To illustrate this, a simple example may be helpful:

Suppose a taxpaying corporation is earning 16% on invested equity capital, a level we believe appropriate in today's market, and that debt costs 15%. If one dollar is raised through issuance of debt, the company will have to generate 15 cents of cash to pay the interest. For the equity, however, 30 cents will be needed--16 cents to support the earnings, and 14 cents to pay the corporate income tax. Thus, in this example, twice the amount of price increases or sales growth is required to support the equity.

A second reason for the increased corporate emphasis on debt financing is the relatively low level of market price of many corporate stocks. In the current environment, a number of corporations find that their stocks are selling at substantial discounts from book value. Under such conditions the sale of new shares tends to reduce the basic equity value of all shares and therefore "dilutes" the future earnings of existing shareholders. Naturally, managements prefer not to take such action, and have turned to the debt markets instead. Table 4 illustrates the extent to which reliance on debt financing has increased in the last six years.

Table 4

Sources of Corporate Funds
(Billions)

	Internal Cash Generation		Net New Debt		Net New Equity		Total	
	Amount	%	Amount	%	Amount	%	Amount	%
Year								
1975	$104.6	72.4	$31.0	21.5	$8.9	6.2	$144.5	100%
1976	132.5	69.7	53.2	28.0	4.3	2.3	190.0	100
1977	139.6	62.5	79.7	35.7	4.0	1.8	223.3	100
1978	152.1	62.3	92.3	37.8	-0.1	-0.1	244.3	100
1979	160.1	60.8	107.8	41.0	-4.7	-1.8	263.2	100
1980	158.0	59.8	95.7	36.2	10.6	4.0	264.3	100

Source: Salomon Brothers

Despite the emphasis on innovative funds generating mechanisms such as the increased investment tax credit (ITC), the ITC based Employee Stock Ownership Plan, Dividend Reinvestment Plans, and employee savings plans, debt financing has continued to grow as a proportion of total sources of corporate funds.

We believe this increased reliance on debt financing has seriously eroded the borrowing margins of businesses generally, and has contributed to a general decline in the quality of debt as perceived by investors. More importantly, perhaps, it has increased the leverage of the affected corporations and therefore their financial risk.

Capital-Intensive Businesses Most Vulnerable

Obviously, companies with the greatest ongoing new investment needs have been most adversely affected by the current conditions described above. When growth rates are high and money is relatively expensive, corporations have a need to conserve cash for additional investment. In relatively high-payout industries such as public utilities, originial-issue Dividend Reinvestment Plans have been increasingly adopted, and, as mentioned above, the number of companies offering such plans now exceeds 175.

Companies that find it necessary to conserve cash have no real alternative to Dividend Reinvestment Plans. The only other way to keep earnings in the business is to reduce or eliminate the dividend, not a realistic alternative in today's market environment, where many shareholders require cash income, and many stocks sell on a yield basis.

The Need For Legislation Such as S. 141

Although Dividend Reinvestment Plans offering original issue stock have achieved a significant level of participation, it seems to me that individuals enrolled in the plans are disadvantaged under existing tax laws. Despite the fact that a participant receives no cash or other disposable income, reinvested dividends are taxed as ordinary income. An investor who chooses to reinvest his or her dividends therefore has a net outflow of cash, and suffers a decline in disposable income.

This situation is in marked contrast with the treatment of owners of stock in so-called "growth" companies - companies that normally pay out none or a small proportion of their earnings. Such companies frequently pay stock dividends instead, and are attractive because the return to the holder is taxed at more favorable capital gains rates.

To illustrate this, I assume that the average individual investor falls into the 30% tax bracket, and owns two types of stock. The first pays a 10% annual dividend and has a dividend reinvestment plan. The second declares stock dividends of 10%. If the investor participates in the reinvestment plan, the net effect on his ownership will be the same--he will receive no cash, but will end the year with 10% more shares. The tax consequences, however, are quite different. Tax at the 30% rate will be due on the reinvested dividends, whereas no immediate tax is due at all on the stock dividends. Obviously, this is a disincentive to reinvest.

Impact of S. 141 on Investors

The stock of high yielding capital intensive companies tends to be more heavily held by individuals than that of corporations generally. For example, a study undertaken by Salomon Brothers indicates that, on average, 76.5% of the stock of the 27 large public utilities for which data are available is held by individuals. This compares to 67% for all shares traded on the New York Stock Exchange. In comparison with other industries, therefore, those that are in greatest need of funds are also most heavily owned by individuals. Because individuals tend to be in higher tax brackets than institutional shareowners, (many of which are tax exempt), the passage of S. 141 should be most effective in precisely those businesses where it is most needed. In my opinion this would have three highly beneficial effects.

The first benefit would be to make such shares more attractive to individuals, thus widening the shareowner base. It is reasonable to believe that a wider ownership would contribute to increased stability in the marketplace and reduced price volatility.

A second benefit would be to attract back to business a number of individual investors who have been concentrating on tax shelters, tax-free investments, and real assets such as land, art, and precious metals. In this regard it is interesting to note that the institution of a 5% discount to existing plans caused a significant increase in participation, more than 100% on average. It also seems reasonable to expect that higher bracket individuals who currently find corporate equities unattractive would be brought back into the market.

The third benefit is that the legislation would put the cash or stock dividend decision in the hands of owners of the stock, who are presumably in the best position to choose the alternative best for them.

On balance, it seems reasonable to believe that provision of a tax deferral would cause participation in qualifying Dividend Reinvestment Plans to at least double, and would provide a valuable incentive for individuals to reenter the equity markets as long term investors.

Impact of S. 141 on Corporations

By increasing participation in Dividend Reinvestment Plans, a greater proportion of a corporation's cash needs could in effect be met internally. The decreased reliance on external financing would relieve pressure on the capital markets and strengthen corporate balance sheets. This will contribute to improved quality of corporate credit and a lower long-term cost of capital.

Because an increased proportion of dividends will be retained within the business, companies will have flexibility to increase the dividend rate, while still maintaining a low effective payout ratio. This in turn will enable the companies to meet the needs of both older, income-oriented shareowners, and those who prefer to increase their investment base.

The relatively smooth inflow of new equity through Dividend Reinvestment Plans reduces the need to sell stock in large amounts. This helps the company avoid having to finance in unusually adverse markets, and can, over time, reduce total financing cost.

Finally, it should be noted that Dividend Reinvestment provides benefits to the existing owners of the company, and helps increase shareowner loyalty and enthusiasm.

Because of these benefits, those businesses not presently employing an original issue Dividend Reinvestment Plan will have an increased motivation to begin one. Lacking any direct experience, it is impossible to precisely quantify the number of additional corporations that would institute such plans as a result of the passage of this legislation. However, it seems reasonable to expect that the great majority of capital-intensive, high-payout companies would choose to participate. Based on this belief, it is my estimate that the number of corporations offering such plans would increase from approximately 175 today to 250 or more.

Impact of S. 141 on Market Prices

There is no doubt in my mind that the ability to defer taxes is valuable to investors, and that passage of legislation such as S. 141 would cause the price of eligible stock to rise. The exact magnitude of any such price change is hard to estimate, but an increase of 10% or more would not be unreasonable. This estimate is based partly on a general feel for the market, and partly on a study of the only directly relevant example: Citizens Utilities Company.

Citizens Utilities is unique in having two series of stock that, in effect, permit holders to select stock dividends or cash dividends. Based on our studies, details of which are shown in Exhibit B, the ability to receive stock dividends has recently been worth about a

10% premium. Even more interesting is the fact that both series traded at a premium to utility stocks generally, as measured by comparison to the Standard & Poor's Utility Index.

This anticipated increase in market price could be expected to have a number of secondary effects. First, it would improve the market to book ratios of the affected companies, and reduce the dilutive impact of the issuance of new shares. Again, this is especially important for utilities, which are regulated as to return on book value. Exhibit C indicates that 86.5% of the offerings of common stock by Public Utilities since the beginning of 1979 were below book value.

Another effect would be to cause a shift in ownership away from large institutions, such as pension funds, that are already tax exempt, towards individuals. As mentioned previously, this should lead to a more stable market with less price volatility.

Impact of S. 141 on Tax Revenues

As I have said above, I believe that an increased rate of savings and investment on the part of individuals will have a long run beneficial effect on the rate of economic growth in the United States. In the short run, however, there is no doubt that the main attraction of the proposed legislation is the tax deferral, and some reduction in tax revenues could be expected. I have not made a detailed study of the tax implications of this legislation, but I am aware of several studies by others.

Analytical work by Robert Nathan Associates points to the potentially beneficial impact of proposals contained in this legislation.

It is estimated that by the third full year of operation, the tax incentive provided would more than double the participation in qualifying reinvestment plans, to about $2.5 Billion. This is estimated to generate an increase of $1.0 Billion in fixed private business investment, of $2.7 Billion in national output, and be likely to create 500,000 new jobs.

The Nathan study further estimates that the effect of the increases in employment, wages, and profits would be an annual net gain by the third year of some $600 Million in federal taxes. Net revenue losses in the first year are projected to be in the region of $350 Million, but this would disappear in the second year and be replaced by a net gain from the third year onward.

It seems to me that in addition to the stimulative effect of the additional investment, the tax impact of the proposed legislation will be lessened by two additional factors. First, it is to be expected that many of the individual investors who will be attracted to a tax-deferred Dividend Reinvestment Plan are those who currently invest in tax-exempt or tax-deferred vehicles. Because such investors currently pay little or no tax on their investments, the net impact of their participation will be minimal.

Secondly, shares held by institutions are largely tax free under current law. Any shift in ownership from tax exempt institutions will have no immediate effect on tax revenues.

Finally, it should be noted that the proposed new legislation would create a tax deferral, not a tax forgiveness. In the short run, individual investor decisions will no doubt result in sale of a portion of the newly-issued shares, and current taxation of the proceeds. In the long run, as the shares are ultimately sold, the reinvested dividends will be subject to taxation (although perhaps at a lower rate).

Impact of S. 141 on the Securities Business

It may seem strange that Salomon Brothers should be in favor of legislation that in effect enables corporations to bypass the investment banking community in the issuance of new shares. However, although passage of this bill would no doubt have an initial impact on the volume of equity underwritings, I believe that its long term effect will be positive for our business. As in the case of tax revenues, the enhanced level of overall economic growth, and the improvement in the securities markets that results, will more than make up for any initial adverse impact on investment banking.

A second consideration favoring this legislation from the viewpoint of the investment banker is its beneficial effect on the credit markets. As noted earlier, the great bulk of external corporate financing is in the form of debt securities. Although the proposed legislation will increase the formation of equity capital, there will always be a need for large amounts of new corporate debt. By strengthening the overall credit ratings of the affected corporations, this legislation will permit increased financing activities of all kinds, and a greater volume of business for the financial community in the long run.

Conclusion

I believe that the arguments presented above indicate that a reasonable provision for deferral of taxes on dividends reinvested in original issue stock will be of overall benefit to all concerned. The dollar limits proposed in S. 141 certainly bring it within the bounds of reason, and should insure that the primary tax benefits flow to the smaller individual taxpaying investor.

The potential benefits of this legislation are so important, and its need so critical, that I urge the members of the Committee to expedite its prompt passage into law.

Thank you for the opportunity to testify on this matter.

Respectfully submitted,

John S. Bain
Vice President, Salomon Brothers

EXHIBIT A

Corporations Currently Offering Original-Issue
Dividend Reinvestment Plans

ACF Industries
Alabama Bancorporation
Allegheny Power System
Allied Chemical
AMAX
American Electric Power
American Security Corp.
American Telephone & Telegraph
Ampal-American Israel
Corporation
Arizona Bank
Arizona Public Service
Atlantic City Electric Company
Ball Corporation
Baltimore Gas & Elec.
Bank of Virginia
Bankers Trust
Bell Canada
Black Hills P&L
Boston Edison
Brooklyn Union Gas
Carolina Power & Light
Carter Hawley Hale
Central Illinois Light
Central Ill. Pub. Svce.
Central Maine Power
Central and Southwest Corp.
Central Tel. & Utilities
Central Vermont Pub. Svce.
Cincinnati Gas & Elec.
Colorado National Bancshares
Columbus & So. Ohio Elec.
Commonwealth Edison
Connecticut General
Consolidated Natural Gas
Consumers Power Co.
Continental Telephone
Crocker National Corp.
Dayton Power & Light
Delmarva Power & Light
Dentsply International
Detroit Edison
Dominion Bankshares
Duke Power Co.
Earth Resources
Eastern Gas & Fuel Associates
Empire District Elec.
Equimark
First & Merchants
First National St. Bancorp
First Penn Corp.
First Security Corp.
Fleming Cos.
Florida Power & Light
Florida Public Service
Gas Service Co.
General Tel. & Electronics
Gulf States Utilities
Harnischfeger Corp.
Hartford National Bank
Hawaii Bancorp.
Hawaiian Elec.
Houston Industries
Illinois Power
INCO
Integon
Interlake
International Paper
Interpace
Interstate Power
Iowa Electric L&P
Iowa - Illinois G&E
Iowa Power & Light
Iowa Public Service
Iowa Resources
Iowa Southern Util.
Jewel Companies Inc.
Kaiser Aluminum
Kansas Gas & Elec.
Kansas Nebraska Natl. Gas.
Kansas Power & Light
Kansas City Power & Light
Kemper Corp.
Kentucky Utilities
Lincoln First Banks
Long Island Lighting
Louisiana P&L
Louisville G&E
Macy, R.H.
Madison Gas & Elec.
Manufacturers Hanover
Marine Corporation
Mercantile Texas Corp.
Middle South Util.
Minnesota Power & Lt.
Montana-Dakota Utilities
Montana Power
National Utilities Ind. Corp.
NCNB
Nevada National Bancorp.
New England Gas & Elec.
New England Electric Co.
New England Elec. Sys.
New York State E.&G.
Niagara Mohawk Power Corp.
"ICOR
NN Corporation
Northeast Utilities
Northern Ind. Pub. Svc.
Northern Natural Gas
Northern States Power
Northern Telecom
Northwest Energy Company
Northwest Natural Gas Co.
Northwestern Publ Svc.
Ohio Edison
Oklahoma Gas & Elec.
Oneida Ltd.
Orange & Rockland Utilities
Otter Tail Power Company
Pacific Gas & Elec.
Pacific Power & Light
Pacific Real Estate
Investment Trust
Panhandle Eastern Pipe-
line Company
Pennsylvania Power & Light
Peoples Gas
Philadelphia Elec. Co.
Pioneer Corp.
Portland Gen. El.
Potomac Electric Power
Property Trust of America
Public Service Colorado
Public Service E&G
Public Service Indiana
Public Serv. New Mexico
Public Serv. N. Carolina
Puget Sount P&L
Pullman, Inc.
Ralston Purina Co.
Rochester G&E
Safeway Stores
San Diego G&E
Savannah Electric Co.
Seaboard Coast Line
Seafirst Corp.
Sears Roebuck
Seattle First Nat'l Bank
Shell Oil
Sierra Pacific Power
So. Carolina E&G
So. California Ed.
Southern Company
Southern Indiana
So. Railway System
Southwestern Public
Service
Sperry Rand
Standard Brands
Suburban Propane Gas
Texas Utilities
Texasgulf
Transco
UGI Corporation
Union Carbide
United Illuminating
United Jersey Banks
U.S. Steel
United Telecom.
Universal Foods
Utah P&L
Virginia Electric & Power
Virginia Natl. Bankshares
Washington Energy Co.
Williams Companies
Wisconsin Elect. Pwr.
Wisconsin P&L
Wisconsin Public Service

EXHIBIT B

Citizens Utilities Company

Citizens Utilities Company is unique among widely held, publicly-owned companies in having a two-series capitalization which provides investment media suitable for all classes of investors.

Citizens Utilities Series B shares carry conventional cash dividends and appeal to investors who wish to receive current taxable income. Since 1956, their Series A shares have paid stock dividends only and therefore have particular attraction to those investors who wish to compound their investment at no additional cash cost and without taxation during the compounding period.

Under the provisions of the Tax Reform Act of 1969 [Section 421 (b)(2)(a)] there is no taxable income to Series A stockholders on stock dividends received through December 31, 1990, and those stock dividends fall in the capital asset category. Sale of the stock received generates capital gains or losses. Such gains or losses are based on the difference between sale price and "adjusted basis" per share. "Adjusted basis", in turn, is calculated by reducing the original purchase cost or investment per share by the percent of each stock dividend subsequently received. Furthermore, if the original shares upon which stock dividends are paid have been held for more than the long-term capital gains period, any gain on sale of shares representing stock dividends (even if immediate) is treated as a long-term capital gain.

The favorable tax implications of holding Series A shares leads one to expect that Series A shares should trade at a premium to

Series B shares. Tables 5 and 6 show that this has indeed been the case.

During 1979, 1980 and 1981 (through March) Series A shares consistently traded at a premium over Series B shares. This premium (based on monthly data) was, on average, 14.69%. Furthermore, over the last five years, the A shares traded at a premium over the B shares for 16 of 20 calendar quarters.

Table 7 compares the yield on Citizen Utilities shares with the yield on the S&P Utility Index. Not only is the yield on Series A for the last three years below that of Series B (as might be expected), but yields on both Series are generally well below yields on the S&P Utility Index. Thus, the market is placing a premium on all of Citizens Utilities' shares, which we feel is more than partially due to the existence of the tax deferral on its Dividend Reinvestment Plan.

Table 5: Quarterly Data

Citizens Utilities Comparison of Series A (Stock Dividend) and Series B (Cash Dividend) Shares During 1979 and 1980

Quarter		Series A HIGH	Series A LOW	Series B HIGH	Series B LOW
1979	1	37.000	35.250	32.000	29.500
	2	40.250	36.000	36.500	32.000
	3	40.000	38.250	36.500	33.750
	4	38.250	32.125	33.500	27.750
1980	1	33.046	26.581	31.750	26.250
	2	37.835	28.017	33.500	27.250
	3	39.500	34.750	34.500	30.500
	4	38.250	31.750	29.500	28.750
1981	1	34.750	31.250	29.500	27.250

Table 6: Monthly Data

	Month	Series A HIGH	Series A LOW	Series A Last Bid	Series B HIGH	Series B LOW	Series B Last Bid	Premium of A Last Bid Over B Last Bid
1979	Jan.	37.000	36.000	36.250	30.250	30.000	30.000	20.83%
	Feb.	36.250	35.500	35.500	30.500	29.500	30.250	17.36
	Mar.	36.000	35.250	36.000	32.000	30.500	32.000	12.50
	Apr.	38.750	36.000	37.500	33.750	32.000	33.000	13.64
	May	39.500	37.500	39.500	35.000	32.750	35.000	12.86
	June	40.250	37.750	40.000	36.750	34.750	36.500	9.59
	July	40.000	39.500	39.750	36.500	36.000	36.250	9.65
	Aug.	40.000	39.500	39.750	36.250	35.000	35.000	13.57
	Sept.	39.750	38.250	38.250	35.000	33.750	33.750	13.33
	Oct.	38.250	34.500	35.500	33.500	30.000	30.250	17.36
	Nov.	37.000	32.125	36.750	30.250	27.750	30.000	22.50
	Dec.	36.500	33.750	34.750	32.500	30.000	31.500	10.32
					1979 Average Premium			14.46%
1980								
	Jan.	33.046	30.651	31.609	31.750	29.750	31.000	1.96%
	Feb.	32.807	29.694	29.694	31.750	29.000	29.000	2.39
	Mar.	30.412	26.581	27.299	29.750	26.250	26.750	2.05
	Apr.	33.764	28.017	33.046	29.500	27.250	28.500	15.95
	May	37.596	33.046	36.638	31.000	28.500	30.000	22.13
	Jun.	37.835	35.750	35.750	33.500	30.000	32.750	9.16

Table 6: Monthly Data (Continued)

		Series A			Series B			Premium of A Last Bid Over B Last Bid
		HIGH	LOW	Last Bid	HIGH	LOW	Last Bid	
1980	Month							
	Jul.	36.000	34.750	35.500	34.500	33.000	34.250	3.65%
	Aug.	39.000	35.250	38.750	34.250	31.750	31.750	22.05
	Sept.	39.500	36.750	36.750	31.750	30.500	30.500	20.49
	Oct.	38.250	36.750	37.750	30.500	28.750	28.750	31.30
	Nov.	36.750	35.750	36.250	28.750	27.500	27.500	31.82
	Dec.	35.000	31.750	33.750	27.500	24.500	27.250	23.85
					1980 Average Premium			15.57%
1981								
	Jan.	34.750	33.000	33.000	29.500	27.250	29.250	12.82%
	Feb.	32.750	31.250	32.250	29.000	28.000	28.750	12.17
	Mar.	33.000	31.750	32.000	28.750	27.750	28.750	11.30
					1981 Average Premium			12.10%

Table 7

Citizens Utilities: Comparison of Series A and Series B Share Yields With the S&P Utilities Index (December Averages)

Year	Series A Yield	Series B Yield	S&P Utility Index Yield
1980	8.6%	10.1%	9.46%
1979	7.8	8.1	9.43
1978	6.8	7.7	8.99
1977	6.6	6.6	7.62
1976	6.8	6.4	7.22
1975	7.5	6.7	8.39

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EXHIBIT C

Summary of Utility Public Common Stock Offerings
1979 Through 7/9/80

Date	Company	Size Shares (000)	Size Amount (000)	Price/Book Ratio*
1979				
1/ 9	Middle South Utilities	8,500	$130,050	84%
10	Louisville Gas & Elect.	1,000	21,000	84
16	Pub.Svc.Co. New Hamp.	2,000	41,000	89
18	Iowa Power & Light	375	9,609	99
23	Texas Utilities Co.	5,000	97,500	96
23	El Paso Electric Co.	1,500	16,500	108
24	Atlantic City Elec.	1,000	19,875	93
2/ 7	Houston Industries	2,000	58,250	89
8	Commonwealth Edison	7,000	187,250	91
14	Ohio Edison Co.	6,000	99,000	101
27	Portland General Electric	5,000	89,375	98
3/ 8	Northwest Energy Co.	500	15,250	71
13	Minnesota Power & Light	1,000	20,150	90
14	Duke Power	5,500	107,250	92
28	Kentucky Utilities	1,000	20,000	80
4/ 3	Philadelphia Electric	4,000	65,500	85
3	Iowa Public Service	1,000	21,500	96
11	Otter Tail Power	500	10,875	92
18	South Carolina E & G	1,000	16,875	91
19	Illinois Power Co.	3,000	66,750	101
24	Pub.Svc.Co. Colorado	2,500	40,313	91
5/ 8	Kansas City Pwr. & Lt.	1,600	40,800	76
15	Pub.Svc. New Mexico	2,500	48,125	87
23	Delmarva Pwr. & Lt.	2,000	25,250	79
6/ 6	Missouri Pub. Svc.	300	3,525	78
13	Northern Indiana Pub.Svc.	2,000	30,500	79
13	Washington Energy Co.	600	8,700	77
19	Toledo Edison Co.	2,000	42,250	86
21	Utah Power & Light	2,200	41,800	106
27	Arizona Public Service	2,000	39,250	89
7/10	Continental Telephone	2,000	33,500	116
11	Pub.Svc.N. Hampshire	2,000	39,000	84
17	Detroit Edison	6,000	89,250	79
17	San Diego Gas & Elec.	3,000	45,000	85
18	NICOR Inc.	1,500	47,250	95
31	Boston Edison	2,000	44,750	72
31	United Energy Resources	1,000	44,000	131

Summary of Utility Public Common Stock Offerings 1979 Through 7/9/80

Date	Company	Shares (000)	Amount (000)	Price/Book Ratio*
1979				
8/ 1	Cleveland Elec. Illum.	4,500	81,000	95
7	El Paso Electric	1,500	16,500	109
14	Oklahoma Gas & Elec.	2,500	41,875	100
15	Idaho Power	1,500	38,438	89
21	Nevada Power Company	750	19,969	105
22	Allegheny Power System	4,700	82,955	83
28	Public Service Indiana	2,000	50,500	105
9/ 6	American Electric Pwr.	8,000	$150,400	87%
20	Central & Southwest Corp.	5,000	73,250	92
25	Niagara Mohawk Power	3,500	46,375	75
25	Southwest Gas Corp.	2,000	24,500	111
26	Northwest Energy Co.	1,800	43,200	106
10/ 2	Mid-Continent Telephone	1,000	20,125	123
3	Kansas Pwr. & Light	1,800	33,300	79
10	Public Service E. & G.	3,000	59,250	76
16	Houston Industries	2,500	68,750	82
23	Pacific Gas & Electric	9,000	196,875	73
30	Long Island Lighting	7,489	99,981	67
31	Kansas Gas & Elect.	2,000	31,000	72
11/ 1	Gulf States Utilities	3,500	39,813	72
7	Duquesne Light Co.	3,800	53,200	93
13	Northwestern Pub.Svc.	300	4,500	77
13	Middle South Utilities	5,000	65,000	70
14	Northwest Natural Gas	700	10,605	121
19	Kentucky Utilities	1,000	18,375	73
19	Virginia Elec.&Pwr.	6,000	66,750	58
20	Arizona Public Service	2,500	43,125	75
20	Montana-Dakota Utilities	850	15,513	85
27	Pennsylvania Pwr. & Lt.	2,500	46,250	71
28	Central Illinois Pub.Svc.	2,200	26,400	83
29	Puget Sound Pwr. & Lt.	3,000	43,125	77
12/ 4	Consumers Power Co.	4,000	81,000	71
4	Iowa Electric Lt. & Pwr.	1,000	14,625	79
4	Eastern Utilities Assoc.	600	7,575	70
11	Union Electric Co.	5,500	63,938	72
12	Northern Indiana Pub. Svc.	2,000	28,750	76

Summary of Utility Public Common Stock Offerings 1979 Through 7/9/80

Date	Company	Shares (000)	Amount (000)	Price/Book Ratio*
1980				
1/10	Portland General Elec.	4,000	$ 57,500	79%
16	Pacific Power & Light	3,000	7,963	87
17	Hackensack Water Co.	350		
29	Cincinnati Gas & Elec.	3,400	54,825	78
2/ 4	Ohio Edison Co.	6,500	87,750	84
5	Southern Calif. Edison	7,000	161,875	68
13	Carolina Pwr. & Light	4,500	75,938	66
13	El Paso Electric	1,500	14,438	93
20	Pub. Svc. New Hampshire	1,500	22,125	66
21	Central Hudson G & E	500	8,250	60
26	Pub. Svc. Colorado	2,750	31,625	67
26	United Illuminating	500	10,250	67
28	Commonwealth Edison	8,000	147,000	64
3/ 4	Eastern Gas & Fuel Assoc.	1,500	33,375	127
4	Texas Utilities	5,000	77,500	75
5	Arizona Pub. Svc.	4,000	59,000	65
5	Montana Power	1,500	31,500	78
6	Illinois Power	3,000	47,625	71
19	Kansas City Pwr. & Light	1,500	27,750	58
20	San Diego Gas & Elec.	2,500	28,750	66
4/ 2	Upper Peninsula Power	200	2,400	60
8	North-West Telephone	175	2,843	104
9	Otter Tail Power	500	9,000	73
15	Houston Industries	3,000	82,125	79
28	Kentucky Utilities	1,500	26,438	73
29	Middle South Utilities	7,000	88,550	69
5/ 6	Sierra Pacific Power	1,500	20,100	83
8	Public Service E & G	5,000	101,875	77
12	Duquesne Light Co.	4,000	59,000	83
13	Connecticut Water Service	200	2,100	78
13	Kansas Gas & Electric	1,500	24,562	80
14	Detroit Edison	4,000	52,500	71
15	Central Louisiana Energy	2,000	46,500	95
20	Toledo Edison	2,000	38,500	79
28	Fitchburg Gas & Elec. Lt.	100	2,300	84

Summary of Utility Public Common Stock Offerings
1979 Through 7/9/80

Date	Company	Shares (000)	Amount (000)	Price/Book Ratio*
1980				
6/ 3	United Cities Gas	200	$ 2,200	63%
4	Montana-Dakota Utilities	1,000	20,000	92
5	Northern Indiana Pub. Svc.	2,000	26,500	71
12	Washington Water Power	1,600	30,000	76
18	Gulf States Utilities	3,000	37,500	80
19	Nevada Power Co.	1,000	24,135	118
19	United Illuminating	1,000	22,125	73
24	Niagara-Mohawk Power	4,000	56,500	80
30	Central & South West	6,000	87,750	89
7/ 7	Piedmont Natural Gas	400	8,250	93
8	Dayton Power & Light	2,500	36,875	80
9	Louisville Gas & Elec.	1,500	28,688	79
9	Pub. Svc. New Hampshire	2,200	37,675	79
10	Philadelphia Electric	7,000	105,000	80
8/ 5	Cleveland Electric	4,000	66,000	86
6	El Paso Electric	2,000	20,750	101
7	Puget Sound Pwr. & Lt.	3,500	47,688	76
12	New York State Elec. & Gas	2,500	41,250	74
12	South Carolina E & G	1,000	15,750	86
14	Iowa-Illinois Gas & Elec.	1,000	17,750	81
19	Duke Power	4,000	69,500	77
20	Century Telephone	950	8,550	90
21	Public Service Indiana	2,700	56,363	83
26	Idaho Power	1,500	35,250	76
9/ 4	Central Ilinois Publ Svc.	2,300	27,600	85
5	San Diego Gas and Elec.	2,000	28,000	82
9	Pub. Svc. Colorado	3,000	39,375	78
10	Consumers Power	4,000	73,000	65
10	Hydraulic Company	400	5,900	78
16	Colonial Gass Energy	700	7,000	66
16	Virginia Electric & Power	5,000	56,250	60
17	Florida Power Corp.	3,000	44,625	83
18	Southwest Gas Corp.	1,000	10,375	93
23	Arizona Public Service	5,000	88,750	83
30	Northern Indiana Pub. Svc.	3,000	35,250	64
10/ 2	Houston Industries	3,000	79,500	77
7	Utah Power & Light	4,000	67,000	90
14	Middle South Utilities	8,000	97,000	68

Summary of Utility Public Common Stock Offerings
1979 Through 7/9/80

Date	Company	Shares (000)	Amount (000)	Price/Book Ratio*
1980				
10/23	Community Public Service	200	3,250	67%
28	Carolina Power & Light	4,000	73,000	74
29	El Paso Electric	2,000	18,750	89
11/12	Southern Company	11,000	129,800	69
18	Hawaiian Electric	420	9,450	76
18	Rochester Gas & Electric	1,500	19,875	62
19	Central Maine Power	1,600	19,600	70
20	Kansas Gas & Electric	1,750	25,375	70
25	Central Hudson G & E	650	11,294	64
25	Pennsylvania Pwr. & Lt.	3,500	57,313	64
12/ 1	UGI Corporation	600	20,295	130
2	Florida Power & Light	1,750	43,969	71
3	Detroit Edison	2,250	25,031	61
3	Pacific Gas Transmission	800	28,800	394
4	United Energy Resources	2,000	100,000	220
9	Pacific Gas & Electric	6,000	120,000	66
9	Union Electric Co.	5,500	58,438	65
11	Mountain Fuel Supply	900	39,825	148
15	Commonwealth Edison	9,000	148,500	58
17	Gulf States Utilities	2,000	21,250	67
1981				
1/13	Panhandle Eastern Pipe Line	2,000	88,000	191
22	Southern California Edison	8,000	195,000	73
28	Iowa Elec. Light & Power	1,000	12,500	69
29	Cincinnati Gas & Electric	2,000	30,500	76
30	Pulbic Service Indiani	3,250	63,781	79
2/ 4	Pub. Svc. New Hampshire	2,200	33,000	71
24	Portland General Elec.	3,000	36,375	70
26	Pub. Svc. New Mexico	3,500	70,875	87
3/ 6	Houston Industries	3,000	75,750	72
18	Texas Utilities Co.	5,000	88,750	82
25	United Illuminating	1,400	27,300	67
26	Arizona Public Service	5,000	83,750	76

Summary of Utility Public Common Stock Offerings
1979 Through 7/9/80

Date	Company	Shares (000)	Amount (000)	Price/Book Ratio*
1981				
4/ 2	Kansas Gas & Electric	2,000	28,600	70%
2	Sierra Pacific Power	1,500	18,188	79
3	Philadelphia Electric Co.	5,000	61,875	66
7	American Electric Power	9,000	146,250	77
9	Montana Power Co.	1,500	43,125	107
14	San Diego Gas & Electric	2,000	24,250	76
21	Toledo Edison	1,500	24,563	69
22	Washington Water Power	1,100	18,425	71
23	Long Island Lighting	9,000	128,250	73

	Issues	
	Number	Percent
Issues under book	154	86.5%
Issues at or over book	24	13.5
Total common issues	178	100.0%

*Reoffering price as a percentage of Book Value

[Hearing adjourned at 1:05 p.m.]

[By direction of the chairman the following communications were made a part of the hearing record:]

STATEMENT OF SENATOR GEORGE J. MITCHELL

The economic climate facing us today makes it clear that our priority in economic policy must be to encourage savings and investment through whatever avenues are possible.

That should include the development of new legislation to help channel funds into longer-term savings through tax incentives, as well as a review of existing law and action to modify those elements of it which inadvertantly discourage savings or discriminate against investment.

One such feature of existing law is the current requirement that when stockholders choose the option of reinvesting in stock rather than accepting cash dividends, the current cash value of the stock is treated as taxable income. The tax penalty does not arise when stock dividends are issued in place of cash dividends, but only in those circumstances where the stockholder is given a choice.

Clearly, this tax treatment discriminates against the person who wants to reinvest his stock dividend. The inflexibility in the law means that a company which would like to offer its stockholders the choice of taking dividends in cash or stocks is forced to penalize those stockholders who would prefer to increase their investment rather than accept cash paid out.

This provision of the law serves neither tax equity nor the national need to increase investment. It should be modified to remove the tax penalty, and a bill before us today, S. 141, provides a means of making that modification promptly and efficiently.

This measure would permit companies to establish qualified plans for stock dividend reinvestment which would retain the element of choice for the stockholder, to accept either cash or common stocks, but would permit those who chose common stocks to exclude up to $1500 per taxpayer from treatment as taxable income. The exclusion would be $3000 for joint returns.

Encouraging dividend reinvestment plans is a highly efficient method of stimulating private saving. Tax benefits are confined to new issues of corporate stock, which is probably the most productive form of private saving.

This modest tax incentive would particularly benefit those companies, such as utilities, for which capital appreciation possibilities are limited because they can offer only a regulated return, and which must therefore offer substantial cash dividends to attract the investment they need. A partial tax incentive plan such as is contained in S. 141 would permit stockholders who rely on cash dividends for current income to be served and would also permit companies to attract and retain the investment dollars of those whose desire for income is not immediate.

I am glad the Committee has chosen to examine this proposal along with other savings and investment incentives, and I hope the full Senate will act favorably on it as well.

ANALYSIS OF THE SAVINGS AND RETIREMENT INCOME INCENTIVES ACT OF 1981

(By Michael J. Boskin, Professor of Economics, Stanford University)

The United States has the lowest private saving rate of any advanced economy; in recent years, the personal saving rate has fallen still further; both to provide a source of income in later years (especially retirement) and to help finance badly needed capital formation, it is widely recognized that an increase in our saving rate is an extremely high priority. The Savings and Retirement Income Incentive Act of 1981 contains a variety of features designed to encourage saving. The extent to which it does so depends upon the extent to which each of its provisions reaches a substantial fraction of the population; the nature of the changes in the incentives these people face; and their response to these changed incentives. The major provisions of the Bill are as follows:

A. Liberalization of Individual Retirement Accounts.

1. Allows all employees to start an IRA;
2. Increases deductible limit to $2,000;
3. Eliminates 15 percent ceiling;
4. Allows supplemental non-deductible annual contributions up to $2,000; and $8,000 lifetime additional;

5. Allows withdrawals prior to age 59½ of up to $10,000 under certain conditions.

B. Makes the $200 interest/dividend exclusion permanent and increases it to $500 for taxpayers over age 65 (double these for joint returns).

For each of these aspects of the Bill, it is necessary to determine the taxpayers who will be affected; how they will be affected; and their response to these changed incentives. Using a variety of data sources, usually from the year 1976 (then updated to the present) such as the Statistics of Income, special supplemental reports on Individual Retirement Accounts, etc., I determine for each of these provisions the number of individuals likely to be affected; the likely change in the incentives they face—both in terms of their after-tax income and the effective after-tax after-inflation rate of return on their saving opportunities; and, their likely response to such changes. It is important to note that at each stage of this process, a variety of assumptions must be made. For example, once we determine how many newly eligible for expanded IRA coverage returns there will be, we still have to assume an interest elasticity of private saving, an effective tax rate, a distribution of current savings in the population newly affected, etc., in order to derive the change in aggregate saving the provision will induce. These assumptions are discussed below.

The effect on saving from expanding coverage would create approximately 33 million newly eligible returns. I estimate under what I consider to be the most reasonable set of assumptions an aggregate annual increase in saving of approximately 10.3 billion dollars. This number is derived by taking the distribution of saving for newly and previously eligible returns to be the same; and assumes that approximagely one-half of those households currently saving zero will have some response to the availability of an IRA. We have also assumed a modest interest elasticity of saving of 0.4.[1]

Approximately 45 percent of those who are already eligible for IRA participation contribute the maximum. By taking the distribution of those already saving $2,000, or greater than 15 percent of AGI, we can estimate those who may be "constrained" by the limit. This leads to an estimated saving increase of 0.4 billion dollars.

The non-deductible contribution is also likely to encourage saving substantially. This occurs because the interest on the non-deductible part of contribution is not taxed on accrual, and hence the effective after-tax, after-inflation rate of return on such contributions is greater than that on ordinary saving taxed on accrual under current law. Once again, the size of the estimated response depends upon assumptions about how those currently saving zero will respond, the assumed interest elasticity, etc. My best estimate is that this provision of the Act will encourage approximately 7 billion dollars of saving annually.

The effect of the special exclusion for those over age 65 is unlikely to be large because the overwhelming bulk of those over age 65 receive interest and dividends beyond the exclusion; hence, there would be no rate of return effect for them. Further, the elderly have higher propensities to consume than the average. The total increase in saving would certainly be less than one billion dollars.

The effect of making the interest-dividend exclusion permanent relative to having it expire as under current law, is difficult to estimate because data for the very recent past on the distribution of interest and dividend receipts is difficult to come by. Using data from even a few years ago, given the substantial increase in interest rates and nominal asset values in last several years, could make the estimate quite misleading. It is important to note that a substantial fraction of the low and moderate income population receives less than the $200/$400 limit, because their saving both annually and in the aggregate is quite modest. For this group, a price effect would be created and we would expect some increase in their saving. My own best guess is that perhaps another billion dollars or so would be generated under such a scenario.

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[1] To test the sensitivity of our results to variations in the assumptions, we note that assuming a larger interest elasticity of saving, such as 1.0, would increase the aggregate saving response by approximately 60 percent; assuming that all of those who are currently saving zero respond would increase the response by about 50 percent; assuming that none do, would reduce it by approximately 50 percent. Assuming that participation rates under the newly available IRA's would remain at the participation rates of 1976 for those then eligible for IRA's would reduce our figures about one-quarter of the total presented above. However, IRA participation has apparently expanded greatly since 1976; the likely development of increased IRA participation by spouses; the preferable liquidity features under the proposed law, etc., all suggest that participation rates are likely to be larger than they were in 1976 under the existing law.

Thus, a best guess aggregate effect would be as follows:

Saving gain from:	*Billions*
Expanded coverage	10.3
Increased limit for those currently with IRA	.4
Nondeductible option	7.0
Interest exclusion (of which maximum of $1 billion due to extra exclusion of elderly)	2.0
Total (in 1976 dollars per years [1])	19.7

[1] Changing this total to 1981 dollars, using the GNP deflator would result in an increase of approximately 40 percent between 1976 and early 1981.

The estimated annual increase amounts to approximately 28 percent of personal saving based on 1976 saving levels; and perhaps slightly more based on the current lower personal saving rate. Therefore, it appears that the impetus for saving will be substantial and very cost-effective from the expansion of IRA coverage and the inclusion of the non-deductibility option. The key is to broaden participation in such programs.

The full analysis upon which these numbers are based is available from the author upon request; the technical derivation of these estimates involves 25 pages of tables concerning who is potentially eligible, how much was contributed, etc. For practical purposes, rather than including all of this here, we merely repeat that we have estimated weighted average marginal tax rates, the distribution of saving, the average propensity to consume, participation rates, etc., from Statistics of Income sources and correlative data. Once again, because of the very large percentage of low and middle income filing units, who would become eligible under this plan, who are currently saving zero, it is important to evaluate how those saving zero will respond to the availability of an IRA. We have had to make a variety of other assumptions in estimating the impact of particular provisions on the available after-tax, after-inflation returns, etc. Our estimates assume that tax rates at retirement are approximately one-half their current rates; nominal interest rates over the next 20 years will average 10 percent with an inflation rate averaging 7 percent (these are approximately the intermediate case assumptions of the Social Security Administration actuarial forecasts), and that the average number of years to dissolving a plan is 20 years. A higher inflation and higher nominal interest rates, will mean that the after-tax, after-inflation return on available non-IRA type saving vehicles is still lower and therefore, the rate of return effect by allowing deductible contributions to an IRA account will be still larger. In this context, I believe these assumptions are conservative, and that the saving response would be still larger in such an environment.

STATEMENT OF
AMERICAN BANKERS ASSOCIATION
BEFORE THE
SUBCOMMITTEE ON SAVINGS, PENSIONS,
AND INVESTMENT POLICY
COMMITTEE ON FINANCE
UNITED STATES SENATE

May 15, 1981

The American Bankers Association (ABA) is a trade association composed of more than 13,100 banks - over 90% of the nation's full service banks. Approximately 4,000 of these banks are authorized to serve their customers as trustees and executors. ABA has consistently supported efforts to eliminate our tax law's inherent bias against savings and investment in favor of consumption. We appreciate the opportunity to present our views on the general subject of savings and investment incentives, with particular emphasis on the exclusion for interest and dividends, dividend reinvestment plans and tax-deferred roll-over accounts.

Before we begin to discuss specific legislative proposals, we would like to make one point very clear. The American Bankers Association has placed its wholehearted support behind the President's National Economic Recovery Program. The problems which created the need for tax incentives have been severely aggravated by the inflationary conditions that have plagued our economy. The spending cuts recommended by the President and the priorities he has set for tax reductions are essential to controlling inflation. This is and will continue to be our Association's highest priority.

Measures designed to encourage savings and investment should be addressed at the appropriate time within the framework of the President's tax reduction priorities. All the proposals under consideration by the subcommittee are constructive in nature and each offers its own benefit for capital growth.

We recognize, however, that Congress cannot enact all of them as proposed. We urge the Committee to support the President's tax proposal and then to the extent that additional tax cuts can be made, we urge Congress to consider the value of each of the following programs to economic growth and allocate revenue reductions to the programs where they will do the most good.

Interest and Dividend Exclusion

Any change in the tax law which encourages and rewards savings and investment rather than consumption is an important weapon in the fight against inflation. The ABA was a principle supporter of the exemption for up to $200 per year in interest on savings which took effect in January. The small saver, particularly, deserves a better break. This exemption is clearly a step in the right direction and we think the exemption should be made permanent. Any increase in the amount of the exemption, however, should be evaluated in the context of the broader tax reductions proposals presently under consideration by Congress. The ABA believes that the overall tax reduction package, including any increase in the exemption level, should be contingent upon the extent to which corresponding reductions in Federal expenditures are made.

Dividend Reinvestment Plans - S. 141

Under current law, a stockholder who elects to reinvest his cash dividend must pay a tax on the fair market value of the stock dividend at the time initially received. This is in contrast to the tax treatment accorded a conventional stock dividend, declared at the election of the company, where the stockholder is not currently taxed upon receiving the stock, but rather is taxed when he or she sells or otherwise disposes of the shares received as a dividend. The imposition of a current tax on reinvested dividends is an obstacle to increased participation in dividend reinvestment plans and a significant limitation on new capital formation, new capital investment and savings provided under such plans.

The dividend reinvestment proposal incorporated in S. 141 would defer current taxes on cash dividends reinvested in newly issued common stock (with an annual limit of $1,500 for a single taxpayer and $3,000 for a joint return) of any domestic company that has established a qualified dividend reinvestment plan. The stock received on such reinvestment would be treated, for tax purposes, as essentially the equivalent of a conventional stock dividend. The basis of the qualified dividend stock would be zero, so that when the stock is sold at a later date the full amount of the sales proceeds would be taxable. In general, the proceeds from the sale of the stock would be taxed as capital gains.

The proposed legislation would not only provide tax relief at the individual taxpayer level, it would encourage capital formation and captial investment which will lead to increased productivity. The dividend reinvestment proposal encompassed in S. 141 represents a direct, closely-targeted and cost-effective program of encouraging <u>new</u> capital formation in those companies that cannot realize or retain tax savings and that are heavily dependent for their capital requirements on outside financing. Reinvestment in new issue stock would substantially assist 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 financing.

In addition to encouraging the formation of new capital where it is most urgently needed, a dividend reinvestment plan would finance more efficient facilities thereby creating new employment opportunities. Moreover, it would absorb cash dividends which might otherwise be added to consumer demands. For the stockholder who does not need cash dividend, a dividend reinvestment plan provides a way for him to increase current savings and to build an investment which can provide larger cash dividends in the future when they may be needed as supplemental retirement income. The proposal as such would be counter-inflationary as it would encourage savings and productive investment rather than consumption.

The objective of dividend reinvestment plans is to encourage new capital formation and new capital investment in capital intensive industries which require frequent infusions of capital. Only those industries which have a continuing need for new common stock will adopt dividend reinvestment plans as a means of raising equity capital. Unless there is a pressing need for additional capital, a company will not want to sell additional shares and unnecessarily dilute the per share earnings and market price of its common stock.

The ABA believes that tax-deferred dividend reinvestment plans should not be limited in scope to any particular industry, for example, public utilities. This would result in a form of credit allocation which we vigorously oppose. This country has well developed capital markets that channel funds to those areas of the economy where they can be used most productively. The creation of incentives to allocate funds into one particular industry may very well divert funds from other industries where they might be more productively used. Capital shortage in this country is not limited to any single industry. It is a problem that confronts all capital intensive industries that find themselves in growth situations.

Dividend reinvestment tax deferred legislation should be equally applicable to any company that has a qualified dividend reinvestment plan and a continuing need for extra capital. To the extent that it is affordable within the context of the President's economic recovery package, a tax deferred dividend reinvestment proposal should be designed to encourage new capital formation and capital investment in all segments of the capital intensive business community.

Tax Deferred Rollover Accounts - S. 457

Currently, the tax laws discourage the shifting of investment capital from unproductive to productive investments through the imposition of a tax on the appreciated value of the transferred capital. Though the taxpayer immediately reinvests the whole amount in another enterprise, the tax laws require that taxpayer to "recognize" the gain and pay a tax on it. Faced with the choice of a lower return on the current investment, or a higher return on the new plus a tax upon the transferred appreciated capital, many investors will prefer to remain with their current investments.

Capital which remains in sluggish enterprises will do nothing toward stimulating the economy, promoting innovation or creating jobs. To achieve these goals, the tax laws should be revised to encourage investors to seek the most productive investments available.

S. 457 is a positive step toward the reshaping of tax policy regarding reinvested capital. By providing for the deferral of tax which would otherwise be imposed, it would facilitate the transfer of capital to investments which offer a greater economic development potential. Deferral will encourage long-term commitment to investment without placing a stranglehold on assets that could discourage small investors.

This deferral will not necessarily result in a revenue loss to the Treasury. Any revenue deferred could be more than offset by additional revenue generated through economic growth. Tax on gain transferred to a new investment will provide a few extra dollars today but the nation will be poorer in the long run for having tied up capital in less productive investments.

S. 457 would free capital for dynamic investments which will yield a higher return for the investor and benefit the economy as a whole. The rollover accounts could not be used to shelter ordinary income or convert it into capital gains. Any dividends received would be fully taxed in the year of receipt. Any capital not reinvested would be subject to the normal capital gains tax.

To qualify for this deferral of tax, an investor would have to set up a qualifying rollover account. These trusts would have to meet various requirements, one of which is the non-commingling of assets of the account with other accounts of the taxpayer or other individuals. Such a criterion, however appealing in the abstract, has the effect of barring investment of these accounts through common trust funds, qualifying as rollover accounts.

A common trust fund ("CTF") is a collective investment vehicle through which a bank is able to invest the assets of the many small trusts of which it is the trustee, and obtain for these trusts advantages which would otherwise be available only to larger trusts. Through the common trust fund, these small trusts receive the strength of diversified investments, greater investment opportunities, improved administration of accounts and reduced costs of operation.

A particular trust accounts's participation in a collective investment fund maybe expressed in terms of units held. The collective funds are periodically valued and the value of the fund is adjusted accordingly. The fund is not taxed as an entity; the tax consequences flow through annually to the participating trusts in proportion to their respective interests in the fund.

Common trust funds are regulated by the Comptroller of the Currency. The types, amounts and methods of investment are controlled and fiduciary duties apply.

Changes should be made to permit individual trusts to roll over units of CTFs to other qualifying investments; and permit individuals to invest in CTFs through their rollover accounts. When an individual rollover account is invested in a common trust fund any capital gains or losses of the fund would not be recognized by the individual account.

These changes should allow taxpayers currently participating in common trust funds not to be at a disadvantage vis-a-vis individuals who made other investments. Unless common trust funds have the flexibility to compete with other investment devices such as money market funds, common trust fund investors will suffer a penalty in the form of a capital gains tax if they choose to shift to a rollover account. In the future common trust funds may find it more difficult to attract new participants since they will not be able to offer the rollover feature available to other forms of investment.

This discrimination is unwarranted. If this subcommittee and the Congress decide that special tax treatment should be afforded to trusts which invest in securities, stock, and interest bearing accounts, common trust funds should not be excluded merely because many small investors have combined to take advantage of certain economies of scale.

The American Bankers Association will be pleased wo work with the staff of the subcommittee to draft appropriate language. The ABA supports the efforts of this subcommittee to address the problem of capital formation in the United States. We would urge you strongly to consider these savings and investment incentive proposals within the context of a program of monetary and fiscal policies designed to combat inflation and restore economic vitality to the nation.

84-080 O—81——28

May 13, 1981

Robert E. Lightizer, Chief Counsel
Committee on Finance
Room 2227 Dirksen Senate Office Building
Wash. D.C. 20510

Dear Mr. Lightizer,

The April 30, 1981 Research Institute of America Weekly Tax Alert indicated that your office was seeking comments to proposed changes in the tax law regarding partial exclusion from income of savings interest.

I have a suggestion that is somewhat related to this savings incentive plan.

I would like to see a regulation passed which would provide 100% tax-free interest for amounts deposited into a special savings account, whose funds are designated specifically for lower cost mortgages. For example, all monies deposited into a 6% tax-free account would be used to supply mortgages at 8½%. Withdrawal restrictions similar to those imposed on Money Market certificates could be implemented as necessary.

Besides making housing more affordable and giving a boost to the construction related industries, lower cost mortgages will provide people with more disposable income for the purchase of other goods and services.

Being a CPA with audit experience in the banking industry, I feel there is a great need for a savings incentive program via preferential tax treatment. I welcome any future opportunities to express my opinion.

Respectfully,

Jon F. Anderton

Jon F. Anderton

Jon F. Anderton
90 Aikahi Loop
Kailua, Hawaii
96734

MAY 8, 1981

DEAR MR. LIGHTIZER:

BASED UPON READING OF THE APRIL 30, 1981, WEEKLY ALERT, I WISH TO EXPRESS MY COMMENTS ON THE FOLLOWING BILLS UNDER CONSIDERATION:

S-145—I BASICALLY AGREE WITH THE PROPOSAL ALTHOUGH I'M UNCERTAIN OF THE VALUE OF THE REDUCTION IN CORPORATE CAPITAL GAINS RATES. IT SEEMS TO ME THAT CORPORATIONS ARE NOT IN BUSINESS TO GENERATE CAPITAL GAINS AS MUCH AS INDIVIDUALS. ANY BILL SHOULD ABSOLUTELY MAXIMIZE CAPITAL GAINS BENEFITS TO INDIVIDUALS.

S-936—I PERCEIVE THAT PASSAGE OF THIS BILL WOULD BE BENEFICIAL TO STIMULATE SAVINGS AND INVESTMENT. I WOULD HOPE THAT THE APPLICATION OF THESE PRINCIPLES COULD BE KEPT ON A SIMPLIFIED BASIS.

S-819—IN MY OPINION THIS BILL APPEARS TO BE STIMULATIVE ALTHOUGH PERHAPS IT COULD BE MORE BY USING, SAY 50%. WITH THIS BILL HOWEVER AND S-936, TAXPAYERS SHOULD BE ENCOURAGED TO SAVE.

IN SUMMARY I AM PLEASED WITH THE

OBJECTIVES OF THESE BILLS. I WOULD CERTAINLY HOPE THAT THE APPLICATION OF THE PRINCIPLES WOULD BE SIMPLE.

VERY TRULY YOURS,

Ronald C. [illegible] C.P.A.

S. J. BARONE - FOLIAGE PLANTS INC.
P. O. BOX 292
COLD SPRING HARBOR, L. I., N. Y. 11724

May 6, 1981

Robert E. Lightizer,
Chief Counsel
Committee on Finance
Room 2227
Dirksen Senate Office Bldg
Washington, D. C. 20510

Dear Mr. Lightizer:

RE: SENATE FINANCE PRESS REL NO. 81-126, 4/22/81

We want to go on record as being FOR the proposed bills aimed at encouraging savings and investments, namely, S.75 ... S.145 ... S.936 ... S.155 ... S.819 ... S.142... S.330 and S.141.

We feel it is in the best interest of our country that the proposed legislation be put into law. It will certainly provide more lending capital needed for industry to provide jobs. It offers a great deal of incentive in a positive way which otherwise necessitates tax shelters of a negative nature to provide this same effect.

Sincerely yours,

S.J.BARONE-FOLIAGE PLANTS INC.

S. J. Barone

S. J. Barone
President

SJB:fb
encl. 5 copies

"Shipper of Tropical Foliage Plants from Selected Sources"

JOHN M. BAXTER
W. A. BAXTER

PHONE (501) 538-3282

Kelso Gin Co., Inc.

Ginners

Dermott, Arkansas 71638

May 15, 1981

Robert E. Lightizer, Chief Counsel
Committee on Finance
Room 2227 Dirksen Senate Office Bldg.
Washington, D. C. 20510

Dear Sir:

We are aware of the hearings that are to be held; or are being held, on savings and incentive tax bills.

We believe very strongly that both individuals and Corporations need relief from taxation and given an incentive to save and invest these savings. In reviewing the different bills, we feel the Capital Gains reduction S. 75 and S. 145 would offer relief if enacted and we strongly urge that this be done.

With reference to Dividends and Interest Exclusion, we feel S. 155, S. 819 and S. 330 would be most effective and encourage investments that created interest and dividend income. We also urge the enactment of these bills or proposals.

We trust that you will find it feasible to urge support of these methods to alleviate our present situation.

Yours very truly,

BAXTER LAND COMPANY, INC.

By W. A. Baxter
W. A. Baxter
Secy.

WAB:np

Encl: 4 Additional Copies

May 28, 1981

STATEMENT OF RICHARD A. BRADY

BEFORE THE SENATE COMMITTEE ON FINANCE

Re: Dividend Reinvestment Plans

On behalf of clients of the law firm of Covington & Burling, in which I am a partner, I support the objectives of S. 141, introduced by Senators Bentsen and Baucus, which provides for the tax-free reinvestment of dividends pursuant to qualified dividend reinvestment plans. However, I urge that the beneficial effect of S. 141 be expanded by permitting certain foreign corporations to establish qualified dividend reinvestment plans.

Currently, the United States has one of the lowest savings rates of all of the industrial nations. By permitting the tax-free receipt of stock under a qualified dividend reinvestment plan, S. 141 encourages United States shareholders to save and invest up to $1,500 ($3,000 on a joint return) of their dividend income each year. The increased savings resulting from dividend reinvestment will help to control domestic inflation and to increase the savings available to our citizens for retirement and other necessities. This benefit, however, does not depend on the dividend reinvestment plan being that of a domestic corporation.

Foreign corporations with substantial numbers of United States shareholders have also established dividend reinvestment plans. This is particularly true of Canadian corporations which often conduct a substantial portion of their operations in this country and attract many United States investors. By encouraging United States citizens to reinvest dividend income received from Canadian and other foreign corporations, S. 141 would contribute to our economic recovery and improve our savings and investment performance just as effectively as does reinvestment of domestic-source dividends.

Indeed, the situs of corporate activity would seem to be irrelevant under S. 141 as currently drafted. Any domestic corporation is eligible to establish a "qualified dividend reinvestment plan" regardless of the location of its operations. The investment of capital generated by the reinvested dividends in domestic production is not a condition of establishing a qualified plan. What is encouraged under the bill is simply increased savings by United States citizens with its anticipated anti-inflationary impact in the United States. Accordingly, to the extent that the current bill precludes foreign corporations with United States shareholders from establishing qualified dividend reinvestment plans, it fails to maximize the intended benefits.

If the purposes of the bill were expanded to encourage domestic productivity and to improve the balance of payments, the operation of the bill might reasonably be limited to those foreign corporations that maintain a substantial portion of their capital in assets or investments within the United States. Thus, for instance, the bill could require that only those foreign corporations that invest 20 percent or more of their total assets (including, for this purpose, the assets of all members of a consolidated group) in the United States would be eligible. This determination could in general be made quite simply on the basis of the asset valuation reflected in the corporate or consolidated group financial statements for the preceding year. As so modified, the bill could encourage corporate investment in the United States without foregoing entirely the economic benefit that stems from increased savings by U.S. shareholders of foreign as well as domestic corporations.

MANUFACTURERS HANOVER TRUST COMPANY

40 WALL STREET, NEW YORK, N.Y. 10015

ROBERT A BYRNE
SENIOR VICE PRESIDENT

May 20, 1981
Telephone Number
(212) 623 - 7825

Mr. Robert E. Lighthizer
Chief Counsel
Committee on Finance
Room 2227
Dirksen Senate Office Building
Washington, D. C. 20510

Dear Mr. Lighthizer:

As a participating member of the Committee for Capital Formation Through Dividend Reinvestment we would like to go on record in support of S. 141 which, by deferring current taxes on dividends reinvested under qualified dividend reinvestment plans, would encourage materially increased reinvestment of dividends in new issue stock and materially increased capital formation.

The following reasons support the proposal:

- because the proposal is limited to plans which utilize original issue stock, it would directly impact the formation of new capital

- the deferral of taxation is an important step in the attempt to reduce the double taxation on dividends

- would foster savings and provide supplemental retirement income

- allows equivalent tax treatment to both stock dividends and dividend reinvestment

- counter-inflationary by absorbing cash dividends and increasing our capital which in turn will increase our ability to finance productive facilities

Mr. Robert E. Lighthizer May 20, 1981

In summary, the dividend reinvestment legislative proposal would both help individuals to save and aid our industry to raise external capital.

Very truly yours,

R. A. Byrne
Senior Vice President

STATEMENT OF GEORGE D. CASHMAN, JR.

IN SUPPORT OF TAX DEFERRAL

FOR REINVESTED DIVIDENDS (S. 141 and H.R. 654)

SUBMITTED TO THE SUBCOMMITTEE ON

SAVINGS, PENSIONS AND INVESTMENT POLICY

OF THE

UNITED STATES SENATE COMMITTEE ON FINANCE

MAY 18, 1981

I strongly support enactment of S. 141 and H.R. 654, legislation designed to defer the taxes on dividends reinvested in original issue dividend reinvestment plans. I believe this legislation to be the most direct, targeted, cost-effective way to increase individual savings and investment and thereby restore the economic strength of our nation.

BACKGROUND

I am particularly concerned over our country's economic results of the past few years and the economic prospects we are facing. Unprecedented increases in inflation and interest rates, and a reduction in the rate of individual savings and investment has led to greatly reduced economic activity. This has had a particularly severe impact on those of us who have only recently entered the workforce and in particular those with young families.

Employment opportunities have been limited as companies have been forced to curtail employment and in many instances layoff many workers. This has had a particularly severe impact on the young. In addition, the benefit of any salary increase has been eroded by inflation, increased social security taxes, tax bracket creep, etc. This has resulted in a decrease in the standard of living for many families as exemplified by the increasing number of two-income families.

Buying a home has become just a dream for many young families as inflation has increased the price of the home and interest rates to record highs. Significantly increased down payment requirements and high mortgage payments have forced these families to put off the purchase of a home. Those families attempting to save for a home are faced with the paradox of the tax laws encouraging current consumption by taxing savings so heavily.

The level of savings in the U.S. has reached record lows. Many individuals, particularly the young, have found it nearly impossible to save for emergencies, the education of their children, retirement, etc. Those who have managed to save tend to hold non-risky investments, typically interest or income producing assets, and as a result have benefitted very litte from the recent reduction in capital gains tax rates.

SOLUTION: Tax Deferral For Reinvested Dividends (S. 141 and H.R. 654

I believe the tax deferral for reinvested dividends legislation (S. 141 and H.R. 654) most appropriately addresses my concerns listed above. This legislation will provide a direct stimulus for savings and investments and thereby significantly increase economic activity. Coupling this with the benefit the companies receive (i.e., increased cash flow and improved balance sheets) will result in increased productivity, create new jobs, and help to control inflation.

Enactment of this legislation will provide a strong incentive for young families to save. By deferring taxes, we are no longer forced to use "out of pocket" cash to pay tax on reinvested dividends. This legislation will begin to eliminate the tax discrimination against dividend paying stocks, and in addition, will increase the stock's market price and the after-tax return to the investor.

Tax deferral of reinvested dividends is also a simple, convenient and economical method for small shareholders to invest. Dividend reinvestment plans cater to the small, odd-lot investor by allowing fractional share accumulation, elimination of brokerage fees and, in many instances, a discount feature. It is my understanding that the vast majority of participants in these plans own less than 100 shares.

CONCLUSION

Tax deferral for reinvested dividends (S. 141 and H.R. 654) is the most direct, targeted, cost-effective way to increase individual savings and investment. I therefore strongly recommend the immediate adoption of this most important legislation.

Central and South West Corporation
2700 One Main Place • Dallas, Texas 75250 • 214-748-8481

DURWOOD CHALKER
Chairman and Chief Executive Officer

May 15, 1981

Honorable Robert J. Dole
Chairman, Senate Committee on Finance
United States Senate
Washington, D. C.

Dear Senator Dole:

I am Durwood Chalker, Chairman and Chief Executive Officer of the Central and South West Corporation. This letter is in support of S. 141, the pending legislation which would defer federal income taxes on dividends reinvested in original issue stock.

We are convinced that enaction of this legislation would benefit every segment of the Nation's economy. The investing public would be able to partially avoid the effect of present double taxation on dividend income by deferring taxes until such time as they may be in a lower income bracket. This incentive would, of course, also serve to encourage individual savings through investment.

On a national scale, highly reliable studies made by Robert R. Nathan and Associates indicate that the national output would increase by $2.7 billion annually; increase fixed business investments by $1 billion annually; and create some 50,000 jobs per year.

The direct sale of new issue stock to existing stockholders is the most efficient and cost effective method for industry to raise capital. Tax deferral on dividends reinvested in the issuing companies would greatly encourage this additional, urgently needed investment in American industry.

Several hearings involving this legislation have been held by the House and Senate during this and previous sessions of Congress. A considerable body of testimony from diverse sources has developed as a result. The only negative comment on this legislation has come from governmental sources who claim that revenue losses of approximately $1 billion annually would occur. The Nathan Study estimates a modest loss the first year; a "break even" the second year; and a net revenue gain of $600 million the third year and thereafter. The government's own estimates, admittedly, address gross revenue losses only, giving no effect to offsetting revenue gains. Were the government's studies to recognize the "economic feedback effect" of this legislation, mentioned above, its estimated losses would be greatly reduced.

We encourage you and your Committee to act favorably on S. 141. Its passage will go far toward reinvigorating our economy, creating employment, reducing inflation, promoting thrift, and making available to industry much needed new capital.

Sincerely,

Durwood Chalker

Durwood Chalker

DC:mm

84-080 O—81——29

A Proposal For Reform Of The Capital Gains Tax

By John Dane, Jr.
Partner, Choate, Hall & Stewart
Member, Taxation Group, The New England Council, Inc.

Taxation of Capital Gains - The Problem:

Even before inflation came to play as large a role in the economic scene as it does today, the taxation of capital gains has presented a host of conceptual, philosophical and economic. problems.

Dan Throop Smith, in the "The United States in the 1980's - Issues in Tax Policy", published by the Hoover Institution of Stanford University, has the following comment:

> "The appropriate tax treatment of capital gains is highly controversial. Many countries do not tax capital gains at all. No country taxes capital gains at the same level as ordinary income. Trust law, corporate law, national income accounting, and, traditionally, people thinking about their own financial affairs all distinguish between capital and income."

These problems lie in two particular areas. First, there has been a serious question in the minds of many people as to whether capital gains are really "income" and, as such, properly subject to an "income" tax. Admittedly, the Supreme Court of the United States has held that capital gains could be taxed under the Sixteenth Amendment to the constitution which permits a tax on incomes. Proper as this decision may be from a purely legalistic point of view, it does not entirely accord with the everyday perception of the average person. Income is generally thought of as a flow of cash which continues with reasonable regularity, as is the case with wages and salaries, interest, and dividends. It is something that can be counted on and can prudently be spent. Capital transactions are as likely to give rise to gains as to losses. Treating capital gains as spendable income can be the height of imprudence as many college endowment fund managers have learned to their cost and that of the institutions whose funds they have managed. This can be particularly seen as over the last decade there has been little, if any, overall appreciation in security values.

The second characteristic of capital gains which makes their equitable taxation extremely difficult is the so-called "bunching" problem. Where a capital asset has been held for a number of years and is eventually sold at a gain, this gain has, in the usual case, accrued over the period. But under the capital gains tax, the entire gain is taxed in the year of sale on top of the seller's other income. With even a moderately progressive tax system, this imposes on capital gains a burden not borne by other income received annually.

Were it not for inflation, our present system of taking only 40 percent of gains as ordinary income would, in general, seem to be a reasonably equitable solution to the problem. However, once we factor in inflation, the result becomes far less satisfactory. In many instances what is being taxed under the assumption that it is gain is not really gain at all--if we mean by "gain" an increase in purchasing power. It is really a decline in the purchasing power of the dollar.

Previous solutions to problem of taxing capital gains:

We could go back to the system which was in force from 1934 through 1937 and scale down the amounts of gain taken into income, depending upon how long the property which is sold has been held: 100 percent if held less than one year; 80 percent--one to two years; 60 percent--two to five years; 40 percent--five to ten years; and 30 percent--over ten years. This system achieves a sort of rough and ready justice but it is not very efficient in removing from taxable income the decline in the purchasing power of the dollar.

A more conceptually satisfying way of approaching the problem is through the use of indexing, or expressing both the purchase price and the sale price in constant dollars. For example, if the Consumer Price Index has doubled from the time of purchase to the time of sale, the sale price would be divided by two to determine the amount of taxable gain.

A third solution has been suggested by Prof. Dan T. Smith of the Hoover Institution. Based on the procedure now applicable when residential property is sold at a profit and the entire sale price is invested in a new residence, it would permit the owner of securities to establish an investment fund. So long as the proceeds of the sale of securities are retained in the fund and not withdrawn for consumption, no capital gain would be recognized for income tax purposes. Whenever cash is withdrawn from the investment fund and used for consumption, the amount so withdrawn is subject to income tax and treated as ordinary income, not as capital gain, to the extent that there are recognized gains in the fund. This plan has much inherent logic. If the taxpayer treats the gain on the sale of securities as income by using it for consumption, he is not in a good position to complain if the tax gatherer takes the same view of the transaction.

Proposed Solution:

Given these problems and suggested solutions, Congress should amend the provisions of the Internal Revenue Code relating to the taxation of capital gains so as to provide:

1. Each individual taxpayer would be entitled to set aside specific securities and/or cash in a segregated Investment Fund. Additions could be made to such fund at any time at the taxpayer's discretion.

2. Whenever the taxpayer sold a security held in the Investment Fund, such a transaction would not be treated as contributing to either gain or loss for

federal income tax purposes provided that the entire net proceeds of the sale were retained in the Investment Fund.

3. Whenever the taxpayer made a withdrawal from the Investment Fund, he would be treated as having received ordinary income (not capital gain) in an amount equal to the lesser of (a) the amount of the withdrawal and (b) the dollar amount of the net gain on previous security sales. In the case of multiple withdrawals, the "net gain on previous security sales" would be reduced by the portion of such gain which had previously been treated as ordinary income in connection with prior withdrawals.

4. In determining the amount of the gain resulting from the sale of a security held in the Investment Fund, the cost basis of the security sold would be increased to reflect the increase in the Consumer Price Index which had occurred between the time of the purchase of the security and time of its sale.

Operation of Proposed Solution:

The present proposal is a refinement of Prof. Smith's investment fund plan by combining it with indexing.

The operation of the above proposal can be illustrated by the following simple example:

Knowing that he will need to buy a house in 1980, Mr. Investor established an Investment Fund in 1970. He knew that he could, at that time, have purchased the kind of house he wanted for $100,000, but expecting that costs would rise, he decided that the best way to protect himself from inflation would be to invest the entire fund in common stock. Mr. Investor's anticipation of inflation proved to be amply justified. Taking 1970 as 100, the CPI stood at 186.9 at the end of 1979. Mr. Investor proved to be equally farsighted in his choice of investments and the stocks which he purchased in 1970 for $100,000 were sold at the end of 1979 for $186,900. Early in 1980, Mr. Investor withdrew the entire amount in his Investment Fund and, assuming that the increase in the cost of houses paralleled the increase in the CPI, he was able to buy the type of house he had in mind in 1970. However, the day of reckoning came on April 15, 1980 when he found that he had a taxable long term gain of $86,900. Forty percent of this, or $34,760, had to be added to his other income in the computation of his federal income tax. Assuming an average 50% tax rate applicable to this additional income, his income tax on the gain was $17,380.

Under the present proposal, Mr. Investor's cost basis for his securities would be increased, based on the increase in the CPI from $100,000 to $186,900, and he would have had no gain in his Investment Fund, and hence no taxable income, when he withdrew the entire fund in 1980 and purchased a house.

Assuming that he had been even more successful, and had sold all his securities for $196,900 in 1979, 100% of the $10,000 gain over his cost basis adjusted for inflation would, under the proposal, be taxed as ordinary income.

The foregoing is a possibly oversimplified example, because it is unlikely that Mr. Investor would have made no changes in securities during a ten year period. If we assume such changes, the unfairness of the present law and the desirability of the proposal becomes even more apparent.

Let us suppose that in 1975, Mr. Investor sold the securities which had cost him $100,000 in 1970 for $138,600, and reinvested the proceeds in his Investment Fund. Under the then present law, he would have had to pay a tax on 50 percent of his $38,600 long term gain. Under the proposal, he would have had no tax to pay because he reinvested the entire proceeds of the sale in his Investment Fund and did not withdraw anything for consumption. This would have been true even if the gain on the securities sold had been greater than the increase in the CPI from 100 in 1970 to 138.6 in 1975.

STATEMENT OF LEE L. DAVENPORT
RETIRED CORPORATE EXECUTIVE,
IN SUPPORT OF TAX DEFERRAL
FOR REINVESTED DIVIDENDS

MAY 26, 1981

For many years while employed as an executive with a major corporation, I was very much aware of the problems of capital formation for businesses, both large and small. When the proposal to defer taxes on reinvested dividends first came to my attention, quite some time ago, I was immediately impressed with the logic of the concept as well as pleased with the potential of the idea for orderly equity growth. After studying the matter in detail, there was no question in my mind that legislative changes should be introduced to implement the concept. I am sure that others have fully documented the many reasons for support of such legislation from the point-of-view of corporate financing.

In this statement, however, I wish to address my comments to the impact of tax deferral on retired individuals; those for whom dividend income and inflation are especially meaningfull. It might appear that dividend reinvestment is not a logical alternative for those retired persons who are dependent on dividend income. However, one must note that the retired have no hope of keeping up with inflation unless the value of their investments increase. In todays environment, the equities which pay substantial dividends are in those companies which are growing slowly - usually because of limitations on investment as much as other factors. Today, the retired really have no choice, they pay the double taxation and take the current income.

This legislation will give the retired a choice - something not now available - a choice of helping ones investment to appreciate or of taking the current income. Not only does that investment grow through the acquisition of more shares, but additionally the corporation, with the added capital at the disposal of management can use that capital to improve productivity, invest in new products and generally increase competitiveness. It is these latter factors which increase the price of a stock, which in turn gives the retired at least some opportunity to keep up with inflation. We are as much interested in capital gains as any group.

It is for these reasons that I strongly support the tax deferral for reinvested dividends (S. 141 and H.R. 654) and respectfully urge its immediate adoption.

Statement of Erroll B. Davis Jr.
Vice President - Finance
Wisconsin Power and Light Company
Regarding the Tax Treatment of
Qualified Dividend Reinvestment Plans
S.141
Submitted to the Senate Finance
Subcommittee on Savings, Pensions and
Investment Policy for the record of
May 4, 1981

Companies need capital to build new facilities and to modernize existing plants. Legislation to permit deferral of taxes on dividends reinvested in common stock will channel financial resources to this critical objective. It should be part of larger capital formation proposals, to help raise this needed capital through induced saving by shareholders. Ultimately, the net revenue gain to the Treasury will increase while new jobs are being created through business expansion. Two measures have been introduced in the 97th Congress which would provide this result: S.141 by Senator Bentsen and H.R.654 by Rep. Pickle. Wisconsin Power and Light strongly supports their enactment.

The measures would be of great help to the capital intensive utility industry, which obtains most of its capital requirements externally. It is estimated that the electric and gas utility industry alone will have to raise more than $50 billion by equity financing during the next five years.

Dividend reinvestment plans now provide over $1 billion annually in new equity for utilities and $2 billion for industry overall. Deferring tax payments on the dividends would probably double shareholder participation rates and greatly increase the number of utility and other companies adopting such plans. It is essential that all companies have the option to offer tax-deferred plans.

Wisconsin Power and Light's DR Plan has reinvested nearly $10 million since its inception in 1976. This has been raised from the more than 7,300 Plan participants, who are:

* Individuals - make up 91% of all Plan accounts and hold more than 90% of the Plan's shares,

* Small accounts - 83% of the participants have 100 or fewer shares in the Plan,

* From Wisconsin - 67%, and

* Company Employees - 28% of all employees are in the Plan, in addition to their ESOP shares.

Our experience is that this generally describes many DR plans in and out of the utility industry.

Additions to capital directly from existing WPL shareowners will probably increase on the order of $6 million annually by 1985, if the proposed measures shortly become law. This amount would be about 70% higher than our projections without the legislation.

The funds raised through our Plan will continue to be used to help build new equipment - from power plants to power poles - a choice shareowners make directly by not spending cash dividends for current consumption. They also support additional borrowing as needed. The proposed bills, then, are a premier, targeted device for capital formation.

Wisconsin Power and Light is working closely with our more than 60,000 shareowners to pass these proposals into law in this session of Congress. We urge the subcommittee to report S.141 favorably.

F32:2:03:1-2
05-07-81

SUBMITTED STATEMENT OF RAY DENISON, LEGISLATIVE DIRECTOR AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS, BEFORE THE COMMITTEE ON FINANCE, UNITED STATES SENATE SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT POLICY ON SAVINGS AND INVESTMENT INCENTIVE TAX BILLS

May 15, 1981

The AFL-CIO is opposed to each of the ten tax cut measures before this subcommittee.

These bills are all attempts to use tax reductions as a device to increase savings. We believe that none of the measures will increase overall savings levels; and, any additions to private savings will come at the expense of greater government deficits and fiscal pressures, higher interest rates and more tax injustice.

The principal beneficiaries of these measures will be upper income individuals who will receive windfall tax breaks merely for continuing to do what they are already doing -- saving and investing. The millions of American families who cannot save, invest in stock or commodity markets, or speculate in real estate, diamonds, paintings, and the like, will receive no benefit from these measures.

Any small tax reductionsthat might flow to moderate and middle income Americans will be far overshadowed by the costly impact of the windfalls to the wealthy on interest rates, and funds available for government programs and equitable tax reductions that would reduce the burdens of those who are paying more than their fair share and help promote the economic growth and balance that is the essential preconditions for increased savings and investment levels.

S. 75, 145 and 457 would increase the amount of capital gains income above the 60% that is already excluded from the tax base. Under present law 60% of capital gains income (basically, profits on sales of stocks, bonds, real estate, etc.) is completely tax exempt and gains passed on at death are 100% income tax exempt.

S. 75 would increase the current 60% exclusion to 75% at an annual cost of $4.5 - $6.0 billion and S. 145 would increase the exclusion to 70% costing $3 - $5 billion annually.

The S. 457 approach to capital gains is somewhat different. Under this measure individuals with profits on the sale of stocks and other securities would be permitted to set up special accounts for such gains and postpone even the preferentially low tax that is now required on such profits. The revenue loss associated with this provision has not been estimated.

The capital gains exclusion is the most costly and equity eroding provision of the tax law. Repeal of this provision was the first item in the tax reforms urged by the AFL-CIO Convention. Through this route almost $30 billion in revenues will be fore-gone in fiscal year 1982 an amount equivalent to two-thirds of the Administration's proposed deficit. Over 80% of this revenue loss will flow to the highest income, five percent of the nation's taxpayers. Moreover, shifting income from fully taxed "ordinary income" to preferentially taxed capital gains is the underpinning for most tax shelter operations.

We believe Congress should reject any and all attempts to expand this privilege. To the contrary, we feel that Congress should be looking at the huge revenue loss associated with this provision as an opportunity to raise revenue needed to provide funds for necessary programs, equitable tax cuts and to minimize fiscal pressures.

S. 936 represents one of the most costly and unconscionable attacks on the concept of taxation based on the principal of ability-to-pay.

Under this bill taxpayers would be permitted to split their income between "personal service income" (wages, salaries, pensions, earnings from self-employment, etc.) and investment income -- interest, dividends, capital gains, and the like. The bill would also reduce the top tax bracket rate which is now 70%, on taxable income in excess of $215,400 on joint returns and $108,300 for single individuals to 50%.

By this device individuals would be able to split their income into two classes and, depending on the taxpayers' bracket and ability to shift from one form of income to another, taxes could be cut by as much as one-third. The revenue loss dramatically illustrates the bills effect on the tax structure. In the first year the loss is estimated at $16 billion and by 1986 according to the staff of the Joint Committee on Taxation, the annual loss would exceed $36 billion. The measure would also be retroactive to January 1, 1981 resulting in a fiscal year 1981 and 1982 loss of $29.6 billion.

S. 155, S. 819, S. 142, S. 330 and S. 492 would exclude from tax even greater portions of income from dividends and interest.

Under present law, individuals will pay no income tax on the first $200 ($400 joint return) of dividend and interest income for 1981 and 1982. The existing law represents a widening of a pre-1980 provision which limited the dividend exclusion to $100 on a single return and $200 for joint returns. The AFL-CIO opposed this measure when it was appended to the Windfall Profits Bill. The existing measure is an inequitable and unnecessary drain on the treasury which should be repealed -- not expanded.

S. 142, the least costly of the dividend and interest exclusion measures would cut receipts by $6.8 billion in 1981, $7.5 in 1982 and rise to an annual cost of $15 billion in 1986 by increasing the exclusion to $2,000 on a joint return and $1,000 for singles. The most costly of these devices, S. 819, would allow after a phase-in period an exclusion of up to 30% of such income at a revenue loss by 1986 exceeding $30 billion.

All these measures suffer the fundamental inequity that results from the fact that (1) only those who are able to save receive any benefit and (2) of those who can benefit, the value is directly related to their tax bracket.

In addition, these measures would also open up opportunities to manipulate present law interest <u>expense</u> deductions in a fashion which, rather than encouraging taxpayers to save, would in fact permit taxpayers to realize a net gain by borrowing, deducting the interest costs and "saving" the newly borrowed funds in order to exploit the exclusion.

<u>S. 141</u> would permit corporate shareholders to choose between receiving a dividend in cash or in the form of the

company's common stock. Under current law a stock dividend for tax purposes is considered just like a cash dividend if in fact the stock has a fair market value and the stock dividend does increase the shareholders equity in the corporation. S. 141 would allow stockholders to exclude from income $3,000 per year on joint returns and $1,500 on single returns on dividends that are paid out in the form of the company's common stock.

This measure would, of course, cut taxes for only those who receive dividends. And, among those who do receive dividends the tax reducing value of the benefit would increase with the shareholders tax bracket. To a shareholder at the lowest (14%) tax bracket the benefit would be $420 or less compared to a cut of as much as $2,100 at the top bracket.

We would like to point out that because of the extreme concentration of dividend income in the hands of the wealthy most any device aimed at dividend recipients will provide windfalls to who do not need them. A 1971 Commerce Department study, for example, found that the 1% of U.S. families with the highest income received 47% of the total dividends and owned 51% of the market value of stock. Similiar indications of concentration were presented in the 1977 University of Michigan Survey of Consumer Finances. According to that survey 75% of the nation's families owned no stock at all, and only 9% of the families had stockholdings of $5,000 or more. And even at 1977 incomes of $25,000 or more almost half owned no stock and over 70% either owned no stock or the value of their holdings was $5,000 or less.

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This bill would also have the perverse effect of encouraging stockholders -- because of the tax benefits -- to accept stock when a prudent market investment decision would call for taking the cash and investing in a different venture. Similiarly, corporate dividend pay-out decisions would be further influenced by tax considerations.

In the light of the intent of these measures to use tax policy as a means to encourage savings and investment, we would like to call the subcommittee's attention to H.R. 3218 sponsored by Representatives Guarini and Brodhead. This bill has the endorsement of the AFL-CIO and calls for targeted individual and business tax cuts which would be fair, have a relatively small budgetary impact and would represent a major beginning toward directing resources and capital in a fashion which would help revitalize and rehabilitate the nation's basic industries and economically distressed areas.

For this subcommittee's convenience we have attached a reprint from the April 30, 1981 Congressional Record which outlines the features of the Guarini-Brodhead bill and the justification for its enactment. We urge your support for H. R. 3218.

Congressional Record

United States of America

PROCEEDINGS AND DEBATES OF THE 97th CONGRESS, FIRST SESSION

Vol. 127 — WASHINGTON, THURSDAY, APRIL 30, 1981 — No. 64

House of Representatives

AN ALTERNATIVE INDIVIDUAL AND BUSINESS TAX AND REINDUSTRIALIZATION PLAN

HON. FRANK J. GUARINI

OF NEW JERSEY

IN THE HOUSE OF REPRESENTATIVES

Thursday, April 30, 1981

Mr. GUARINI. Mr. Speaker, on April 10 I introduced H.R. 3218, legislation to begin the task of revitalizing our economy and providing for long-term economic stabilization. The bill, which is cosponsored by Representative BRODHEAD, is a $30 billion program targeting $14 billion in tax and nontax relief to the business sector and $16 billion in tax relief to individuals. This two part plan is an alternative individual and business tax cut which would be more fair, less costly, and less inflationary than that advanced by the administration.

Title I of H.R. 3218 establishes a Reconstruction Finance Corporation to invest both public and private funds and guaranteed loans to help strengthen the Nation's industrial base. Title II contains an alternative to the proposed cuts in Federal income taxes. Under this bill workers would have 20 percent of their social security tax refunded to them through a tax credit. Employers would benefit by receiving a 5-percent credit for their share of the payroll tax.

The idea for a Reconstruction Finance Corporation is not a new one. We have turned to a Reconstruction Finance Corporation in the past. During our darkest period, the Great Depression, legislation creating a RFC was signed into law. The RFC helped boost American productivity and employment for nearly two decades. Its service in helping industries convert to a war footing at the beginning of the 1940's is well documented.

The original RFC was created to help reduce unemployment, stabilize prices and encourage economic growth. I am not going to argue that this Nation is in a Great Depression such as we saw in the 1930's. However, no amount of technical statistical data can convince those in our society who are facing economic troubles—whether they be individuals about to lose their jobs or homes, businesses about to go under, or cities on the verge of bankruptcy—that the situation is not every bit as grim as what we faced in the 1930's. As a nation we are faced with high inflation and high unemployment at the same time. On top of this there have never been no clear growth signs in productivity, gross national product, and capital formation.

The above are recognizable categories describing our economic standing. However, we have begun to understand that our present economic plight cannot be understood simply by looking at statistics. There has been a serious deterioration of our cities, particularly those in the Northeast and Midwest, our industrial society is losing ground to a service oriented economy, and the loss of basic industrial strength bodes poorly for our future defense needs.

To confront these U.S. problems of the 1980's we need to create a Reconstruction Finance Corporation. A Reconstruction Finance Corporation could be geared toward the need of creating a stable economy, with an emphasis on private sector employment, and the need to have all areas of the country to participate in this growth. Basic U.S. industries must be bolstered by an industrial policy committed to making the U.S. competitive in world markets, and that policy must have the purpose of advancing all sectors of our economy.

The first goal can be met only if we change our thinking toward our current economic situation. The notion of simply catering to those parts of the economy which are the strongest is shortsighted. Presently, several industries which have been important to our past economic and military defense strength have faced difficult economic circumstances. When these industries are examined in light of our future economic and defense needs, one must ask if our Nation can endure the long-term effects of the present laissez faire governmental philosophy.

The second goal of advancing all sectors of the economy through a restructuring of our industrial policy is endemic to more immediate concerns of our society. We are in a period that has seen great damage done to the American cities—our centers of communications, culture, transportation, finance, and employment. Our cities have faced a decade of outmigration. Population loss has decreased urban tax bases, weakened service delivery infrastructure, and made vast urban areas unattractive to industry. During this same period many urban based industries began to face the reality of changing economic circumstances without the resources necessary to adapt with the times.

These two developments have created an economic circle of decline that must be broken in a way that addresses long term American needs. Under these present conditions, establishment of a Reconstruction Finance Corporation would serve as a needed catalyst in reversing present economic trends and spurring economic development. A RFC would provide the equity capital that our older industries need. It would also target investment funds to those areas in serious need of economic revitalization.

Title I of H.R. 3218 creates a Reconstruction Finance Corporation as an independent entity with powers to make investments in industries and in areas that the RFC deems in the national interest. The broad discretionary powers given to the Board of Directors would include both tax subsidies and nontax tools. Tax subsidies at the Board's disposal include investment tax credits, accelerated depreciation, first year present value depreciation, and carry back-carry forward devices. The nontax tools would include the use of loans, loan guarantees, and interest subsidies.

The Corporation is to be administered by a Board consisting of the Secretary of Commerce, the Secretary of Labor, the Secretary of the Treasury, two representatives of business and two representatives of labor organizations. The Board would have a first year authority to allocate $5 billion in tax expenditures, and an additional $5 billion to assist industries that have difficulty in obtaining financing. This would include older industries that have difficulty obtaining financing, high risk industries with growth potential, firms competing with subsidized foreign firms, and industries vital to the United States on national security grounds.

In each case where a firm seeks financing, the RFC staff would have to realistically assess its chances to survive. RFC involvement would not be extended if the industry was found to be in terminal condition. In other cases, RFC involvement would not be extended unless the financial assistance applied for is not otherwise available from private lenders or other Federal agencies. The RFC would also try to target benefits to firms in areas that are economically distressed, based on criteria such as unemployment, poverty, or pending economic instability due to plant closings.

Title II of my bill would provide alternative individual and business tax cuts to those proposed by the administration. For individuals I am proposing a refundable credit equal to 20 percent of a worker's social security payroll tax. This tax relief would also be extended to public and railroad employees not covered by social security through an equalization credit.

I am convinced that this approach targets tax relief more readily to low- and middle-income families who are having extreme difficulty dealing with double-digit inflation. Families with incomes up to $30,000 would receive 80 percent of the benefits under this proposal, while 15 million low-income workers who do not stand to benefit under President Reagan's tax package would also gain some relief.

This tax credit would be worth more to the majority of workers than the Reagan proposal. However, it would cost less because the tax credit would top-off at $895 for an individual and $790 for a working couple, while the administration's income tax plan would give substantially larger payments to the very affluent and less to the hard-pressed low- and middle-income taxpayers.

This Congress has come to realize the importance and the depth of the economic realities facing the United States as we enter the decade of the 1980's. Reindustrialization and capital formation are vital to our Nation's future, and this Congress has the greatest opportunity to begin this revitalization process.

By supporting a Reconstruction Finance Corporation we can offer the businesses of America a flexible tool to foster a fair and efficient growth of our private sector predicated on our own national interests. The AFL-CIO stands firmly behind this legislation, and I am asking you to join with me in sponsoring H.R. 3218 to establish a Reconstruction Finance Corporation and fair and equitable tax relief measures for both individuals and the business community.

STATEMENT OF JAMES M. DUNN, JR.*

IN SUPPORT OF TAX DEFERRAL

FOR REINVESTED DIVIDENDS (S. 141 and H.R. 654)

SUBMITTED TO THE SUBCOMMITTEE ON

SAVINGS, PENSIONS AND INVESTMENT POLICY

OF THE

UNITED STATES SENATE COMMITTEE ON FINANCE

MAY 18, 1981

I strongly support enactment of legislation for tax deferral for reinvested dividends as embodied in S. 141 and H.R. 654. The principal advantages and disadvantages of the proposed legislation are listed below:

Principal Advantages

- Provides a direct stimulus for individual savings and equity investment.
- Is a simple, convenient and economical method for individuals to invest.
- Particularly benefits the small shareholder.

* Business Executive with approximately 30 years' experience in financial management. Presently Vice President and Treasurer of a large company and as such responsible for its financings, capital structure, etc. Also responsible for pension fund (ERISA) investment in excess of $3 billion. Graduate of the Wharton School of Finance and Commerce, University of Pennsylvania, BS in Economics, and the Harvard University Graduate School of Business Administration, MBA in Finance.

- Increases after-tax return on investment to the shareholder and therefore should increase the market price of the company's stock.
- Improves badly deteriorated corporate balance sheets by reducing the burdensome reliance on debt.
- Is targeted legislation - benefits the most those companies requiring common equity capital.
- Stimulates creation of new jobs and helps in the control of inflation.
- Is guaranteed to work - tax benefit is received only if investment is made.
- Is cost-effective - net additional revenues will be generated for Treasury within three (3) years.
- Has broad based support - labor unions, pensioners, security rating agencies, regulatory bodies, professors of finance, investment bankers and others have all endorsed this legislation.

Principal Disadvantages and/or Misconceptions

- Minor loss of Treasury revenue in the first year. A report prepared by Robert R. Nathan Associates, Inc. estimates that the revenue loss to the Treasury would be only $300 to $400 million in the first year, a wash in the second year and in year three alone the revenue gains to the Treasury will more than offset year one revenue losses.

In addition, all future years will result in larger gains in Treasury revenues.

- Tends to temporarily lock in investment as tax deferral and capital gains treatment is foregone if the investment is not maintained for at least a 12 month period. Given the urgent need for increased long-term savings and equity investment, a 12 month holding period does not appear to be at all unreasonable. Furthermore, in all probability only those investors wishing to take advantage of the tax deferral benefit by holding the investment for the 12 month period will enroll in these plans. A holding period also tends to reduce speculative activities and promote long-term investment.
- Is not tax neutral in that it tends to favor investment in the common stock of companies that pay dividends. This is, in fact, an advantage since: 1) common stock equity is the type of capital most needed to redress badly eroded balance sheets and 2) those companies that pay dividends are the ones most disadvantaged by the double taxation of dividends. This legislation, in fact, modifies the current tax discrimination against dividend paying stocks.
- Is not the ideal or best possible means by which to solve the double taxation of dividend issue. This assertion is partially true; however, this legislation is an effective, cost-efficient first step toward eliminating double

taxation of dividends. It is obvious that the major reason dividend reinvestment plans are not presently larger is because of this tax discrimination, as shareholders must pay ordinary income tax on dividends they choose to reinvest while receiving no cash.

- Investors would borrow money, take the resulting tax deduction and reinvest dividends tax deferred. Participants in these plans are generally investors owning less than 100 shares, and with the $1,500 tax deferral limitation, it is highly unlikely that a borrowing strategy will be used by many participants. Furthermore, if need be, such activity could be precluded by appropriate legislation.
- The limitation of $1,500 per year ($3,000 on a joint return) is so low that this bill will not be effective. This legislation is designed to increase individual savings and investment without providing a new tax benefit to the high bracket taxpayer. In 1979, dividend reinvestment plans provided about $2 billion in much needed equity capital which represented almost 25% of all new common equity issued that year. Estimates indicate that enactment of this legislation will result in a two to three-fold increase in this level of investment and provide over 50% of all new common equity issued. Furthermore, the

limitation could be increased as the significant benefits of the legislation are proven to be highly successful.

Conclusion

Based on the above and the thoughtful evaluation of many experts from management, labor, regulatory bodies, rating agencies, investment bankers, academicians and others, it is very clear that tax deferral for reinvestment of dividends (S. 141 and H.R. 654) is advantageous. The advantages far outweigh the temporary cost to the Treasury. In addition, it should be stressed that most of the other arguments against this legislation are in fact misconceptions. Therefore, prompt enactment of S. 141 and H.R. 654 is respectfully urged.

STATEMENT OF LILLIAN G. DUNN,

A RETIRED PERSON, IN SUPPORT OF TAX DEFERRAL

FOR REINVESTED DIVIDENDS (S. 141 and H.R. 654)

SUBMITTED TO THE SUBCOMMITTEE ON

SAVINGS, PENSIONS AND INVESTMENT POLICY

OF THE

UNITED STATES SENATE COMMITTEE ON FINANCE

MAY 18, 1981

From the vantage point of a retired person, I strongly support tax deferral for reinvested dividends (S. 141 and H.R. 654).

THE PROBLEM

Many retired persons depend to a large extent on dividend income. We tend to invest primarily in high dividend paying, large, stable, relatively secure companies in basic industries. These industries include utilities, banks, thrift institutions, food companies, very large industrials (so called smoke stack companies or Dow Jones Industrial Average type companies). Unfortunately, as you realize, the common stock performance of these companies in the past twenty years has been extremely poor relative to other investments. This is due to many factors including inflation, deterioration of the balance sheets of many of these companies, and the double taxation of dividends. In addition, the lowering of capital gains taxes, although good for many investments and many people, has also further disadvantaged these types of investments.

SOLUTION: Tax Deferral For Reinvested Dividends (S. 141 and H.R. 654)

This legislation would:

- Help to curb inflation by encouraging savings and investment and increased productivity. It is guaranteed to work in that the tax deferral is not given unless the dividends are reinvested.
- Particularly benefit those companies in which retired persons invest most (i.e., high dividend paying, capital intensive companies).
- Improve the cash flow and balance sheets of those companies and thereby protect the current dividend and promote future dividend growth.
- Begin to eliminate the tax discrimination against dividend paying stocks and the double taxation of dividends.
- Increase the after-tax yield to investors and thereby increase the price of common stocks. Studies by major brokerage houses indicate that this legislation would increase stock prices by 10 - 20%.
- Help retired persons to save and thus better cope with inflation and better meet emergencies, medical expenses, etc.

Allow younger people to better accumulate savings and investments so they are better prepared for their retirement years.

CONCLUSION

I strongly recommend the immediate adoption of the tax deferral for reinvested dividend legislation (S. 141 and H.R. 654). Clearly, this legislation is in the best interest of, and will provide a significant benefit to, all retired persons, the companies on whom we depend for a significant portion of our income, and the nation as a whole. In addition, this legislation is strongly supported by the American Association of Retired Persons.

AT&T

Robert N. Flint
Vice President and Comptroller

American Telephone and
Telegraph Company
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May 18, 1981

The Honorable John H. Chafee
Chairman, Subcommittee on Savings, Pensions and Investment Policy
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

This statement is made on behalf of the American Telephone and Telegraph Company and associated Bell System Companies, which are listed in Appendix A, with respect to S. 141, relating to tax treatment of qualified dividend reinvestment plans.

The Bell System has often stated its support of bills to encourage capital formation and to provide new incentives for equity investment. In our judgment, S. 141 is such a bill in that it would help to accomplish these important objectives by encouraging shareholders, particularly small shareholders, to reinvest dividends received on stock holdings. Accordingly, we are happy to endorse this bill.

Dividend reinvestment plans redirect savings directly into new capital in the private sector while increasing individual savings and providing for supplemental retirement income and thus will be of substantial benefit to capital intensive industries, such as utilities, as well as to individual shareholders.

On numerous occasions, eminent scholars, economists and members of Congress have acknowledged the importance of increasing capital formation in our nation's economy. Additional investment capital is essential for implementing basic research and technological development, improving productivity, controlling inflation, reducing unemployment and enhancing America's international trade posture.

Clearly an influx of new capital will increase the nation's productive capacity, contributing to faster productivity growth and reduced inflationary pressures.

Yet current tax law discourages equity investment and thus slows the rate of equity capital formation. Furthermore, it encourages debt financing, thus forcing capital intensive companies to go to the debt market for funds, causing even higher interest rates nationwide. This is particularly true in the case of public utilities which have heavy construction costs coupled with high dividend payout ratios.

At present, over 1,000 major companies have some form of dividend reinvestment program. It is likely that enactment of S. 141 would result in significantly more companies using such plans for capital formation, thus increasing the economic benefits for the country as a whole.

As a pioneer in offering a dividend reinvestment plan, we believe our experience may be helpful to the Committee in assessing the benefits of this proposal. The Bell System has had a dividend reinvestment plan since 1969, when shares for the plan were purchased in the open market; in 1973, AT&T began to issue authorized, but previously unissued, shares at market price to plan participants; and in 1975, AT&T became one of the first corporations in the country to offer to its shareholders stock purchased with reinvested dividends at a discounted price.

Our dividend reinvestment plan has proven to be an effective means of raising equity, improving shareholder goodwill, and encouraging small shareholders to own a larger portion of the company. At present, AT&T has over 3 million shareowner accounts. Our shareholders reside in all fifty states and the vast majority are individuals with modest holdings. Over 800,000 AT&T shareowners participate in the dividend reinvestment plan, which represents 25% to 30% of all our shareowners. Moreover, nearly three out of four of the participants in our dividend reinvestment plan own fewer than 100 shares of AT&T stock and 38% of the plan participants own 20 shares or less. These figures do not include the nearly one million Bell System employees participating in dividend reinvestment through the Bell System Employee Stock Ownership Plan and savings plans. As these figures indicate, our dividend reinvestment plan has proven most attractive to the smaller investor.

Dividend reinvestment plans for new shares provide a convenient means of investment without market fees. Additionally, the tax deferral offered in the bill before your Committee would be a forceful incentive for the smaller investor to reinvest dividends and, for an individual with modest means who owns no stock, a persuasive reason for purchasing a few shares. The $1,500 ceiling ($3,000 for joint returns) on reinvested dividends effectively limits the benefit to be realized by the individual shareholder.

This proposal would enhance and increase the number of dividend reinvestment programs and encourage shareholders to take advantage of this simple, convenient, and economical way to build up their investments. With the added incentive of deferred tax, shareholder participation in dividend reinvestment plans would increase -- a development that should widen the stream of capital available to business and make new offerings of equity more attractive.

Dividends which are reinvested in original issue reinvestment plans become immediately available to a corporation to help meet its capital needs. Accordingly, they provide a stimulus to construction, productivity, and employment and contribute to a healthy economy. The equity capital that is produced reduces reliance on debt capital and provides for more stable capital structures.

There are two changes in S. 141 that we recommend the Committee consider: 1) the appropriate period for determining the minimum price of stock purchased with reinvested dividends as a percentage of fair market value; and 2) the effect a qualified dividend reinvestment plan will have on the issuing corporation's earnings and profits.

The bill, as it is now written, stipulates that for a plan to be qualified, stock purchased with reinvested dividends must be priced at not less than 95% of its fair market value during the period immediately before the distribution to be determined under regulations prescribed by the Secretary of the Treasury.

Many plans in existence today provide that market value will be determined over a fixed number of days prior to distribution, in order to protect shareholders and the issuing corporation. Because the length of the period for determining whether a plan is qualified is left to the Secretary to prescribe by regulations, we are concerned that taxpayers will not be able to say with certainty that their plan is qualified during the period between the effective date of this legislation and the promulgation of regulations. We respectfully recommend that the bill should be broadened to explicitly permit such a multi-day average pricing procedure for stock listed on a national exchange and to state the maximum number of days to be considered in the relevant period.

The second change we suggest refers to earnings and profits. Under the proposed legislation, if any shareholders elect to have the benefits of proposed section 305(e)(1) apply with respect to one or more distributions, the corporation will be unable to compute its earnings and profits accurately. Normally, a corporation must reduce earnings and profits by the amount of a dividend distribution. However, when a shareholder elects the benefits of section 305(e)(1), the shareholder's reinvested dividends are to be treated as a stock distribution under section 305(a). Pursuant to section 312(d)(1), the distributing corporation may not reduce its earnings and profits by the amount of the distribution treated as a stock dividend under section 305(a). However, the corporation has no way of knowing whether its shareholders will have made the election provided by section 305(e)(7) so it cannot determine the appropriate adjustment to its earnings and profits.

This problem may be solved by adding legislative language providing that the entire amount of the distribution shall reduce earnings and profits. Such an approach has the virtue of administrative simplicity and does not diminish tax revenues.

In conclusion, the Bell System favors steps to aid the small investor. With the recommendations discussed above, we fully support this proposal with respect to qualified dividend reinvestment plans. We believe such tax deferred plans would make positive contributions to capital formation and would thereby provide vital aid to the economy.

We appreciate this opportunity to comment on the legislation and will be happy to work with the Staff in providing appropriate statutory language to effectuate our recommendations.

Very truly yours,

R. Flint

Appendix A

BELL SYSTEM COMPANIES

American Telephone and Telegraph Company
The Bell Telephone Company of Pennsylvania
The Diamond State Telephone Company
Bell Telephone Laboratories, Incorporated
The Chesapeake and Potomac Telephone Company
The Chesapeake and Potomac Telephone Company of Maryland
The Chesapeake and Potomac Telephone Company of Virginia
The Chesapeake and Potomac Telephone Company of West Virginia
Cincinnati Bell, Incorporated
Illinois Bell Telephone Company
Indiana Bell Telephone Company, Incorporated
Michigan Bell Telephone Company
The Mountain States Telephone and Telegraph Company
New England Telephone and Telegraph Company
New Jersey Bell Telephone Company
New York Telephone Company
Northwestern Bell Telephone Company
The Ohio Bell Telephone Company
Pacific Northwest Bell Telephone Company
The Pacific Telephone and Telegraph Company
and Bell Telephone Company of Nevada
South Central Bell Telephone Company
Southern Bell Telephone and Telegraph Company
The Southern New England Telephone Company
Southwestern Bell Telephone Company
Western Electric Company, Incorporated
Wisconsin Telephone Company

The Dayton Power and Light Company
Courthouse Plaza Southwest, Dayton, Ohio 45401

Robert E. Frazer
President

STATEMENT OF

R. E. FRAZER

PRESIDENT

AND CHIEF EXECUTIVE OFFICER

THE DAYTON POWER AND LIGHT COMPANY

IN SUPPORT OF

DIVIDEND REINVESTMENT TAX PROPOSALS INCLUDED IN S. 141

AS PART OF

TAX REDUCTION PROPOSALS

BEFORE

UNITED STATES SENATE

COMMITTEE ON FINANCE

MAY 18, 1981

R. E. Frazer

R. E. FRAZER

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The Dayton Power and Light Company
Courthouse Plaza Southwest, Dayton, Ohio 45401

Robert E. Frazer
President

I submit this statement on behalf of The Dayton Power and Light Company (DP&L), an investor-owned public utility serving a population of 1.3 million in West Central Ohio.

With the energy shortages facing this nation and the national goal of curtailing oil imports, we at DP&L are convinced that electricity and natural gas will be called upon to salvage the future deteriorating national economy as it becomes starved for the additional energy it needs. To this end, DP&L has a system in which 98% of its electricity is produced by American-mined coal and through joint ownership arrangements we have two additional coal-fired generating units and one nuclear generating unit under construction.

To obtain the funds necessary to build and maintain these plants in addition to our existing facilities, DP&L depends heavily on a continuous flow of new investment capital. It is questionable whether utilities such as DP&L will be able to raise sufficient capital in the future without tax incentives for investors. The dividend reinvestment proposal included in S. 141 provides for deferral of current Federal tax on dividends reinvested in an original issue stock of any company having a qualified dividend reinvestment plan. Adoption of the dividend reinvestment proposals would:

1. Encourage capital formation.

2. Eliminate or reduce the double tax on dividends reinvested.

3. Encourage individual savings for supplemental income after retirement.

4. Treat stock acquired by reinvestment of dividends as conventional stock dividends.

5. Assist in financing essential energy facilities and in dealing with the energy problem.

6. Help reduce consumer demand and counter inflation.

DP&L has an Automatic Dividend Reinvestment and Stock Purchase Plan and actively supports the work of the Committee for Capital Formation through Dividend Reinvestment. We are vitally concerned about our ability to raise the necessary capital to continue the construction program essential for our customers' future energy needs. The Company's capital expenditures for the 1981-1985 period will total $993 million. It is anticipated that $273 million of this sum will be spent in 1981, primarily for the construction of new electric generation facilities. This will require more than $200 million in investment capital during 1981.

In summary we feel the adoption of legislation permitting deferred taxation of dividends reinvested would stimulate greater participation in dividend reinvestment programs such as ours and make a significant contribution to capital formation in the utility industry where capital is so urgently needed. We strongly urge your favorable consideration of this legislation as part of the tax reduction program.

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Statement of
General Telephone & Electronics Corporation
on the
Tax Treatment of Qualified Dividend Reinvestment Plans (S. 141)

Submitted to the
Subcommittee on Savings, Pensions and Investment Policy
of the Committee on Finance
United States Senate
May 15, 1981

General Telephone & Electronics Corporation (GTE) supports the enactment of legislation that will allow shareholders the complete or partial deferral of income taxes on dividends reinvested.[1] Specifically, we encourage legislation such as S. 141 presented by Senators Bentsen and Leahy providing limited tax relief to shareholders who elect to participate in a qualified dividend reinvestment plan.

It is important to include the dividend reinvestment concept in any major tax legislation to be enacted in Congress. Dividend reinvestment plans are essential to stimulate capital formation and increase the level of savings and investment in our nation.

The Need To Increase Corporate Cash Flow

Sufficient corporate cash flow is critical in a business to permit the modernization of its productive facilities, achieve substantial improvements in the efficiency of the operations and maintain a reasonable rate of growth. This essential cash flow may be generated internally by increasing profitability and reducing dividend payments, for example, or it may be generated externally by issuing new debt or new stock.

In the past decade, U.S. corporations have relied more and more on new debt to maintain an adequate cash flow to finance its operations. This reliance can be attributed, in part, to our system of taxation of corporate profits which makes equity investment more expensive to sustain than debt investment. Also important in explaining this trend is the relatively low market price of many corporate stocks in the past several years. This debt financing has seriously weakened the financial position of most companies, has increased the cost of its operations, products and services and has reduced for shareholders their rate of return on their

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1. GTE is the parent company of more than sixty communications, products, research, and service subsidiaries with operations in forty states and twenty countries abroad. It has over 201,000 employees worldwide and over 450,000 shareowners.

investment. To briefly illustrate the increase in the cost of operations, interest expense of corporations equalled a record high of 45% of net profits before taxes in 1980, as compared with only 14% for the 1960's.

For capital intensive industries such as telephone, banking, airlines, steel, etc., this situation has been more dramatic. These industries have been facing considerable difficulties in raising funds to meet their requirements to expand and modernize plant, increase productivity, meet increasing competition and improve service to customers.

Over the past five years, the vast majority of these industries that have decided to issue new common stock to increase their cash flow have been faced with stock sales below book value. This condition does not permit these industries to issue additional common stock without fear of further diluting stockholders' investment.

In recent years, economic conditions have aggravated this need to maintain an adequate corporate cash flow. Rising interest rates, a decline in the level of private savings and investment, the impact of inflation and heavy federal borrowing needed to finance government deficits are just some of the major causes intensifying this serious situation.

The Need To Increase Savings and Investment

For the past decade, the level of private savings and investment in our economy has been insufficient to provide for economic growth and preserve our standard of living. We are all aware of the Government statistics showing how the U.S. ranks last among the six leading industrial nations in the average rate which its businesses reinvest in manufacturing. On the individual side, Americans fall behind the citizens of the other industrialized countries in the level of savings and investment. As a nation, we merely save an average of only 5.5% of our disposable income while the British save an average of 13%, West Germans 15% and the Japanese a robust 26%.

This dangerous trend in overconsumption and underinvestment has seriously eroded our capital base reducing our industrial capacity, our ability to compete, the efficiency of our operations and the rate of economic growth in our nation. Definite steps must be taken to reverse this trend and assure a prosperous future for the generations ahead of us.

Capital Formation is a National Goal

Economists have long recognized the importance of capital formation needed to increase productivity and achieve significant levels of economic growth. In recent years, there has been widespread concern that the rate of U.S. capital formation is not sufficient to assure a level of growth in the total supply of goods and services in the economy that will enable a healthy rate of overall economic growth with reasonable price stability and minimum unemployment. New capital investment is also needed to allow the nation to meet numerous social goals such as energy production and conservation, environmental improvement and maintenance of the skill, health and safety of our workers.

To address such widespread concern for capital formation, numerous legislative proposals have been introduced in Congress to liberalize the present depreciation system to allow business to recuperate faster their invested capital in productive facilities and permit the reinvestment of the recovered amounts. The dividend reinvestment proposal also addresses the issue of encouraging capital formation and is perhaps the most direct, most closely targeted and most cost effective proposal for increasing savings and investment. It is most direct because the reinvestment in new issue stock represents instantaneous savings, investment and formation of new capital. It is targeted because it proportionally allocates this common equity to those sectors of the economy where it is most sorely needed, i.e., capital intensive industries. It is cost effective because it has been projected that this legislation will result in net additional tax revenues being generated forth within three years of enactment.

Importance of Dividend Reinvestment Plans

There are about 185 companies with dividend reinvestment plans for new issue stock with about two million shareholders participating in these plans. The plans are providing in excess of $2 billion a year of needed funds to business. Economic consultants forecast that if tax deferral on reinvested dividends is adopted the flow of funds could well be in excess of $4 billion a year and would represent over 50% of the total external common stock capital raised in public offerings in 1979. This less expensive method of increasing the flow of funds to business as compared to the costs associated with issuing new stock or carrying debt would be translated into the production of better goods and services at a lower price.

The attached exhibit highlights the results GTE has experienced with its dividend reinvestment plan. Annual investment in the plan has grown at a rate of 27% per year, increasing from $5 million in 1972 to $40 million in 1980. The plan has proven extremely popular among small shareholders, as over 93% of all participants own fewer than 200 shares. In addition, shareholders' participation has increased at a rate of 10% per year so that currently over 105,000 shareholders (23% of total shareholders) are participating.

Tax deferral on reinvested dividends would make equity investments more attractive for individuals, thereby increasing the number of shareholders and new investments. It would also provide for a simple, convenient and economical way to increase the level of private savings and investment in our economy.

Enactment of the proposal would increase the after-tax return on investment to the shareholder while simultaneously helping the company.

Salomon Brothers and Goldman, Sachs in separate studies have estimated that enactment would increase the stock price of original issue dividend reinvestment companies in the range of 10 to 20 percent. Such a price increase could lower a firm's cost of capital and help the company provide better products, service and other benefits to all of its customers.

Finally, by promoting savings over consumption this proposal would definitely assist in reducing inflation and unemployment, build a stronger economic base and improve overall conditions more favorable to further investment and economic growth.

Conclusion

GTE strongly urges the immediate adoption of the dividend reinvestment proposal (S. 141). Enactment of this legislation would be most beneficial to the investor and is a direct, focused, cost-effective means of encouraging capital formation. It promotes the creation of new equity in those sectors of the economy where it is most crucially needed, while generating additional tax revenues for the Treasury in the long run. As a result, this legislation will create jobs, improve productivity, reduce inflation and increase economic activity.

GTE Shareholder Systematic Investment Plan

Two bills are currently before Congress (H.R. 654 and S. 141) which could have significant impact on GTE Shareholders. These bills propose the deferment of taxes on dividends reinvested in new-issue dividend reinvestment plans (such as the GTE Plan). Under such proposals, no federal income tax would be incurred by shareholders on dividends automatically reinvested (up to $1,500 annually per individual) until the stock purchased with the reinvested dividends is sold. Any gain on the sale would then be taxed at the lower capital gains rates. In effect, the stock received as a result of reinvested dividends would be regarded, for tax purposes, as essentially the equivalent of a conventional stock dividend with similar tax consequences.

Enactment of this legislation would be most beneficial to the investor and is a direct, focused, cost-effective means of encouraging capital formation. It promotes the creation of new equity in those sectors of the economy where it is most crucially needed, while generating additional tax revenues for the Treasury in the long run. As a result, this legislation will create jobs, improve productivity, reduce inflation and increase economic activity.

ADDITIONAL INFORMATION CONCERNING THE GTE SHAREHOLDER SYSTEMATIC INVESTMENT PLAN MAY BE OBTAINED BY WRITING TO GTE SHAREHOLDER SERVICES INCORPORATED, P.O. BOX 158, NORTH QUINCY, MASSACHUSETTS 02171, OR CALLING (TOLL FREE) (800) 225-5160, OR FOR MASSACHUSETTS RESIDENTS, (800) 972-5094; FOR RESIDENTS OF ALASKA OR HAWAII, (800) 225-5440.

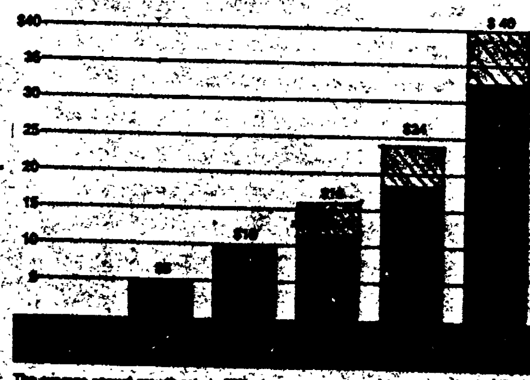
Shareholder Participation

	Shareholders	Plan Participation	
Shares Held	Registered Shareholders	Participants	Percent Participation
1-100	342,119	95,671	28%
101-200	75,466	10,110	13
201-500	59,349	6,393	11
501-1,000	17,040	1,707	10
1,001-over	7,829	446	6
Total	501,802	114,328	23%

Participants owning 200 shares or fewer 105,781 / Total Participants 114,328 = 93%

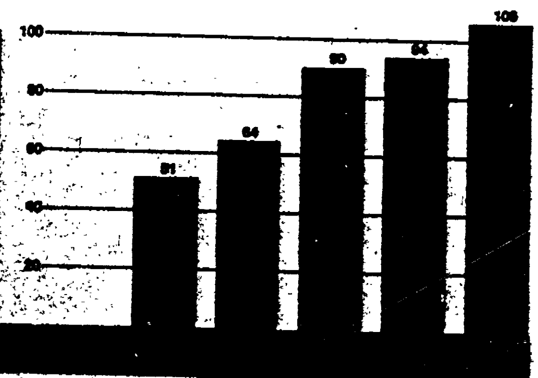
As of January 1, 1981, a total of 114,328 or 23% of all registered GTE shareholders were participating in the plan. The plan is particularly popular among small investors who represent 93% of all participants.

Annual Investment
(Dollars in millions)



The average annual growth rate is 27%. Approximately 80% of the 1980 investment is from the reinvestment of dividends and the remainder is from optional cash payments.

Average Shareholder Participation
(Participants in thousands)



The average annual growth rate is 10%.

Statement of William S. Gray, Jr., Vice President
and Chief Financial Officer of Union Carbide Corporation

Submitted to the Subcommittee on Savings, Pensions and Investment Policy,

Committee on Finance, United States Senate

May 18, 1981

Summary

Union Carbide Corporation supports the enactment of S.141, the dividend reinvestment proposal sponsored by Senators Bentsen and Baucus.

From its experience with its own dividend reinvestment plan, Union Carbide believes that this proposal is a carefully targeted and cost-effective means of stimulating capital formation among capital-intensive businesses and others with a continuing need for new equity capital. At the same time, enactment of the bill could stimulate saving by small investors, help dampen inflation, and improve the stability of capital markets. The bill would be especially conducive to capital formation in those capital-intensive industries that form the basic infrastructure of our American economy.

The proposal would defer federal income tax on dividends reinvested in the original issue stock of companies with qualifying dividend reinvestment plans, with an annual cap of $1500 for a single taxpayer and $3000 for a joint return. The distribution of stock in lieu of cash dividends through such plans would be treated, for tax purposes, as essentially the equivalent of a conventional stock dividend.

If enacted, the proposal should not apply to public utilities only, but to any capital-intensive or other company with a continuing need for common stock capital. There is no need to limit the application of this bill for fear that revenue loss would be excessive, or that companies would be stampeded into providing dividend reinvestment programs they really did not endorse.

* * * * * *

Statement of William S. Gray, Jr., Vice President
and Chief Financial Officer of Union Carbide Corporation

Submitted to the Subcommittee on Savings, Pensions and Investment Policy,

Committee on Finance, United States Senate

May 18, 1981

My name is William S. Gray, Jr. I am Vice President and Chief Financial Officer of Union Carbide Corporation.

Union Carbide Corporation supports the enactment of S.141, the dividend reinvestment proposal sponsored by Senators Bentsen, Baucus and others. From our experience with our own dividend reinvestment plan, we believe this proposal is a carefully targeted and cost-effective means of stimulating capital formation among capital-intensive businesses and others with a continuing need for new equity capital. At the same time, we believe enactment of the bill would stimulate saving by small investors, help dampen inflation, and improve the stability of capital markets. The bill would be especially conducive to capital formation in those capital-intensive industries that form the basic infrastructure of our American economy.

If enacted, the provisions of the proposal should apply to all companies that wish to set up qualifying plans, not just to public utilities.

Union Carbide's Experience with Dividend Reinvestment

Since September of 1978, Union Carbide has offered its shareholders a Dividend Reinvestment and Stock Purchase Plan through which they can receive additional shares of stock in the company instead of cash dividends. Under the Plan, shares purchased through the reinvestment of dividends are purchased at 95% of their market price. No brokerage or other fees are charged.

The Union Carbide Plan issues new shares of stock in the company rather than buying up previously-issued shares in the marketplace. Consequently, all purchases by shareholders participating in the Plan represent new equity capital for the Corporation.

Participation in our Plan has grown rapidly. As of March 2, 1981, almost 21% of the Corporation's declared dividend was being reinvested. Almost 16% of our shareholders were participating. During 1980 the dividend reinvestment feature of the Plan brought more than $37 million of new equity capital into the Corporation.

The plan is particularly popular with our smaller shareholders. Some 98% of the plan's participants own fewer than 500 shares of Union Carbide stock; some 70% own fewer than 100 shares. (With our annual dividend per share currently at $3.20, that means that some 70% of participants receive less than $320 per year from the Corporation, and some 98% less than $1600.)

Looking at the other side of the coin, of all our shareholders who own less than 100 shares, more than 20% are enrolled in our Plan, compared with the 16% participation for shareholders as a whole.

<u>Advantages of Dividend Reinvestment for Raising Capital</u>

A dividend reinvestment plan can offer many companies that need to raise new equity capital an efficient and effective means of doing so.

The traditional method of raising equity is to float a large block of stock through an investment banker and underwriting syndicate. To do so successfully requires careful attention to market timing -- but even when carefully timed, the issuance of a large block of stock tends to depress the share price of the issuing company.

In a dividend reinvestment plan, in contrast, equity is raised continuously through the periodic issue of small amounts of stock. Current shareholders of the company get first crack at the new shares; and, since shares are purchased with dividends, and thus in proportion to current holdings, shareholders who wish to do so may preserve their relative positions in the company by participating in the reinvestment plan.

Since relatively small amounts of stock are issued through a reinvestment plan at any one time, they do not create the depressing effect on stock price of an underwriting offering. (We certainly have noticed no such effect on Union Carbide stock attributable to our Plan.) Furthermore, since no underwriting is involved, the company saves the underwriting fee it would otherwise pay its investment banker. Our Plan, like those of many other companies with original issue dividend reinvestment programs, passes on the savings to participants.

The 5% discount is one reason why our Plan is so popular with smaller shareholders. But equally important to them (as we found in a recent survey) is that we are allowing them to buy stock without paying brokerage commissions and fees. We are also allowing them to buy small amounts of stock at a time, so that they can set up a regular stock savings plan and stick to it.

The greatest disadvantage of a reinvestment plan currently is that it raises rather small amounts of equity at any one time compared with a traditional public offering. On the other hand, the reinvestment plans, because of their on-going nature and their appeal to the small shareholder, are capable of raising equity at times and under financial market conditions when a big underwriting might not fly.

In any case, it is the current inequitable tax treatment of those who reinvest their dividends that is in large measure holding down the size and capability of dividend reinvestment programs. Under current tax law, those who reinvest their dividends must nevertheless pay taxes on them as if they had received them in cash, even though they don't see the money until they later sell their shares.

Advantages of S.141

S.141 would defer federal income tax on dividends reinvested in the original issue stock of companies with qualifying dividend reinvestment plans, with an annual cap of $1500 for a single taxpayer and $3000 for a joint return. The distribution of stock in lieu of cash dividends through such plans would be treated, for tax purposes, as essentially the equivalent of a conventional stock dividend.

Based on Union Carbide's experience with dividend reinvestment, I believe that S.141 has an important place among the various capital formation proposals.

(1) In the first place, passage of the proposal would stimulate the reinvestment of dividends, which, as described above, is a particularly efficient means of raising equity capital. Next to retained earnings, reinvested dividends can be the most direct and efficient source of new equity available to a company.

(2) Furthermore, S.141 would directly stimulate savings and investment by the individual shareholder. This tax-cut proposal takes the form of deferring and possibly reducing taxes for the individual taxpayer rather than the corporation, in return for the individual's contribution to capital formation. Both the individual and the corporation stand to gain.

(3) A proposal like S.141 could help dampen inflation. As described above, dividend reinvestment plans have a unique ability to invest small amounts of capital directly from individuals, because they accept small orders and absorb transaction costs. Furthermore, the tax benefits of S.141 would be available only to individuals investing in additional common stock, to the extent that they did so. S.141 is thus encouraging the saving of amounts that might otherwise dribble away into current consumption, with corresponding inflationary effects. The savings so created would be available to business for investment in additional productive capacity.

(4) Because it focuses on dividend reinvestment, and because of the dividend limitations written into it, S.141 would encourage the accumulation of capital by small individual investors, as opposed to large institutional shareholders.* This "grass-roots" approach to capitalism could help to stabilize the American capital market, since small individual investors are less likely than professional buyers to bring about short-term price fluctuations.

(5) S.141 would be especially conducive to capital formation in those dividend-paying, capital-intensive industries that are basic to our economic infrastructure. The proposal would be of greatest benefit to those companies with stock on which a relatively high proportion of the total return is in the form of dividends as opposed to stock price appreciation from retained earnings. The high-dividend companies tend to be those active in capital-intensive industries such as electric power, communications, steel, and chemicals -- industries which are the cornerstones of our American economy, and which have an urgent need for new equity capital.**

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*Even without the dividend limitation the bill would not benefit the many institutions that enjoy tax-exempt status.

**Because of their close ties to the economy, such companies may experience a certain cyclicality in their earnings. They have therefore traditionally offered a relatively high dividend payout, compared with so-called "growth" companies, in order to help compensate for the relative unpredictability of the appreciation in their stock price.

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(6) By changing the tax treatment of reinvested dividends, S.141 would promote a more efficient distribution of capital between dividend-paying and non-dividend-paying companies. Under current tax laws, investors who are satisfied with the business risks and rewards of an investment may shy away from it simply for tax reasons; and as a result, capital may be diverted from its optimum business use.

Many high-dividend companies naturally enough have attracted to themselves a relatively high number of shareholders who prefer dividend income to stock price appreciation. Even the discounts and cost savings of a dividend reinvestment program do not induce them to forego cash dividends. On the other hand there are people -- including many wealthier investors who can afford to forego a cash dividend -- who are induced by tax law to invest elsewhere, in so-called "growth" companies that pay little or no dividends.

Thus, certain companies tend to attract certain kinds of investors, on the basis of the tax consequences of the dividend policy followed by each company. In particular, many of our basic industries seem unappealing to wealthier investors in search of capital gains, even though companies in those industries may offer perfectly acceptable business risks.

One of the great advantages of a dividend reinvestment program is its potential for making the company that adopts it more acceptable to the broad spectrum of investors. By installing a dividend reinvestment program, a company allows each stockholder to decide for himself how much of his return to take in the form of an immediate cash dividend, and how much to leave invested in the hope of future stock price appreciation. Shareholders seeking primarily stock price appreciation need not avoid a company that offers a large dividend, when they can instruct the company to reinvest their dividends in additional stock.

Unfortunately, current tax treatment of reinvested dividends frustrates this potential of dividend reinvestment plans. Shareholders reinvesting their dividends now must nevertheless pay taxes on them as if they had received them in cash. Therefore investors seeking capital gains are forced to abandon even those high-dividend companies that have reinvestment plans in place.

By correcting the current inequitable treatment of reinvested dividends, S.141 would help our basic industries and others with qualifying plans to attract a broader spectrum of investor, including those wealthier investors most able to forego dividends in favor of increased capital investment. Investors would be encouraged -- not only with respect to basic industries but with respect to their investments generally -- to focus on the business rather than the tax consequences of their investments. In the long run, in our free market economy, that will help to optimize the distribution of capital to where it is most needed and most appropriately invested.

Need for General Application of S.141

The effectiveness of S.141 in promoting capital formation would be severely limited if the provisions of the bill were limited to public utilities or any other particular class of industry. If enacted, the proposal should apply to any capital-intensive or other company with a continuing need for common stock capital.

There is no need to limit the application of this bill for fear that revenue loss would be excessive, or that companies would be stampeded into providing dividend reinvestment programs they really did not endorse.

(1) The revenue loss that would result from passing a bill like S.141 has been estimated by various parties, on the assumption that the provisions of the bill would apply generally to American companies. These estimates indicate the loss is quite tolerable under such circumstances.*

*After giving effect to the "feedback" associated with the increase in national output, business-fixed investment and jobs, Nathan Associates estimates that there would be a net revenue loss of $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 thereafter.

The staff of the Joint Committee on Taxation which, as a matter of principle, does not take into account any "feedback" revenue gains, estimated that the gross cash revenue loss in the first fiscal year would be some $240 million; and that the gross revenue loss would increase in succeeding years but would in no case exceed a little over $1 billion a year. (These estimates are included in a letter dated October 24, 1979 from Bernard M. Shapiro, Chief of Staff for the Joint Committee, to Congressman Pickle.)

(2) Not all companies would adopt a qualifying dividend reinvestment plan simply because S.141 were passed. Qualifying plans would be of interest only to companies which had made the determination to seek capital through the sale of new stock. That is a financing decision that is never made lightly, since it can involve dilution of earnings per share and other effects.*

(3) The number of companies that would actually adopt a qualifying program is limited still further, since, as mentioned earlier, dividend reinvestment as a method of raising equity tends to be of interest primarily to capital intensive companies in basic industries -- those that are paying out a relatively large proportion of their total return tc investors in the form of dividends.

(4) The number of industrial companies that currently have in place dividend reinvestment plans that would qualify under S.141 is small compared with the number of public utilities that would qualify.** This reflects the historical origins of dividend reinvestment plans within the utility industry, and also the fact that qualifying plans

*Georgeson and Company has estimated that of the 1,060 companies offering their shareholders some sort of dividend reinvestment as of December, 1980, only 182 were offering "original-issue" plans. It is only the latter that would qualify under S.141.

**For example, of the 182 potentially qualifying plans in the Georgeson study cited in the note above, only a handful -- perhaps a dozen -- were industrial companies. There were a few financial and retail companies as well.

are of most interest to companies which, like the utilities, are capital-intensive. Even if S.141 were passed, the number of non-utilities interested in establishing qualifying plans would remain limited, for the reasons cited in (2) and (3) above. So not much would be saved from revenue loss if the provisions of S.141 were limited to public utilities. On the other hand, the more efficient allocation of capital investment that this bill could make possible, as I have described earlier, would be severely and unfairly compromised.

Conclusion

In sum, we believe the substance of S.141 merits inclusion in any tax legislation designed to promote savings and capital formation. In encouraging dividend reinvestment, the proposal is encouraging a particularly efficient mechanism for raising equity capital. At the same time, the bill would promote individual saving, and could help dampen inflation and stabilize capital markets. The bill would direct capital especially to those basic industries of our economy that most need it, and open those industries for consideration by investors who now shun them because of current tax laws. For maximum effect, the provisions of this bill should apply to all companies that wish to set up qualifying plans, not to public utilities alone.

May 14, 1981

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• NOT ADMITTED IN D.C.

May 14, 1981

The Honorable John H. Chafee
Chairman, Subcommittee on Savings,
Pensions, and Investment Policy
Committee on Finance
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

On behalf of the Prudential Insurance Company of America, I am submitting this letter for inclusion in the printed record of the Hearing on Savings and Investment Incentive Tax Bills which the Subcommittee held on May 4, 1981.

Several of the bills which were the subject of this hearing would make permanent the new tax exclusion for interest income and would increase the amount of interest which may qualify for the exclusion. With the Subcommittee's consideration of these proposals, an unresolved issue associated with the present interest exclusion is becoming of increasing concern to Prudential and other insurance companies. This issue is the treatment of interest on insurance company deposits.

Interest on insurance company deposits includes interest paid on policyholder dividends left with an insurance company to accumulate; interest paid on insurance policy proceeds left on deposit with the insurance company; and interest paid on prepaid insurance premiums which are deposited with the company. These types of interest are fundamentally equivalent to other types of interest eligible for the exclusion. Interest on insurance company deposits is interest on savings, and it is interest on corporate indebtedness. It performs the same economic function and, to date, receives the same tax treatment, as other types of interest eligible for the exclusion.

Denying the exclusion for interest on insurance company deposits would undercut the legislative purpose of the interest exclusion to promote capital formation and to promote such capital formation in a way which prevents disintermediation. Denying the exclusion for such interest would also be extremely unfair, both to the individuals who receive it and ultimately to the insurance companies that pay it.

Interest on insurance company deposits not only meets the policy purposes of the interest exclusion, but also meets its technical requirements. The statute makes the interest exclusion available for various types of interest, including the following:

> to the extent provided in regulations prescribed by the Secretary, [interest on] other evidences of indebtedness issued by a domestic corporation of a type offered by corporations to the public. § 116(c)(1)(C)(ii)

Interest on insurance company deposits meets this statutory description. Interest on insurance company deposits constitutes interest, it constitutes interest on evidences of indebtedness, and these evidences of indebtedness are of a type offered by corporations to the public.

Over six months ago we submitted a memorandum to the Assistant Secretary for Tax Policy and the Commissioner of Internal Revenue presenting the basis for these conclusions. The American Council of Life Insurance, whose members write 95 percent of the life insurance in the United States, strongly supports this position. In addition, Senator Lloyd Bentsen, the primary Senate sponsor of the present interest exclusion, and Senator Russell Long, who was then Chairman of the Finance Committee, expressly brought this matter to the attention of the Senate during the Senate debate on the conference bill which included the present interest exclusion. Their colloquy indicates the appropriateness of concluding that interest on insurance company deposits satisfies the foregoing statutory provision and indicates approval of this conclusion. Their colloquy also evidences an assumption that Treasury will provide the clarification needed in regulations.

Since this matter affects a large number of individual taxpayers and also affects most life insurance companies, we have asked the Treasury Department to confirm that interest on insurance company deposits qualifies for the exclusion. This confirmation has not been received. The Treasury Department has not yet proposed regulations to implement the interest exclusion and is not expected to do so in the near future. Thus, the status of interest on insurance company deposits remains uncertain.

The lack of official guidance on this matter has created a difficult problem for Prudential. Now that the interest exclusion has taken effect, there is an immediate danger of disintermediation. Policyholders who maintain insurance company deposits may withdraw the deposits in the mistaken belief that the interest does not qualify for the exclusion (while interest on bank deposits does qualify).

We also are faced with the problem of advising policyholders as to whether interest on insurance company deposits qualifies for exclusion. This is because the tax information reporting form for interest payments requires payors of interest to inform recipients whether the interest paid qualifies for the exclusion. This form may be issued at any time after April 30 if it is furnished with the final interest payment for the calendar year. In the past, Prudential has found it highly cost efficient to provide information reporting on interest payments throughout the year, rather than waiting until the following January, and we would like to follow the same practice this year.

We also note that although we have run into technical and timing problems on this matter, no one has yet expressed any policy reasons why interest on insurance company deposits should not be treated the same as other types of interest which qualify for the exclusion, since it is so clear that they should be.

It would be highly desirable to resolve the treatment of interest on insurance company deposits at an administrative level. It is not clear that we will be able to do so, however. Also, unlike other questions of interpretation, this issue cannot be resolved on the basis of a reasonable interpretation by the taxpayer (for example, by obtaining the opinion of counsel), since the statute requires that the issue be resolved through regulations.

Accordingly, if this issue is not resolved favorably by the time the Subcommittee takes action on the interest exclusion, it is respectfully requested that the Subcommittee provide further clarification that interest on insurance company deposits does qualify for the interest exclusion.

Sincerely yours,

Theodore R. Groom

Theodore R. Groom

Attorney for
The Prudential Insurance Company
of America

STATEMENT OF
DUFF AND PHELPS, INC.

Re: Tax Deferral of Reinvested Dividends (S 141)

Duff and Phelps, Inc.,[1] a nationally recognized credit rating firm, supports tax legislation designed to stimulate capital investment in U.S. industry. Stimulating capital investment is an essential step to bring about a reduction in the rate of inflation and to improve our international competitive position. These goals are in the public interest. The achievement of these goals makes it mandatory that U.S. industry increase its productivity. This cannot be accomplished without higher levels of savings and investment. Legislation aimed at deferring or reducing income taxes on investment income and capital gains would encourage savings and equity investments.

The tax deferral of reinvested dividends would encourage additional equity investments. Many companies already have dividend reinvestment plans which represent an important source of equity capital. Enactment of tax deferral legislation would increase participation of stockholders in those plans and would further stimulate other corporations to form dividend reinvestment programs.

There are many advantages to be derived from the additional savings flowing into equity investments. First, more funds seeking equity investments should lead to a lower cost of equity capital. Second, a larger equity base should reduce the cost of debt financing, and, three; a larger equity base permits a company to borrow more funds for reinvestment. In general, a company's credit standing improves as the equity proportion of its capitalization increases. This leads to a higher debt rating and lowers the cost of new debt financing to the issuing company. Lower capital costs for both equity and debt encourage more capital investments which lead to increased productivity. Lower capital costs and higher levels of productivity would result in low costs for products and services. This can be an important factor in dampening the rate of inflation and improving our international competitive position. Without increasing the level of capital investment industry is not in a position to create the jobs which will be essential in reaching these long term goals.

[1] Duff and Phelps is unique as a large independent investment research organization, which has been providing investment consulting services for close to 50 years. It is not a broker or investment banker. The Company is widely recognized in the financial community and in industry as a firm of investment analysts specializing in both fixed income securities and common stocks. Duff and Phelps is retained in a professional advisory capacity for advice and consultation on investments by more than 300 financial organizations which, in turn, serve many investors. Thus, directly and indirectly, Duff and Phelps provides independent, objective, professional investment research to a very large cross section of investors of all types.

SUMMARY OF THE PRINCIPAL POINTS
OF THE
STATEMENT OF GEORGE H. LAWRENCE
ON BEHALF OF
THE AMERICAN GAS ASSOCIATION
BEFORE THE
SUBCOMMITTEE ON
SAVINGS, PENSIONS, AND INVESTMENT POLICY
OF THE
SENATE FINANCE COMMITTEE
ON S. 141
MAY 4, 1981

I. A.G.A. supports the dividend reinvestment program established under S. 141 because it would provide a significant stimulus for equity capital formation.

II. A.G.A. estimates that the natural gas utility industry requires a cumulative capital investment of approximately $400 billion for financing system supply and construction between the years 1981 and 2000.

III. A.G.A. supports S. 141 because it generally provides for more equitable tax treatment of shareholders.

IV. A.G.A. supports S. 141 because it would stimulate savings and investment and is projected to produce a net revenue gain in the third and successive years of implementation.

The American Gas Association (A.G.A.) is a national trade association made up of nearly 300 natural gas transmission and distribution companies in all 50 states. In serving over 160 million customers, A.G.A. member companies account for approximately 85% of all gas utility sales in our nation. We appreciate this opportunity to present our views on S. 141 (Bentsen, D-TX).

A.G.A. member companies believe that the most salient policy feature of the S. 141 dividend reinvestment program is that it would encourage capital formation. Because the dividends, under this reinvestment program are immediately converted into new equity capital, the program provides substantial and direct aid in the formation of new capital. Generally speaking, such programs have been adopted in companies having the greatest need for new capital; therefore, this legislation would allow capital formation to take place where it is most urgently needed at present. For this reason, A.G.A. member companies support the dividend reinvestment proposal in S. 141 because it will help the regulated natural gas utility industry meet its capital requirements which are sizeable between now and the year 2000.

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 a cumulative capital investment of approximately $400 billion (1980 dollars) is required by the U.S. natural gas utility industry between the years 1981 and 2000 in order to finance gas supply and development and to meet the requirements for pipelines and distribution system maintenance and construction.*/ This $400 billion capital requirement is more than 6 times the industry's current level of total capitalization, which is $60 billion as of December 1978. In short, over the next two decades, stimulating capital formation will be the most fundamental challenge facing the regulated gas utility industry and the nation. Indeed, the importance of stimulating capital formation cannot be overemphasized if our nation is to develop domestic energy supplies in order to reduce our dependence on imported oil.

S. 141 provides certain tax benefits to shareholders participating in a qualified dividend reinvestment plan when these shareholders elect to reinvest cash dividends and receive common stock of the issuing corporation. The effect of this election under S. 141 would be to defer the shareholder's federal income tax liability on the amount of the reinvested dividends until the time of disposition of the acquired stock. The bill would, therefore, effectively convert the tax on the reinvested dividends from that of ordinary income to capital gain. In this respect, the attractiveness of a dividend reinvestment plan is enhanced which, in turn, fosters an increased rate of capital formation.

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*/This capital requirement estimate is based upon the North American Focus, a gas supply scenario which emphasizes gas supply coming from secure sources in North America. By the year 2000 this gas supply scenario is expected to yield natural gas supplies in the range of 26.0-32.0 Tcf. (The Gas Energy Supply Outlook: 1980-2000, A Report of the A.G.A. Supply Committee. The American Gas Association, Arlington, VA 22209; October 1980.

A.G.A. wholeheartedly endorses S. 141 for several other reasons. In addition to providing a significant stimulus for equity capital formation, the measure also provides a more equitable tax treatment of shareholders generally. Shareholders who receive a conventional stock dividend at present enjoy a tax benefit similar to that proposed in S. 141 for reinvested dividends, i.e., deferral of taxable gain to a later date. Inequitable treatment 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, or a cash dividend with no such benefits. S. 141 eliminates this inequity by providing that corporations which adopt a qualified dividend reinvestment plan can provide their shareholders a choice. Under S. 141, 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. The dividends in the latter case are taxed as capital gain, and then, only upon the disposition of the stock acquired by such reinvestment.

Moreover, making this favorable tax option available to shareholders will also help to encourage increased individual savings, a desirable national goal. The same intent was an underlying factor in the enactment of the Keogh and IRA programs.

In a much broader perspective, A.G.A. would like to highlight the independent appraisal conducted by Robert R. Nathan Associates, Inc. This appraisal assesses the economic impact likely to result from the enactment of a dividend reinvestment program such as that proposed in S. 141. The Nathan firm's estimates show that such a dividend reinvestment program would produce a net revenue gain of approximately $600 million in the third and successive years.

In conclusion, A.G.A. supports this reinvestment plan because such a plan would provide more equitable, balanced treatment between shareholders receiving conventional stock dividends and those shareholders who now cannot "plow back" their cash dividends into common stock, thereby receiving tax deferral benefits. Moreover, the instant dividend reinvestment plan will encourage individual savings, stimulate the economy, and is projected to produce a net tax revenue gain ultimately.

Of most importance to the regulated gas utility industry, however, is the fact that such a plan will have a dramatic, beneficial effect in assisting regulated gas utilities to obtain the significant amount of capital necessary over the next two decades.

84-080 O—81——33

April 29, 1981

STATEMENT IN SUPPORT OF S. 141

This statement in support of S. 141 is being submitted on behalf of LIFEMARK Corporation, an investor-owned health care management company headquartered in Houston, Texas. LIFEMARK owns and operates hospitals and professional dental laboratories, manages hospitals for others under contract, and provides ancillary services to hospitals in areas of cardiopulmonary care, pharmacy and physical therapy management. The company's shares are traded on the New York Stock Exchange (NYSE: LMK).

Similar to other types of businesses, the investor-owned hospital management companies are capital intensive and have a continued need to obtain additional common stock capital to finance their business. They find it more and more difficult and expensive to attract the necessary capital through large public offerings in the market place.

S. 141 has as its primary purpose the encouragement of capital formation and the provision of a stimulus to construction of essential capital facilities, employment opportunities, and a stronger economy. It would encourage increased reinvestment of dividends in original issue (OI) stock by deferring current taxes on dividends which are reinvested. The bill places an annual reinvestment limit of $1,500 for a single tax payer and $3,000 for a joint return.

It is important to emphasize that this proposal applies only to qualified dividend reinvestment plans wherein the pool of reinvested dividends is used to purchase original issue stock from the corporation at prices related to the then current market price and generally without brokerage or acquisition costs to the participating stockholder.

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. It is clear that this discourages participation by 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.

S. 141 provides that a stockholder purchasing stock with reinvested dividends would be required to hold the stock for at least one year and would then be treated when sold as a capital gain. Any sale of the stock so acquired within one year of acquisition would be taxed as ordinary rather than at capital gains rates. Suitable provisions are incorporated in the proposal to prevent abuse of the tax deferral privilege.

In 1978, the Committee for Capital Formation through Dividend Reinvestment, comprised of over twenty-one member companies of various sizes but similar in that they are capital intensive, retained the firm of Robert N. Nathan Associates to conduct a study of the economic impact of this proposal. The Nathan firm concluded that adoption of the proposal with the annual cap of $1,500/3,000 would:

1. Increase dividend reinvestment by more than 100%;
2. Increase national output on the order of $2.7 billion annually;
3. Stimulate business-fixed investment by close to $1 billion annually;
4. Add the equivalent of 50,000 jobs per year; and
5. The proposal would involve, on a dynamic basis, a first-year revenue loss of about $350 million, result in a wash in the second year, and produce a net revenue gain of about $600 million in the third and each successive year.

The Nathan revised estimate of revenue effects, based upon the bills introduced in the 97 Congress (S. 141 and H.R. 654), as noted in point 5 above, is almost identical to estimates by members of the staff of the Joint Committee on Taxation.

Increased participation by stockholders, as predicted by the Nathan report, would obviously be of major help in capital formation. It would help a large number of stockholders 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 which can provide larger cash dividends when the stockholder has need for such income.

The passage of S. 141 may be expected to further important and desirable national policies in at least six areas:

1. It would provide substantial, direct and immediate help in the formation of new capital--a highly desirable national objective--and in most capital-intensive companies where it is urgently needed.
2. It would eliminate, in whole or in part, the double tax on corporate dividends at the stockholder level. Dividends reinvested in the corporation can lead to additional taxable earnings at the corporate level.
3. It would provide fairness and equity for the participating stockholder as compared with the recipient of a conventional stock dividend.

Recipients of stock dividends pay no current tax; while recipients of cash dividends do. S. 141 will assure equitable consideration to participants in qualified dividend reinvestment plans.

4. It would encourage individual savings to provide supplemental income for retirement. In this respect, the proposed program is analogous to Keogh and IRA programs which have been fostered by favorable tax treatment.
5. It would help materially in financing essentially needed energy facilities. Out of about 1,000 corporate dividend reinvestment plans today, 132 now involve the issuance of new shares, and these are primarily capital-intense public utility companies.
6. It would act as an anti-inflationary measure since it would encourage reinvestment of cash dividends which would otherwide add to the consumer demands.

In summary, the proposal embodied in S. 141 would make a substantial contribution to a healthier economy, would further several desirable national objectives, and would do so with a positive growth effect upon the national treasury. Passage of S. 141 will provide multiple benefits for investors, for business and for the government.

For LIFEMARK Corporation:

Robert W. Carithers

Robert W. Carithers
Vice President, Public Affairs
RWC:srw

STATEMENT IN SUPPORT OF
DIVIDEND REINVESTMENT PROPOSAL
CONTAINED IN S. 141

BEFORE THE
UNITED STATES SENATE FINANCE COMMITTEE

BY
W. S. LEE, PRESIDENT
DUKE POWER COMPANY
CHARLOTTE, NORTH CAROLINA
MAY 4, 1981

The electric utility industry is the most capital intensive industry in the United States. As the nation's ninth largest investor-owned electric utility, Duke Power Company is an important member of this industry. Because Duke Power serves the most populous, industrialized and growing sections of North and South Carolina, its load is increasing somewhat faster than the national average. This growth calls for a highly capital intensive construction program to meet the electric energy requirements of the Piedmont Carolinas.

Unfortunately, like most utilities, Duke Power has not been able to attract adequate capital on reasonable terms in recent years. For example, seven of the last eight public sales of new common stock, occurring over the period 1974 through 1980, have been issued at prices below the book value of the stock at the times of such sales. This, among other things, led Duke Power's Board of Directors in February 1981 to delay indefinitely the completion of the first two units of the Cherokee Nuclear Station previously scheduled for service in 1990 and 1992. This delay makes it probable that serious power shortages will develop in Duke Power's service area in the late 1980s and early 1990s. This action was necessary, however, to preserve the Company's financial strength and avoid the significant dilution implied by continued sales of common stock below book value.

The Piedmont Carolinas cannot continue their rapid growth without an adequate supply of electric energy. Accordingly, it is essential that measures be taken to promote capital formation, encourage common equity investment in electric utilities and make utility common stocks, including that of Duke Power, competitive and more attractive to potential investors. This would assist Duke Power and other utilities in financing needed capacity to serve growing energy demands, and would foster the development of more jobs for future generations.

We believe that the legislative change to defer income taxes on dividends reinvested in companies' common stocks as proposed in S. 141 would indeed foster capital formation and the market price of companies' stocks offering such plans. Duke Power presently has a qualified dividend reinvestment plan with over 21,000 participants who, in 1980, contributed about $9.2-million through this plan. While it is not possible to predict with precision the degree by which the proposed legislation would increase capital formation, studies have indicated that the estimated benefits would be substantial.

We wholeheartedly endorse S. 141. We believe this legislation will increase capital formation, make utility common stocks more attractive and serve as one important element toward enabling utilities to compete on reasonable terms for capital needed in providing future electric generating capacity.

WRITTEN STATEMENT OF WILLIAM P. MARSHALL
SUBMITTED TO THE
SENATE FINANCE COMMITTEE
MAY 22, 1981

Deferral of tax on the first $1,500 of dividends that are reinvested via dividend reinvestment programs as stipulated by HR 654 and S 141 will benefit America by:

1) INCREASING JOBS due to expanded production facilities.

2) REDUCING INFLATIONARY PRESSURES by increasing production capacity.

3) IMPROVING CORPORATE FINANCIAL CONDITION via enhancement of ability to raise equity capital and reduce borrowing requirements, which will help lower interest rates.

4) STIMULATING INDIVIDUAL SAVINGS which are low in comparison with other countries. The diversion of dollars from consumption will also contribute to lower inflationary pressures.

5) LESSENING OVERALL DEPENDENCE ON THE SOCIAL SECURITY SYSTEM by fostering greater accumulation of individuals' net worth for their retirement years.

6) CONTRIBUTING TO INCREASED LONG RANGE TREASURY DEPARTMENT REVENUES due to increased employment. Initially there would be a slight decrease, but this is a small price to pay for such a powerful economic shot in the arm.

The legislation embodied in HR 654 and S 141 will contribute strongly to improved long range economic health of America.

STATEMENT OF JAMES MURPHY

IN SUPPORT OF S. 141 and H.R. 654

TAX DEFERRAL FOR REINVESTED DIVIDENDS

SUBMITTED TO THE UNITED STATES

SENATE COMMITTEE ON FINANCE

MAY 27, 1981

Tax Deferral For Reinvested Dividends Is Direct, Targeted and Cost-Effective

Tax deferral for reinvested dividends (S. 141 and H.R. 654) is the most direct, targeted, cost-effective means of encouraging individual savings and investment in the U.S. With the current level of savings at a record low, enactment of this legislation will provide the necessary common equity capital for American industry to invest in capital facilities to modernize our industrial plant, increase productivity, and improve our competitive position in world markets.

This legislation is most direct because it will instantaneously result in increased savings, investment, and the formation of new equity capital. Of all the bills considered by the Subcommittee on Savings, Pensions and Investment Policy, only the tax deferral for reinvested dividends results in a direct investment in new common equity capital. Equity investments, as opposed to other forms of investment, have a far greater impact on capital formation because of the multiplier effect. Each dollar of equity adds to the base on which additional debt can be sold, thereby financing additional productive assets. In addition, its effectiveness is guaranteed as the individual receives no tax benefit unless an equity investment is made. In this way, tax deferral works in a manner very similar to the highly successful investment tax credit.

This legislation is targeted because it benefits most those companies in need of common equity capital. These companies are typically in those industries which comprise the infrastructure of the U.S. economy (i.e., banking, airlines, utilities, steel, etc.). The balance sheets of many of these companies have deteriorated to record lows through an increased reliance on the use of debt. As a result, the interest expense of corporations in 1980 equalled a record high 45% of net profits before taxes as compared to only 14% for the 1960's.[1] The infusion of new common equity capital into these companies will greatly improve their financial health and provide them funds to modernize plant, increase productivity, create new jobs and improve our competitive posture worldwide.

This legislation is cost-effective as it will result in a substantial increase in savings, investment and thus, the creation of new equity capital, while involving only a

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1 Henry Kaufman, "The Potential for Conflict in National Policies and in Financial Markets," Salomon Brothers, April 22, 1981.

modest or non-existent revenue loss. In 1980, existing dividend reinvestment plans provided in excess of $2 billion in new common equity or approximately 25% of all equity capital issued. Estimates indicate that enactment of this legislation will result in well over $4 billion, or over 50% of all external common equity raised in public offerings, being generated through these plans.

Minimal Revenue Loss

The estimated revenue loss resulting from this legislation, as estimated by the Joint Committee on Taxation, is illustrated on the attached table. This table also includes the revenue loss estimates for each of the bills aimed at increasing individual savings and investment which were considered by the Subcommittee on Savings, Pensions and Investment Policy. It is clearly shown that the revenue loss from the tax deferral of reinvested dividends is dramatically less than that for all other bills. In fact, in 1982 the revenue loss is less than one-third that of the legislation with the next lowest revenue loss, and by 1986 it decreases to almost one-fifth of that loss.

Summary and Conclusion

The tax deferral for reinvested dividends is the most direct, targeted, cost-effective means of creating much needed common equity capital. It is also a simple, convenient and economical means for individuals to invest. By providing much needed equity capital, this legislation will allow companies to improve their balance sheets, modernize plants, improve productivity, create jobs and thereby be a help in the control of inflation. The revenue loss to the Treasury is significantly less for this piece of legislation than for any other legislation being considered, and private estimates indicate that when "feedback" is considered this legislation will actually generate net additional revenue to the Treasury within three years.

Based on the above and the strong support this legislation has received from shareholders, unions, regulatory bodies, rating agencies, investment bankers, academicians, management and others, I strongly urge the prompt enactment of the tax deferral for reinvested dividends (S. 141 and H.R. 654).

JOINT COMMITTEE ON TAXATION
ESTIMATE OF REVENUE LOSS (CALENDAR YEAR) OF TAX BILLS
PROVIDING INCENTIVES FOR INDIVIDUAL SAVINGS AND INVESTMENT
HEARD BEFORE THE SUBCOMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT POLICY

Number	Description	1981	1982	1983	1984	1985	1986
S. 141	Tax deferral for reinvested dividends	$ -	$ 725	$ 932	$1,133	$1,118	$1,123
S. 75	Increase capital gains deduction from 60% to 75%.	4,240	4,571	4,930	5,316	5,735	6,184
S. 145	Increase capital gains deduction from 60% to 70%.	3,175	3,491	3,847	4,252	4,716	5,248
S. 457	Provide tax deferred investment account - capital gains not realized until distribution.	---------------not available---------------					
S. 936	Separate computation of tax on personal service income and reduction of maximum rate on any income to 50%.	15,899	18,697	22,116	26,170	30,812	36,075
S. 155	Dividend and interest exclusion of $200 plus 25% of div. and int. in excess.	-	2,299	8,255	12,341	17,535	24,087
S. 819	Dividend and interest exclusion of $200 or 30% of div. and int.	-	4,233	13,950	22,946	26,419	30,428
S. 142	Dividend and interest exclusion of $1,000	6,803	7,483	11,278	12,405	13,645	15,010
S. 330	Dividend and interest exclusion of $1,250	597	3,429	9,248	12,405	16,052	17,658
S. 492	Dividend and interest exclusion or $1,000	-	7,483	11,278	12,405	13,645	15,010

STATEMENT OF
JOSEPH A. McELWAIN, CHAIRMAN
THE MONTANTA POWER COMPANY
BEFORE THE
SUBCOMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT POLICY
UNITED STATES SENATE COMMITTEE ON FINANCE

TAX DEFERRED DIVIDEND REINVESTMENT PLANS
May 4, 1981

My name is Joseph A. McElwain, chairman and chief executive officer of the Montana Power Company, a large investor-owned utility based in Butte, Montana. My Company is engaged principally in the generation, purchase, transmission and distribution of electricity and the production, transmission and distribution of natural gas in Central and Western Montana.

I wish to endorse the oral testimony to be given today by Mr. Herbert Cohn and his colleagues on the panel discussing the tax deferral provided in HR 654 and other legislation for qualified dividend reinvestment plans.

Electric utilities, as the Committee knows, are capital-intensive and because of the nature of our regulated business, we are unable to generate the capital we need on an internal basis. However, we have a heavy and continuing need for new capital to finance the expansion required if we are to continue to provide adequate and reliable service to our customers.

Although conservation is reducing somewhat the rate of growth in demand for electric power, the necessity of switching to electricity in preference to other sources of power means that the economic well-being and comfort of Americans depends upon our ability to handle the new load. The capital needs of my own company in 1981 will exceed $100,000,000, and that is a very large sum indeed for one utility.

Dividend reinvestment plans have been developed by a growing number of utilities as a self-help way to meet a part of that capital requirement.

My own company launched its dividend reinvestment plan in May, 1979. It was welcomed by our shareholders. As of the last report, February 2, 1981, over four thousand of them were participating. We had issued 180,921 shares of new common stock under the program, at an average price of $22.43. We raised $4,057,688 through this program.

We are completely convinced that the tax deferral provided in HR 654 and related legislation would greatly enhance the attractiveness of dividend reinvestment plans and enlarge very considerably the participation of our shareholders and those of the many other companies that now have DRIP plans.

This has a twin effect. As stated, it will increase substantially the amount of capital that we can raise through this program. And, secondly, it will give tens of thousands of Americans new incentive to save rather than spend the money that comes to them in dividends. This is an important contribution to the overall national goal which has been endorsed by members of this Committee and both the current and former Administrations. Savings for investment means new plan capacity, enhanced productivity and eventual economic recovery for the United States. Tax deferral on dividends reinvested will be a small but very important contribution to that national goal.

We recognize that there are those who fear a revenue loss from our proposal, and that is understandable. However, I am confident that the economic benefits that would flow therefrom would shortly wipe out any such loss and eventually increase the revenues from the government. Many influential and respected economists agree with that outlook.

For all of these reasons, I strongly recommend that tax deferral with respect to dividend reinvestment be a part of any tax legislation in 1981.

84-080 O—81——34

SUMMARY OF POINTS INCLUDED IN STATEMENT OF ROBERT R. NATHAN IN SUPPORT OF S. 141, A BILL RELATING TO TAX TREATMENT OF QUALIFIED DIVIDEND REINVESTMENT PLANS, BEFORE THE SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT POLICY OF THE U.S. SENATE COMMITTEE ON FINANCE

May 4, 1981

The Dividend Reinvestment Proposal

S. 141 would amend the individual income tax laws so that the stock received by shareholders participating in qualified dividend reinvestment plans (DRPs) would be regarded, for tax purposes, as essentially the equivalent of a conventional stock dividend. That is, the tax on such dividends would be deferred until the acquired shares are sold and the proceeds would then be subject to capital gains tax rates. A limit to the tax benefit would be established through a "cap" on qualified dividends of $1,500 per year for a single return and $3,000 for a joint return. Under the provisions of the bill, only corporations that have a continuing need for external financing of plant and equipment expenditures would, as a practical matter, be qualified to provide this opportunity to their shareholders.

On the basis of analyses done by Robert R. Nathan Associates for the Committee on Capital Formation Through Dividend Reinvestment, I urge approval of the proposal embodied in S. 141. Its enactment would stimulate increased savings by dividend receivers. It is largely the relatively small shareholders who participate in DRPs. The resulting increase in personal savings would be immediately reinvested and be directly targeted for capital formation purposes by the companies with qualified plans. These business firms represent key sectors of the economy that have large financing demands for expanded and modernized plant capacity but face great difficulty in raising the necessary funds at reasonable costs. They include utilities and other capital intensive firms which have a continuing need for additional equity capital. Many of them have precariously high ratios of debt to equity, resulting in high interest costs, low interest coverage, and recurring downratings of their bond issues.

The accelerated depreciation proposals of the Administration would be of only limited help to these firms wherever flow-through provisions of States prevail. S. 141

would provide sorely needed help to these firms, to firms with limited profits seeking to invest in risky new energy or other ventures, and to firms that must rely heavily on external financing for their capital investment.

It is targeted for firms that will actually use the reinvested dividends to provide additional capital formation. S. 141 will improve productivity, lower costs per unit of output and reduce inflationary pressures. It will be anti-recessionary, adding about 50,000 jobs per year. After taking account of its economic "feedback," its immediate revenue loss will be temporary and 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.

Tax reductions generally

I would like to express some additional, personal views for which the Committee on Capital Formation Through Dividend Reinvestment and its members bear no responsibility and with which they may not agree. First, I agree with the basic objectives of the new Administration's economic recovery program. These objectives will not be attained if we rely exclusively on the tax proposals of the Administration. The proposed accelerated capital cost recovery system is a step in the right direction, but our economic program must include more actions that are targeted directly at the specific inflation and growth problems we face. Additional tax changes designed further to improve productivity, to stimulate new investment, and to lessen tax impacts on the Consumer Price Index are all anti-inflationary and needed. At this time they would also be anti-recessionary.

In summary, the economy is in critical need of tax incentives for expansion and modernization of plant and equipment and tax reductions to relieve inflationary spiral pressures. Such tax measures -- and S. 141 is a significant such measure -- should encourage increased capital formation, improve productivity, lower unit costs of production, foster innovative research and development, promote greater energy independence, and strengthen the competitiveness of U.S. goods and services in domestic and international markets. S. 141 can help relieve inflationary pressure in both the short and long run and can set the stage for improved economic performance in the coming decade.

STATEMENT OF ROBERT R. NATHAN, CHAIRMAN,
ROBERT R. NATHAN ASSOCIATES, INC., WASHINGTON, D.C.
IN SUPPORT OF S. 141, RELATING TO TAX TREATMENT OF
QUALIFIED DIVIDEND REINVESTMENT PLANS

Before

THE SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT
POLICY OF THE U.S. SENATE COMMITTEE ON FINANCE

May 4, 1981

Mr. Chairman and Members of the Subcommittee:

I appreciate this opportunity to update the testimony I presented before the Senate Finance Committee on July 29 of last year. I continue to urge enactment of the proposal embodied in S. 141 on the basis of analyses done by Robert R. Nathan Associates for the Committee for Capital Formation Through Dividend Reinvestment.[1] This statement also deals more broadly with my personal views on the need for certain other business tax incentives.

The Dividend Reinvestment Proposal

The statement submitted today by Mr. Herbert B. Cohn, Chairman of the Committee for Capital Formation Through Dividend Reinvestment, describes the dividend reinvestment plan (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 directly reinvested in original issue stock. The stock received by shareholders in those companies having a qualified dividend reinvestment plan

1. The business firm members of this Committee appear in a list appended to the statement of Mr. Herbert Cohn presented to your Subcommittee on this date.

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. S. 141 limits the tax benefit by establishing a "cap" on qualified dividends of $1,500 in any one year for a single return and $3,000 for a joint return.

I strongly endorse this DRP tax incentive which serves as an inducement to reinvest immediately and directly dividends which would otherwise be received by the shareholders in the form of checks and be subject to current income tax. It would substantially increase investor participation in DRPs, particularly by small shareholders. Most importantly, more savings would be made available as equity capital to qualifying corporations. In fact, only corporations that have continuing need for external financing of plant and equipment expenditures would, as a practical matter, be qualified to provide this opportunity to their shareholders. Provisions of the bill have been designed to make it difficult for other businesses to circumvent its basic objective.

Thus, S. 141 would aid those key sectors of the economy that 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 restore and preserve sound financial structures. The regulated sectors of the economy (gas and electric, transportation and communication utilities) come immediately to mind as examples, but the bill would apply as well to capital intensive firms in other industries that have a strong need for equity capital which they are finding extremely difficult to raise. Many of the qualifying companies already have precarious capital structures. They have inordinately high debt to equity ratios, resulting in low interest coverage ratios, high interest costs, and recurring downratings of their bond issues. These companies are faced with inexorable large increases in their required capital and operating expenditures due to inflation and to environmental requirements. Especially for the utilities, these problems are aggravated by lagging and inadequate rate relief by federal and state regulatory agencies.

Moreover, the accelerated depreciation provisions proposed by the Administration would be of only limited help to utilities wherever "flow-through" provisions of States prevail. Accelerated depreciation also would not be immediately helpful to firms investing in risky new sources of energy and those currently or prospectively not profitable enough to be subject to substantial income taxes. On the other hand, the dividend reinvestment proposal embodied in S. 141 would strongly encourage such equity investments in a direct and cost-effective manner. Qualifying corporations would be enabled to obtain readily and at lower cost more of the essential equity capital most of them have great difficulty in acquiring.

Increased savings by dividend receivers -- and I repeat that it is largely the relatively small shareholders who participate in DRPs -- would make directly available for investment a larger and more readily accessible volume of private equity capital. Once the shareholder decides to reinvest through the DRP, those dividends are not immediately available for consumer expenditures. They are saved and reinvested. The funds so reinvested are directly targeted for capital formation purposes. They aid in obtaining the balanced expansion and modernization of the industrial capacity required to achieve improvement in the productivity of our economy. Higher productivity is essential in our current fight against recession and inflation, in support of a strong dollar, and in our efforts to make our goods more competitive in domestic and international markets.

Robert R. Nathan Associates studied the economic impact of the dividend reinvestment provision and concluded that by its third year of operation such a provision, with the $1,500/$3,000 "cap," would about double the dollar volume of participation in qualified reinvestment plans. The estimates I presented to the full Committee last July indicated that the measure would also:

1. Increase business fixed investment by about $1 billion annually;

2. Increase gross national product by approximately $2.7 billion annually;

3. Add some 50,000 jobs per year;

4. 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. Our estimates include the economic "feedback" of the proposal on Treasury revenues.

In summary, enactment of such a fruitful dividend reinvestment provision would enhance and reinforce constructive national economic policies designed to stimulate savings and investment. 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 generally 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. These are broadly supported objectives.

Tax Reductions Generally

The following part of this statement is an expression of my own views. The Committee on Capital Formation Through Dividend Reinvestment and its members bear no responsibility for it and may not agree with it.

The basic stated objectives of the new Administration's economic recovery program are desirable. It is important that the economy move along the path outlined in the listing of economic assumptions that represent the economic program the Administration presented in its March 10 booklet of budget revisions. The problems of recession and inflation, of high interest rates, high unemployment and poor productivity must be attacked vigorously. In my view, however, to succeed in this effort, we cannot rely exclusively on the tax proposals of the Administration. The economic program must include more actions that are targeted directly at the specific problems we face. As I said before your full Committee last July, "enactment of anti-inflationary tax shifts or reductions ... 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."

Large budget deficits are being forecast for this year and next. They are likely to be even higher if private investment outlays do not increase substantially. That is why I urge substantial and directly targeted tax reductions to encourage and facilitate investment. Unless we get much larger levels of private investment outlays, we will find ourselves fighting inflation with recession, and that 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 largely attributable to excess demand. From the first quarter recession trough of 1975 to the first quarter of 1980, unemployment never fell below 5.7 percent. It has recently been running close to 7.5 percent and, after adjustment for inflation, the national output in the first quarter of 1981 was not significantly greater than the level reached in the first quarter of 1980. If excess demand is not the major cause of the inflation and the economy is not overheated, then overcooling and other recessionary policies will not work unless they are carried to extreme depths and durations that few would advocate.

Inflation will likely continue to be with us for many years to come because we have not attacked its basic causes, especially our poor productivity performance. 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, 1975, and again in 1979 and 1980, productivity, measured as the output per hour of all persons in the private sector, actually declined. The need is urgent 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. Increased capital formation would not only attack inflation in the right way and the right place, but is fully compatible with reasonable recovery objectives as well, and is essential for sound, solid economic growth. In addition to a carefully formulated reduction in individual income taxes, we must stimulate investment-related jobs and incomes in order to expand consumer demand and to compensate for the restrictive impact on purchasing power of 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, even though we might argue about some of the details, early enactment of the Administration's proposed accelerated capital cost recovery system for businesses would be a step in the right direction. But in my view, additional tax incentives immediately and directly targeted to stimulate greater investment in new, modern, and more productive capital facilities are needed.

In supporting business tax incentives to spur investment I do not mean to imply that poor productivity has been the major cause of the present inflation, nor has the rate of 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. Well-designed research and development programs yield discoveries that also foster economic growth and help fight inflation by reducing unit costs of production. Tax incentives to support additional R&D of this nature would therefore be desirable. Cooperative efforts by management and labor can lead to greater efficiency.

Also, highly inflationary is our dependence on oil imports and seeming past helplessness in the face of drastic OPEC price increases. We must not continue to allow OPEC to affect seriously U.S. price levels and balance of payments. To achieve greater energy independence, we must greatly expand investments in building up our domestic energy sources and we must also speed investments in new energy efficient plant and equipment by relatively intensive industrial users of energy. We still need to foster much more conservation in energy consumption.

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 modernize and convert our steel and auto industries, to cite just two examples, will do far 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 relate to the high priority goals of reducing the rate of inflation and restoring economic growth. These objectives can be facilitated by enactment of such proposed tax provisions as accelerated depreciation and the dividend reinvestment plan proposed in S. 141. Accelerated depreciation of plant and equipment should result in shortening the duration of risk exposure and in lower corporate income taxes and higher immediate cash flows for profitable firms. This will provide business with stronger motivation and internal funds for the investment that is a key ingredient in improving our productivity. But businessmen must perceive levels of customer income and demand that justify the investment in expanded and modernized facilities. Avoidance of serious recession is therefore essential. Increased investment will result in a stronger economy and, in turn, tend toward smaller or fewer federal deficits, making more funds available for future private investment.

In summary, the economy is in need of tax incentives for modernization of plant and equipment. Such tax measures should encourage 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 help set the stage for improved economic performance in the coming decade.

STATEMENT OF JAMES J. O'CONNOR
on behalf of
COMMONWEALTH EDISON COMPANY
for the hearings of the
SENATE FINANCE SUBCOMMITTEE ON
SAVINGS, PENSIONS AND INVESTMENT POLICY
on
TAX-DEFERRED DIVIDEND REINVESTMENT

May 1, 1981

This statement is made on behalf of Commonwealth Edison Company, which provides electricity to more than eight million people who live and work in Chicago and northern Illinois. Commonwealth Edison has about 263,000 holders of its common stock, and sixteen percent, or about 41,500 of the stockholders, presently are participating in Commonwealth Edison's dividend reinvestment plan.

The passage of S. 141, which was introduced by Senator Bentsen, will provide for a limited amount of tax to be deferred on reinvested dividends and will help significantly to resolve Commonwealth Edison's and the electric utility industry's financial problems. Restoration of the electric utility industry's financial health is essential to increasing productivity, reducing inflation, and decreasing the nation's reliance on imported oil.

The electric utility industry is experiencing devastating financial problems at this time as evidenced by the following:

(1) At the present, very few utilities are willing to commit to new large-scale construction projects because of financial constraints. On the other hand, because of commitments already made, investor-owned electric utilities will have to expend about $155 billion on new construction during the next five years. That amounts to about 72 percent of the industry's 1980 year-end capitalization. Commonwealth Edison is planning to spend $5.7 billion during the next five years, primarily for the completion of construction of six nuclear generating units which were started many years ago. Without an adequate infusion of capital, Commonwealth Edison and others in the industry necessarily will have to slow down or halt construction of many of these facilities.

(2) Electric utilities' internal generation of funds, principally retained earnings, depreciation, and deferred income taxes, fell to less than 30 percent of construction expenditures in 1980; however, in the mid-sixties, about two-thirds of all electric utility construction was financed internally. Consequently, utilities now are forced to go to the marketplace for more than two-thirds of new-money requirements. Yet, the markets for utility stocks and bonds have gone from bad to worse during the last few years.

(3) According to a study by Salomon Brothers of 100 electric utilities, the ratio of the market price of their common stock to book value fell from 107 percent in 1976 to 73 percent in 1980. Today, Commonwealth Edison's ratio of market price to book value is about 70 percent. When book value is higher than the market price and new shares are brought to market, the value of the shares held by existing shareholders is diluted.

(4) Whereas in the recent past, the electric utility industry was characterized predominantly by AAA and AA bond ratings, the industry now falls predominantly in the AA and A category, resulting in a one- to two-percent increase in the cost of debt capital at today's rates. According to Moody's rating system, 14 more electric utilities had their senior debt downgraded in 1980. For example, the rating of Commonwealth Edison's first mortgage bonds was AAA two years ago, but they have been downgraded two times since then, and now are rated as A. Paying higher rates on these less-creditworthy securities aggravates even more the utilities' depressed earnings condition.

(5) During 1980, the interest rate on new long-term debt issued by electric utilities averaged about 14 percent, whereas utilities earned an average of only 11 percent on common equity. Commonwealth Edison's last issue of bonds carry an interest rate of 14 percent, while earning only 10.2 percent on common equity during 1980. In other words, earnings do not cover the cost of new debt obligations.

(6) The public service obligation of utilities makes utilities different from other industries. Utilities must raise capital on terms which frequently are highly uneconomical because plant must be constructed to meet customer demand. Common stock is the foundation of the capital structure and to continue construction, stock must often be sold even when market conditions make such issues uneconomical. Because utilities do not have the investment discretion enjoyed by others, the tax-deferred dividend investment proposal contained in S. 141 offers an important and needed way to make electric utility stocks more attractive.

(7) The prospect for long-term market appreciation of electric utility stocks is not very good. To attract investors, therefore, utilities must offer high yields by paying a significant portion of earnings as dividends. For example, in 1980, Commonwealth Edison paid 89 percent of its earnings as dividends.

(8) Approximately 50 percent of all new common stock issued by the nation's publicly-held corporations is issued by electric utilities.

Because the stocks of electric utility companies offer little prospect of capital appreciation through earnings growth, they generally are not purchased by wealthier investors because such investors generally prefer capital gains. The relatively high yields of utility stocks are more attractive to the modest investor or to the investor who intends to use the dividends to supplement income. Of course, investors in low yield stocks as a matter of course defer income taxes and benefit by being able to convert their investments into capital gains because a great portion of the earnings on such stocks are retained and reinvested in the business. On the other hand, most of the earnings on utility stocks are paid in the form of dividends and are immediately taxed as ordinary income, whether reinvested or not. Consequently utilities are at a substantial disadvantage in attracting new classes of shareholders, and their existing shareholders, in effect, are discriminated against.

Commonwealth Edison has had a new-issue dividend reinvestment plan since 1974 and its shareholders have invested almost $190 million through that plan. More than 60 percent of the participants in the plan own 100 or fewer shares of stock, meaning that the value of a typical individual's holding is under $2,000. Last year, 5.4 percent of Commonwealth Edison's external financing needs was fulfilled through dividend reinvestment. That occurred even though the reinvested dividends were subject to tax at ordinary income rates. If income tax were deferred by law on at least a portion of reinvested dividends, electric utility shareholders would be placed on a more equal basis with shareholders in other businesses. Commonwealth Edison believes that if income tax were deferred on reinvested dividends, the amount reinvested by its shareholders would at least double. Other electric utilities have expressed similar views about the beneficial impact that would follow from having tax deferred on reinvested dividends.

(9) The electric utility industry is by far the most capital-intensive industry in the country. For example, for every $1 of revenue, about $4 must be invested in plant facilities. In contrast, the oil industry, which usually is considered to be very capital-intensive, needs only about $1 of investment for every $1 of revenue, and the automobile industry requires only about 50 cents of investment for each $1 of revenue. Consequently utilities must issue much more new stock than most other businesses in order to finance their much-needed new facilities.

In 1980, the electric utility industry raised about $4 billion by means of issuing common stock and probably about $5 billion will have to be raised this year through common stock financing. Estimates have been made which indicate as much as half of the $5 billion could be raised through dividend reinvestment plans if S. 141 were passed. Commonwealth Edison alone could raise in excess of $100 million with tax deferred dividend reinvestment, or about twice as much as it raised through dividend reinvestment during 1980.

Therefore, the passage of S. 141 will have several desirable results. It will make utility stock more attractive to a broader group of individuals. It will provide utilities with much needed capital without their having to go to the marketplace as often. It will help utilities to continue the construction of much-needed power facilities for their customers. This, in turn, will permit utilities to keep about 150,000 construction workers on the job.

All of this can be accomplished at really no detrimental effect on the government's tax revenues because of the expected feedback effect and because tax would not be forgiven; rather, tax merely would be deferred. Robert R. Nathan Associates, an economic consulting firm, made a study which indicated, after applying a feedback effect, that the net tax revenue loss to the government, in 1979 dollars, would be about $350 million in the first year of tax-deferred dividend reinvestment, a wash in the second year, and a gain approaching $600 million thereafter.

In sum, the passage of S. 141 will help capital formation in several ways. It will encourage shareholders to reinvest their dividends. It will make electric utility stocks more attractive to investors, causing stock prices to increase and thereby enabling the utilities to raise more common equity funds in the marketplace. It will provide a greater equity base on which to issue increased amounts of securities. It will enable utilities to more easily finance much-needed electric facilities to make the nation energy strong and less dependent on foreign supplies.

S. 141 should be enacted.

J. J. O'Connor
Chairman and President
Commonwealth Edison Company

Standard Brands INCORPORATED
625 Madison Avenue • New York NY 10022 • (212) 759-4400

April 29, 1981

Hon. Robert E. Lighthizer
Chief Counsel
Senate Finance Committee
Room 2227
Dirksen Senate Office Building
Washington, D.C. 20510

Re: S.141

Dear Mr. Lighthizer:

Standard Brands Incorporated respectfully requests that the comments incorporated herein be made part of the record of hearings of Senator Chafee's Subcommittee on Savings, Pensions and Investment Policy, which we understand will commence on May 4, 1981.

Standard Brands hereby endorses the passage of S.141 allowing the deferral of taxation of dividends reinvested in all corporate original issue reinvestment plans. We urge that this proposal be incorporated as part of any tax reduction legislation to be reviewed by Congress in 1981. Standard Brands is a publicly held manufacturer and distributor of food and related products. Holders of Standard Brands' stock are currently afforded the opportunity to reinvest their dividends in new corporate shares.

We believe deferral of tax on reinvested dividends encourages investment by individuals in United States corporations, thus providing a source of new equity for participating American corporations.

We have heard that the House of Representatives' "mark-up" of this bill will limit its application to dividend reinvestment plans of qualifying public utilities. We feel this discriminates against all other taxpayers maintaining dividend reinvestment plans and, more importantly, against all our shareholders.

Standard Brands recognizes the need of public utilities to raise capital. However, the capital requirements of corporations engaged in manufacturing is no less acute. While utilities may pass high debt service costs on to their ratepayers, companies, such as Standard Brands, engaged in the highly competative food product manufacturing business, do not have this option.

The shareholders participating in dividend reinvestment plans of corporations, other than utilities, would be doubly penalized. First, the benefit of dividend tax deferral is denied. Second, the benefit of lower cost financing through equity capital is lost.

It is difficult in today's market to raise capital through the issuance of equity. Providing an incentive for shareholders to reinvest dividends will allow a new non-inflationary source of capital.

Over time, federal revenues will not be adversely affected. The temporary effect of deferred tax on reinvested corporate dividends will be offset by a permanent increase in taxable corporate earnings brought on by the corporation's capital expansion and a decrease in deductible interest expense. Revenue lost on dividend reinvestment would also be made up on subsequent sale as the shares sold would have a zero basis.

Standard Brands would be pleased to answer questions posed by you or your staff with regard to the effect of S.141 on our company or the industry in general.

Very truly yours,

STANDARD BRANDS INCORPORATED

J. Pearson

J. Thomas Pearson
Vice President - Taxation

SHS:rs

Written Statement of
NICOR Inc.
before the Senate Committee on Finance

NICOR Inc. appreciates the opportunity to present a written statement in favor of the dividend reinvestment legislative proposal submitted by Congressman Pickle in the House (HR654) and a substantially identical bill which has been introduced in the Senate (S141). The proposal provides basically for the deferral of current taxes on dividends reinvested in original issue stock (with an annual limit of $1,500 for a single taxpayer and $3,000 for a joint return) of any company having a qualified dividend reinvestment plan. The stock received on such reinvestment would be regarded for tax purposes, as essentially the equivalent of a conventional stock dividend.

NICOR Inc. (the "Company" or "NICOR"), incorporated in 1976, is a holding company and through its subsidiaries is engaged in the distribution and sale of natural gas; development of gas storage; exploration and development of oil and gas properties; contract drilling for oil and gas operators; barging of petroleum and chemical products; marine and diesel equipment repairs; offshore marine service and supply shipping; acquisition, development and mining of coal reserves; and other energy-related activities. The Company has approximately 4,700 employes. The five-year projection (1981-1985) for capital expenditures is about $2 billion. NICOR's address is 1700 West Ferry Road, P. O. Box 200, Naperville, Illinois 60566.

NICOR Inc. adopted its Automatic Dividend Reinvestment and Stock Purchase Plan in 1976. The plan offers a 5 per cent discount on the price of shares purchased with reinvested dividends, provides for optional cash payments of up to $5,000 a month (higher amounts at discretion of the Company), permits investment of Common, Preference and Preferred dividends and absorbs the cost of brokerage commissions. The plan is an original or new issue plan but with the option reserved to the Company to purchase in the open market. To date all stock issued has been primarily new issue, plus a small amount of treasury shares.

At the present time 15 per cent of NICOR's shareholders participate, broken down into the following categories as of December 26, 1980:

	Shareholders		Plan Participation	
Shareholders	Shares Held	Registered Shareholders	Participants	Per Cent Participation
1-99	1,855,387	79,323	11,385	14.4
100-200	3,780,175	27,915	3,879	13.9
201-1000	5,471,805	13,631	2,983	21.9
1001-Over	9,875,935	1,080	202	18.7

The plan has increased participation from 11 per cent to 15 per cent of its shareholders over a five-year period. The plan offers a convenient means for stockholders to invest in shares of the Company without the payment of brokerage commissions or service charges. The plan has generated the following amounts for NICOR since 1976:

1976	$ 4.6 million
1977	7.2 million
1978	9.0 million
1979	10.3 million
1980	13.3 million

NICOR supports HR654 and S141 because the bills would defer the payment of taxes for the shareholder until his investment is liquidated rather than tax him at a time when he wishes to convert his dividends to savings. It should increase participation signficantly. This will in turn help increase the rate of individual savings and investment. By encouraging savings and thereby the formation of capital, the legislation will create a stronger base for economic growth, will therefore help reduce inflation, increase employment and boost the American economy. We strongly urge that this legislation be included in the tax proposal S(141) currently before the Committee.

Thank you for the opportunity to make this written statement.

April 30, 1981

J. M. Quigley
Financial Vice President
and Secretary
NICOR Inc.
P. O. Box 200
Naperville, Illinois 60566

MINNESOTA POWER & LIGHT COMPANY
30 WEST SUPERIOR STREET. DULUTH. MINNESOTA 55802
PHONE (AREA 218) 722-2641

A. J. SANDBULTE
Executive Vice President

May 1, 1981

Members of the Senate Finance Subcommittee
on Savings, Pensions and Investment Policy:

As you know, Senator Lloyd Bentsen has introduced S. 141, dividend reinvestment legislation, in the 97th Congress. On behalf of the customers and shareholders of Minnesota Power, I strongly urge your support of this important legislation.

The proposal is intended to increase stockholder participation in the Dividend Reinvestment Program (DRIP). Also, stockholders may be prevented from participation in DRIP because of the cash needed to pay the current taxes on dividends.

It is well known that the investors expected return for equity stock is comprised of the current yield and future dividend growth. This places a great deal of importance on the role of a dividend program. The electric utility industry, being faced with the ravaging impact of inflation, is caught between providing a satisfactory real return to the current shareholder and the concern for retained earnings growth as a source of capital. This conflict is extremely critical during these present times when the electric utility industry is being called upon to find new ways to meet the increasing electrical energy demands of the future. This legislation will serve to improve the attractiveness of DRIP and would therefore make a significant contribution towards the ability to raise common stock capital.

Legislation to encourage increased new capital formation will ultimately benefit our shareholders and customers alike. Our customers would benefit in these times of escalating rates by our securing new capital at the lowest possible cost. By increasing the attractiveness of the stock, the price will be bid upward which is also a step toward solving the dilution of equity problem which has plagued our industry and Minnesota Power for the past five or six years.

The proposed legislation would also serve to reduce the current double tax on dividend income. It is a more equitable form of taxation in that dividends reinvested would then be taxed similar to conventional stock dividends. It would also encourage thrift for individual supplemental retirement income. The individual would be encouraged to save, or perhaps even be able to save, which translates into an anti-inflationary tax cut.

MINNESOTA POWER & LIGHT COMPANY

May 1, 1981
Page 2

Saving and investing will fuel progress toward the goal of improving productivity, which is so desperately needed throughout the U. S. industrial sector. I believe increased capital investment is the hedge to such gains. Therefore, all companies with a qualified plan should be eligible for dividend reinvestment. This plan should not be limited to utilities. The Company respectfully requests your support of the Dividend Reinvestment Plan, S. 141.

Sincerely,

A J Sandbulte

Arend J. Sandbulte

AJS:mp

FIRST NATIONAL BANK

Columbia's Bank

AND TRUST COMPANY • P.O. BOX 1867 • COLUMBIA, MISSOURI 65205 • PHONE (314)449-3811

May 26, 1981

Mr. Robert E. Lighthizer
Chief Counsel, U. S. Senate
Committee on Finance
Washington, D.C. 20510

Dear Mr. Lighthizer:

I understand that the Committee on Finance is receiving comment on Senate Bill #141.

This is to indicate my strong support of the concept of tax deferral on dividends reinvested as embodied in this Bill. Such a move would be consistent with the nationwide goal of assisting in the formation of capital.

I urge the committees' immediate and affirmative action on this Bill.

Very truly yours,

FIRST NATIONAL BANK & TRUST COMPANY

Joe W. Scallorns
Executive Vice President

JWS.lo

STATEMENT OF THE INVESTMENT COMPANY INSTITUTE
BEFORE THE SENATE COMMITTEE ON FINANCE
SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT POLICY
RE: DIVIDEND REINVESTMENT PLANS

May 18, 1981

The Investment Company Institute (the "Institute") */ supports the objectives of S. 141, introduced by Senators Bentsen and Baucus, which provides for the tax-free reinvestment of dividends in domestic corporations. However, as currently proposed, S. 141 does not permit regulated investment companies to establish qualified dividend reinvestment plans. Therefore, the Institute strongly urges that these dividend reinvestment programs be expressly made available to the shareholders of regulated investment companies, popularly known as mutual funds, on a pass-through basis.

The Institute's member mutual funds, having some 12 million shareholders and assets of more than $160 billion, are designed to make available to investors of modest means the opportunity to pool their investment resources with those of other persons in order to obtain diversification of risk and expert investment management they might not otherwise be able to obtain. Since the purpose of mutual funds is to place the investor in the same position as a direct investor with a diversified and professionally managed portfolio, it is clearly desirable to extend to these persons the privilege of participating in the proposed dividend reinvestment programs as long as the guidelines prescribed in the bill are made applicable.

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*/ The Institute is the national association of the mutual fund industry. Its membership includes 571 open-end investment companies ("mutual funds"), their investment advisers and principal underwriters.

Those guidelines can readily be made applicable to "qualified reinvested dividends" passing currently through regulated investment companies to their shareholders, just as long-term capital gains and the $200/$400 dividend and interest exclusions pass through those companies to their shareholders under the present provisions of the Code. This can be accomplished by permitting the regulated investment company to declare "qualified reinvested dividends" in the shares of its own stock to match currently the "qualified reinvested dividends" which it receives. All the rules that would be applicable to an individual receiving shares under a dividend reinvestment program directly (including the $1,500/$3,000 limit and the one-year holding requirement) would apply to the shares that he elects to receive from the regulated investment company, provided those shares have been properly designated by the regulated investment company in the same manner that it designates capital gain dividends and interest and dividend pass-throughs.

A draft amendment to S. 141 to carry out this pass-through in the case of regulated investment companies is attached hereto.

Under the proposed amendment the qualified reinvested dividend provisions would not apply to the regulated investment company itself in determining its income received. Thus, the regulated investment company would have gross income in the amount of the fair market value of any qualified reinvested dividends received by it (without any dividends received deduction, just as in the case of other dividends received by it), and would have a dividends paid deduction in the amount of the fair market value of the qualified reinvested dividends paid by it.

Proposed changes in S.141 providing for dividend reinvestment programs to make them applicable when currently passed <u>through regulated investment companies</u>

1. Change the parenthetical clause on page 3, line 5 of proposed new section 305(e)(5) to read as follows:

"(other than a regulated investment company, unless it complies with the requirements of section 852(b)(6))"

2. Change the designation of the effective date provisions of the bill on p. 4, line 9 from "Section 2" to "Section 3" and insert a new Section 2 reading as follows:

"SEC. 2. Section 852(b) (relating to method of taxation of regulated investment companies and their shareholders) is amended by inserting after paragraph (5) the following new paragraph:

'(6) Qualified Reinvestment Dividends. --

'(A) Qualification of Company. -- If a regulated investment company receives a distribution which would be a qualified reinvested dividend, as defined in section 305(e)(5) if received by an individual, such company shall be qualified to pay reinvested dividends, as so defined, to its shareholders.

'(B) Limitation on Amount. -- A distribution made by a regulated investment company shall qualify as a qualified reinvested dividend only to the extent that it is designated as a qualified reinvested dividend in a written notice mailed to its shareholders not later than 45 days after the close of its taxable year. If the aggregate amount so designated with with respect to a taxable year of the company (including qualified reinvested dividends paid after the close of the taxable year as described in section 855) is greater than the amount of the distributions received by the company during the taxable year that would have been qualified reinvested dividends if received by an individual, the portion of such distributions made by the company which shall constitute qualified reinvested dividends shall be only that proportion of the amount so designated as the amount of the qualified reinvested dividends so received bears to the aggregate amount so designated.

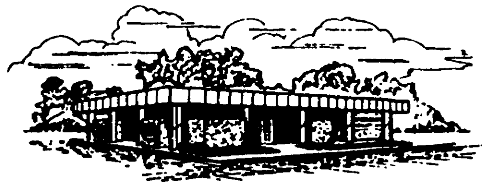
'(C) Special Rules. --

'(i) In determining whether a distribution received by a regulated investment company would qualify as a qualified reinvested dividend if received by an individual, the provisions of section 305(e)(2) (relating to limitations on the amount of such distributions received) shall not apply.

'(ii) Paragraph (6) (relating to purchases by a corporation of its common stock) of section 305(e) shall not apply to distributions made by a regulated investment company.

'(iii) In determining the deduction for dividends paid (as defined in section 561) in the case of a regulated investment company, section 305(e) shall not apply.'"

STATE BANK of RENSSELAER



DONALD P. STEINER
Sr. Vice President & Trust Officer

May 11, 1981

Mr. Robert E. Lightizer, Chief Counsel
Committee on Finance
Room 2227, Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Lightizer:

I would be in favor of increasing the exclusions of interest earned by individuals in the amount of $1,000.00 or $2,000.00 on a joint return. In the past, the feeling has been there can be no control over the Money Market Funds which declared dividends. Therefore, I believe this exclusion should be only for interest earned on deposits at financial institutions rather than on all dividends and interest. This would promote savings in our country which would be beneficial to try to fight these difficult times.

Your consideration of this matter will be appreciated.

Very truly yours,

Donald P. Steiner
Sr. Vice President
and Trust Officer

DPS:ljm

P.O. BOX 257 / RENSSELAER, INDIANA 47978 / PH. 219/866-5154

MEMBER FDIC

Dr. M. Richard Sussman, C.F.A.
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TAX DEFERRAL OF AUTOMATIC DIVIDEND REINVESTMENT PLANS: AN AID TO EQUITY CAPITAL FORMATION

Committee on Finance
United States Senate
Subcommittee on Saving, Pension and Investment Policy

Dividend and Interest Exclusion

Reinvestment Plans

S. 141

TAX DEFERRAL OF AUTOMATIC DIVIDEND REINVESTMENT PLANS: AN AID TO EQUITY CAPITAL FORMATION

Summary

In spite of the generally recognized capital formation problems in the United States, the amount of corporate dividends paid have approximated the amount of new long-term capital raised. Rather than utilize these funds for investment purposes, managements have felt impelled to meet the perceived dividend requirements of their shareholders. As a consequence, these potential additions to the capital base have been dissipated and the ability of corporations to raise new equity capital at reasonable rates has been impaired.

Tax deferral of a substantial portion of automatically reinvested dividends would permit corporations to comply with the wishes of their diverse shareholder constituencies without incurring the associated capital-raising penalties that currently exist. Dividends could be declared to affirm the corporation's financial health, to meet the income requirements of some shareholders, and to place the reinvestment option directly at the discretion of the shareholder. Yet, tax leakage of potentially reinvestable funds would be eliminated. In addition, the cost and inconvenience of replacing a substantial portion of the distributed funds by the public issuance of new shares would be avoided.

TAX DEFERRAL OF AUTOMATIC DIVIDEND REINVESTMENT PLANS: AN AID TO EQUITY CAPITAL FORMATION

A review of recent financial statistics indicates a striking similarity between the amounts of new long-term corporate capital, particularly debt capital, that has been raised and corporate dividends paid. It could be easily inferred that a large portion of these funds were acquired to pay dividends. Given the much publicized and generally accepted problems of capital formation in the United States, this would appear to be an anomalous phenomenon. This apparent paradox is further highlighted by the continued payment of common stock dividends by corporations that have experienced deficits from their operations or publicly indicated cash flow deficiencies; Ford and General Motors, for example.

One possible explanation of this situation could be the desire of some corporate managements to maintain desired proportions of debt and equity in their balance sheets. However, given the heavy debt proportions that currently exist, attention is properly directed toward the "dividend controversy" as a more probable, pervasive cause. This controversy focuses on the questions of why corporations pay dividends and whether common stock dividends are highly valued by shareholders.

Theory dictates that if internally generated funds can be invested by the corporation at a higher explicit or implicit rate than is available to shareholders individually, then these shareholders will derive net benefits from the omission, cessation or limitation of dividend payments. Frequently cited studies have

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also indicated that under these circumstances share values are, at least, not penalized for firms paying no or low dividends. Nevertheless, most corporate managements feel impelled to pay dividends to obtain the assumed or perceived benefits that are derived from them. They believe that the limitation or cessation of dividend payments would create dissatisfaction among their shareholders and negative reactions in the financial markets. Thus, this type of action would unfavorably impinge upon their share values and their ability to raise additional funds at reasonable rates.

It can be posited that funds distributed in the form of dividends can be easily reacquired by means of the issuance of additional common shares. However, new common shares are commonly recognized as the most expensive of all capital raising media, if only because of the issuance expense associated with them. In addition, they represent a substantial inconvenience, and more importantly, may have to be undertaken at an inopportune time in terms of financial market conditions. Finally, the recapture of dividend-distributed funds would have to be directed to an investor group beyond that of existing shareholders, dividend tax leakage having reduced the potential reinvestable funds of this latter group.

The enactment of a provision for the tax deferral of a significant amount of reinvested dividends would permit corporate management to retain the assumed benefits of dividend payments, while at the same time substantially eliminating the capital constraint problems associated with such distributions.

There are a number of reasons why dividends are believed to be desired by shareholders and thus, by the financial markets. Among them are: (1) the affirmation of a company's performance; (2) the desire of some shareholders for current cash income; and (3) the option to explicitly determine whether an investment in a particular firm should be increased.

In spite of independent audit and governmental surveillance, reports of corporate performance tend to be viewed with an element of incredulity. There is a common recognition that discretion and substantial latitude can be exercised in determining the indicated results. It is suggested that the willingness and ability of a firm to pay a cash dividend affirms its reported financial health and progress.

A consistent history of dividend distributions is typically one of the requirements for the inclusion of a stock on a fiduciary legal list of acceptable investments. In a similar vein, many loan covenants require that the debt be repaid each year, even though it may be renewed shortly thereafter. The ostensible purpose being an explicit demonstration of the firm's financial health and its ability to repay.

Although the desired dividend action may reinforce a shareholder's wish to commit additional resources to the corporation, the tax levy upon dividends reduces his ability to do so. Tax deferral of reinvested dividends would permit the corporation to undertake this action of affirmation, without the concomitant problems of tax leakage and complete reacquisition of the funds available for distribution.

Some investors desire cash dividends to meet current cash requirements, while others have no need to receive this current flow. Corporate managements are thus, in a quandary as to how they can satisfy the requirements of diverse clientele. The payment of a dividend would satisfy some shareholders, but because of tax leakage, it would penalize those who wish to retain and increase their equity in the firm.

It has been argued that in favorable situations, corporations should retain and invest their internally generated funds. Those shareholders who require cash could sell some shares to meet their needs. However, at best, this action is a nuisance to shareholders, and many may be reticent to reduce their shareholdings by small amounts. In addition, it might be required at a time when market conditions are inappropriate. If a firm alters its dividend policy to accomplish, what it believes, is to the long-term benefit of its owners, ultimately, its shareholder constituency should change to represent those who are in accord with such policy. However, the transition period would probably be a disruptive one. Change is typically perceived as risk by the financial markets and it probably would negatively effect the firm's ability to raise additional capital.

Tax deferral of reinvested dividends would provide a solution to this problem. It would assist firms in meeting the needs of their diverse clientele and in the management of their resources.

Finally, dividends may be desired as a convenient means of providing the shareholder with an explicit investment option. If all internally generated funds are reinvested by the corporation, an increase in investment is automatically made for him. Under those circumstances, the investor's only options are to concur, or to sell some shares. Again, this latter action may be an inconvenient or undesirable one. If dividends are paid, the investor who wishes to increase his commitment is penalized by tax leakage.

Tax deferral of reinvested dividends would provide shareholders with this desired option, but without the leakage penalty. As a result, it would provide the corporation with a convenient, less expensive means of acquiring equity capital.

In summary, tax deferral of reinvested dividends would eliminate many of the problems associated with the dividend controversy. As a consequence, it would permit corporations to comply with the perceived wishes of its shareholders and thus, facilitate the retention/acquisition of equity capital.

Dr. M. Richard Sussman, C.F.A.
Chairperson Finance, Insurance and Real Estate
Central Michigan University
Mt. Pleasant, MI 48859

WARBURG PARIBAS BECKER
INCORPORATED
A. G. BECKER INCORPORATED

May 15, 1981

Mr. Robert E. Lighthizer
Chief Counsel
Committee on Finance
Room 2227
Dirksen Senate Office Bldg.
Washington, D.C. 20510

Dear Mr. Lighthizer:

The investment banking firm of Warburg Paribas Becker very much appreciates the opportunity to enter into the record its views on Senate bill S.141 which would allow a shareholder to defer income taxes on a specified amount of common stock cash dividends reinvested in common equity pursuant to qualified Dividend Reinvestment Plans.

As investment bankers, it is our job to assist corporations in the raising of funds for capital investment. We at Warburg Paribas Becker have had a great deal of exposure to the efforts which the utility industry, one of the most capital intensive in our economy, has mounted to raise such needed capital.

Our affiliate, A. G. Becker, currently issues commercial paper for 87 utility companies, including telephone, gas, and electric companies, representing about 45% of all utility companies active in the commercial paper market. We therefore carefully follow the progress of the industry and are concerned with the financial standing of our issuers. In addition, our firm participates in the underwriting and distributing of equity and debt securities of utilities.

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Utilities by their nature have significant and growing needs for capital. For example, it is estimated that electric utilities require $5 in new capital investment for every additional $1 of revenue, while the steel industry needs $3 of investment to produce $1 in revenue and the automobile industry only $1 of investment for $1 of revenue. Such capital needs must be met through both equity and debt financing. The debt/equity ratio for the utility industry, an important measure of prudent financial management, is already considerably higher than that for industry in general.

In 1980, utilities invested $27.3 billion for new plant, property and equipment, or 14.5% of the total U.S. industrial capital investment. Because utilities' needs for additional equity surpass that which they obtain by reinvesting their own retained earnings, they must raise additional equity from investors. As a result, utilities continually bring to market a large percentage of all corporate equity issues, accounting for one third of all such issues in 1980, according to the Federal Reserve.

In the 12 months ended April, 1981, utilities raised a total of $19.1 billion in the financial markets. Of this amount, according to estimates recently released by the Irving Trust Co., utilities raised $3.935 billion, or 21% of their needs, in the form of common equity, alone.

Periodic visits to the capital markets for new equity have generally supported the needs of the industry. However, there have been periods when utilities have found it very difficult to raise capital with new equity issues. In 1973 and 1974, for example, some utilities were forced to postpone issues and defer raising needed capital. In the fall of 1978 and 1979, utilities faced the prospect of having to delay, in some cases for long periods of time, issuing equity needed to fund the cost of rising capital expenditures. While today's market conditions are less critical than in 1978 and 1979, they are still not attractive for those utilities which need to issue equity, and investor demand has been low.

Since 1973, Dividend Reinvestment Plans have grown slowly but steadily to become a valuable, supplemental source of equity capital. Dividend Reinvestment Plans can provide a steady, predictable, quarter by quarter, addition to equity capital which may be viewed as being analogous for purposes of building equity capital to a utility being allowed to earn a higher rate of return on capital--or being able to pay out a smaller proportion of earnings to shareholders.

These programs capture and re-cycle funds into new equity that might otherwise not be re-introduced into the stream of business investment.

One drawback of Dividend Reinvestment Plans has been that shareholders must pay taxes on the dividends which are reinvested, even though they receive no cash. The proposed deferral of income taxes in Senate bill S.141 on the first $1,500 of common dividends received by shareholders and reinvested in approved Dividend Reinvestment Plans would, we believe, be a positive step towards encouraging greater investor participation in these plans, especially among investors holding a relatively small number of shares. Thus, the proposed tax deferral contained in Senate bill S.141 would further support this important, supplemental source of equity for capital intensive industries like the utility industry.

Sincerely,

Robert L. Henkle

Robert L. Henkle
Managing Director

RLH:ds

NICHOLAS B. TOURNILLON
MIDWOOD DRIVE
GREENWICH, CONNECTICUT 06830

STATEMENT OF NICHOLAS B. TOURNILLON
IN SUPPORT OF TAX DEFERRAL FOR REINVESTED DIVIDENDS
SUBMITTED TO THE UNITED STATES SENATE COMMITTEE ON FINANCE

As a professional practitioner of finance, I would like to urge the passage of S.141 or similar legislation extending tax benefits to, and thereby encouraging, dividend reinvestments.

It is increasingly evident that major corporations from many industries are becoming excessively leveraged. This situation has become particularly noticeable among public utilities and banks whose stock prices have recently been below book value. Since corporate prudence urges that the interest of existing shareholders not be diluted with the below-book-value sale of equity to new shareholders, some mechanism to ensure the raising of necessary equity is in order. I believe that the dividend reinvestment bill S.141 would address this problem.

Aside from the threat to the financial integrity of our nation's major corporations, there are many valid positive reasons for supporting this legislation. One is the counter-inflationary need to increase private savings and investment levels in the United States. In the international arena where I work, it is particularly noticeable that our most formidable competitors reside in Japan and Germany where savings and investment rates are generally conceded to exceed those of the United States. This naturally impacts productivity levels - which were the source of much U.S. pride in the decade following World War II - and ultimately sales prices.

Economists have long recognized the impact of capital formation as a national goal. Unfortunately, our national leaders have trailed those of our allies in implementing the types of financial incentives to which free societies have historically responded.

After years of living with low savings rates, our national interest has focused attention on the capital formation needed, and I urge that the Senate Finance Committee rapidly approve S.141. This should contribute to restoring the United States to its internationally competitive position.

N.B. Tournillon

Nicholas B. Tournillon

May 26, 1981

Written Statement of
Alan T. Wenzell, Managing Director
Blyth Eastman Paine Webber Incorporated
Submitted to
Subcommittee on
Savings, Pensions, and Investment Policy
of the United States Senate
Committee on Finance
with respect to S. 141
May 4, 1981

As leading stockbrokers and investment bankers deeply interested in maintaining our strong capital markets, we in the Paine Webber Group have been seriously concerned with the slow rate of capital formation in the United States economy. In fact, our parent company, Paine Webber Incorporated, has included in several of its Annual Reports discussions dealing with various aspects of this problem.

American business must over the next few years be recapitalized through an extensive inflow of investment funds. Only this will permit an enhanced rate of productivity which, in turn, will increase our economic prosperity and our competitive position in world markets. Our current economic malaise is due in considerable part to our tax laws which discourage the savings and subsequent investment (particularly equity investment) which is required to rebuild corporate America.

The Congress has presently under consideration several proposals whose objectives are to reduce these tax disincentives to savings and investment. All are worthy of your careful consideration because, by reducing taxes, they release funds for potential investment. However, today we would like specifically to discuss and endorse S. 141 which would defer taxes (up to a stated maximum) on cash dividends reinvested in a company's stock. It is important to note that, of all the proposals presently being considered by the Subcommittee, only S. 141 requires that the taxpayer reinvest, and thereby contribute to capital formation, in order to have his taxes deferred. We strongly urge that S. 141 be included as part of the important tax legislation that the Congress will soon enact.

Perspective on Capital Formation and Capital Markets

Over the past decade, the U.S. economy has experienced structual change and instability. It has been a period of inflation, rising interest rates, and uncertainty about the future. Most importantly, there has been a dramatic decline in the rate of productivity improvement from an annualized rate of 2.5% in the thirty-one years from 1950-1980 to 1.3% in the past ten years.[1/] Certainly to reverse this disappointing trend will necessitate greatly increased levels of capital formation in the private sector in the 1980's, particularly if we are to achieve such vital national objectives as energy independence, rearmament, and urban renewal.

What will be the sources of these greatly increased capital funds?

In the years 1978-1980 internal funds of non-financial corporations available to finance capital expenditures totalled approximately $559 billion. External funds provided $310 billion. Most significantly, only $17.5 billion, or about 6%, of these external funds came from net new equity issues.[2/] Debt equity ratios have increased dramatically over the past decade for all non-financial corporations. This has obviously been influenced by the encouragement the tax laws give to financing through debt. Some managements are now constrained from going further into debt by indenture restrictions. Many others are reluctant to incur further indebtedness due in large part to today's high interest environment.

Let us now ask to what extent the alternative of seeking equity in the public capital markets has helped to supply badly needed capital funds.

As investment bankers we have noted the relative infrequency in recent years of public offerings of equity for large industrial companies. The bulk of the new equity issues in recent years have been for smaller companies engaged in high growth businesses where investors perceive an opportunity for long-term appreciation, paying capital gains taxes upon eventual disposition. Most large industrial companies (which are asset intensive and sell at relatively low multiples) fail to come to the equity markets, either because underwriters are unable to bring the issue without seriously depressing the market price of the shares or because, even if priced at current market, the issue would be dilutive to existing shareholders. In the years 1978-1980, 207 NYSE and AMEX listed industrial companies offered common stock in the public markets. Of these, only 33 were for companies listed in the Fortune 500 sales ranking as of December 31, 1980, and only 2 were for corporations included in the 30 company Dow Jones industrial grouping. Unfortunately it is these large companies, representing the bulk of America's industrial capacity, which will require the lion's share of the new capital needed by industrial companies to improve the country's overall productivity.

Ironically, in addition to facing greater difficulties in selling equity in the public markets, these larger industrial companies tend to pay substantial dividends and, therefore, are unable to build capital through internal growth to the same extent as the smaller, faster growing companies so in favor with equity investors.

Utilities have had no choice but to sell equities frequently and in very large amounts through public offerings. During 1978-1980, utilities raised approximately $11.6 billion through the issuance of shares of common stock in public offerings, which were able to be marketed principally because of the attraction of their very high dividends, leaving little opportunity to build up retained earnings. Shares have often had to be sold at below book value, resulting in a dilution of the investment of existing shareholders.

Because of somewhat slower construction programs and the hope of a combination of regulatory and tax relief, it is hoped that in the next five years a larger portion of the utilities' capital requirements will be internally generated. Even so, utility companies will still have to raise sizeable amounts of equity capital, which may at times strain the capabilities of our public distribution channels.

Dividend Reinvestment Plans

In recent years many companies have established Dividend Reinvestment Plans ("DRP's") under which shareholders are given the opportunity to use the cash dividends they receive to purchase additional shares.

According to estimates made by Georgeson & Co., the investor relations firm, DRP's have grown by 550% in less than eight years. Today there are over 1,100 DRP's, compared with 200 in 1972. However, only about 150 of those DRP's are designed to reinvest dividends in the newly-issued stock of the sponsoring corporations and thus create new equity capital. It is estimated that these original issue DRP's raised between \$2 and \$3 billion of equity capital for their sponsoring companies in 1980. Since July 1, 1979, 60 companies have introduced original issue DRP's. Of these 60, 35 were sponsored by industrial or financial corporations and 25 by utilities.

Obviously the reason original issue DRP's have not grown more rapidly is that shareholders must pay taxes at ordinary income rates on the dividends they choose to reinvest. It is this situation that S. 141 proposes to alleviate.

The Benefits of S. 141

- Clearly, the tax deferral provisions of S. 141 would encourage the formation of more original issue DRP's, and more frequent participation by shareholders in existing ones, which in turn would plow back a larger portion of dividends into corporate capital. This should help to decrease the short-fall in new equity capital needed by many segments of American industry. Thus, this legislation is designed to aid in the process of capital formation especially for those companies and industries that are most in need of help: i.e. those that payout a substantial part of their earnings in dividends and who require large amounts of outside capital, and those who, for various reasons, have shown reluctance to bringing equity issues to market.

- Companies which form original issue DRP's as a result of S. 141 will be able to reduce the cash drain on their balance sheets, while maintaining or increasing per share dividend rates. To the extent that equity capital is increased, companies may leverage that capital through the issuance of additional debt securities, adding to overall capital resources.

- The proposed legislation will encourage savings rather than consumption. Investors in these companies will have the option, exercisable each year, to reinvest dividends and so defer their taxes. If an investor exercises this option, the tax deferral of his dividends and the subsequent capital gains treatment will increase his after tax return. This should make the stocks of these companies appealing to more investors and may tend therefore to increase the price earnings multiples at which they sell in the market. Also, new public issues of these companies may become somewhat more feasible as additional investors are attracted to the market.

- The $1,500 cap on individual tax deferral ($3,000 for joint returns) targets the legislation to benefit smaller stockholders. Studies by the New York Stock Exchange indicate that stockholders have a median household income of $27,500. 68% of all stockholders have portfolios valued at less than $10,000.[3/] With such a cap, or even a somewhat larger one, it cannot be argued that S. 141's purpose is to benefit the wealthy individual taxpayer.
- We believe that this legislation takes a first step in removing the inequitable double taxation of corporate dividends.
- Finally, the proposed legislation is helpful because it directly encourages capital formation, and therefore will enhance our economic prosperity and our competitive position in world markets.

We wish to express to the Subcommittee our appreciation for the opportunity to be heard.

FOOTNOTES

1/ Monthly Labor Review, U.S. Department of Labor, Bureau of Labor Statistics, January 1981.

2/ Definitions based on data of non-financial corporations compiled by the Federal Reserve Board, Flow of Funds Accounts, February 1981. External funds include both short and long-term debt.

3/ Figures were obtained from a study to be published by the New York Stock Exchange in June 1981.

SUMMARY OF

Statement of W. S. White, Jr.,
Chairman of the Board of
American Electric Power Company, Inc.
180 East Broad Street
Columbus, Ohio 43215

To

The Subcommittee on Savings, Pensions
and Investment Policy
of
The Senate Finance Committee

On

S. 141 Relating to
Tax Reduction Through Deferred
Taxation of Reinvested Dividends

Deferring taxation to the shareholder of a limited amount of dividends reinvested in newly issued common stock of the corporation, and in general treating the additional shares acquired in the same manner as stock dividend shares, should be proposed by the Senate Finance Committee because such treatment --

1. Would raise large amounts of common stock equity for capital-intensive corporations which must sell common stock on a recurring or regular basis.
2. Would furnish a savings incentive for stock-owning individuals, which would permit them to accumulate assets to produce retirement income supplementing Social Security.
3. Would initially result in a tolerable revenue loss, and would in the long run produce revenue gain.
4. Would alleviate to some extent the present double taxation of corporate earnings distributed to shareholders.

STATEMENT OF W. S. WHITE, JR., CHAIRMAN OF THE BOARD OF
AMERICAN ELECTRIC POWER COMPANY, INC.
180 EAST BROAD STREET
COLUMBUS, OHIO 43215
TO
THE SUBCOMMITTEE ON SAVINGS, PENSIONS
AND INVESTMENT POLICY
OF
THE SENATE FINANCE COMMITTEE
ON
S. 141 RELATING TO
TAX REDUCTION THROUGH DEFERRED
TAXATION OF REINVESTED DIVIDENDS

This statement is submitted, in connection with hearings commencing May 4, 1981 being held by the Subcommittee on Savings, Pensions and Investment Policy of the Senate Finance Committee, in support of permitting deferred taxation of a limited amount of dividends reinvested at the election of the shareholder in unissued stock of the corporation. Such tax treatment would both encourage savings by individuals for later retirement income, and provide capital to the corporation for investment in productive plant.

In connection with hearings held by the Senate Finance Committee which commenced in July, 1980, American Electric Power Company, Inc. (AEP) submitted a statement similar to this statement. AEP reaffirms its support for the proposed bills (discussed below) covering reinvested dividends and presents some updated information in this statement.

AEP is the parent company of an electric utility holding company system. Its operating subsidiaries serve the public in parts of seven states, Indiana, Kentucky, Michigan, Ohio, Tennessee, Virginia and West Virginia.

The electric utility industry is the most capital-intensive industry in the country. While the emphasis is now on conservation, the demand for electricity continues to grow, partly as a substitute for more scarce forms of energy. In order to continue providing adequate and reliable service to its customers, the American Electric Power System (AEP System) must each year spend large amounts for new facilities for the generation, transmission and distribution of electric energy. Such construction, particularly of generating facilities, has long lead times. During the last ten or twelve years there have been very large increases in the cost of new facilities, including dramatically increased pollution control and other environmental expenditures. This, coupled with higher interest rates, has meant that a larger proportion of the needed capital must be raised externally.

AEP System companies are required by the Securities and Exchange Commission to maintain a certain ratio of equity capital to debt capital. All of the common stock of the operating companies must be owned by AEP. As a result, all of the common stock equity capital of the operating companies is furnished by AEP, mainly through contributions to capital but also through purchases of additional shares of their common stock. This means that AEP must sell large amounts of its own common stock on a recurring basis. At the same time, AEP must as a practical matter offer a high cash dividend payout.

AEP raises a portion of the common stock capital requirements of the AEP System through a dividend reinvestment plan (DRP), which has been in effect since 1977. Under the DRP, holders of AEP's common stock may elect, through an agent, to reinvest cash dividends in unissued shares of AEP common stock at a price equal to 95% of current market value. Under present law the value of the stock purchased, including that acquired through the 5% discount, is given the same treatment as cash dividends actually received by the shareholders.

There are a number of bills pending in Congress which would permit deferring the taxation of dividends reinvested in newly issued stock of the corporation, up to $1,500 per year on a separate return and $3,000 a year on a joint return, and would treat such reinvested dividends very much like stock dividends. One such bill in the Senate is S. 141, introduced on January 19, 1981 by Senator Bentsen on behalf of himself and Senator Baucus. This bill, which is substantially identical (except for the effective date) to S. 1543 in the 96th Congress, is supported by at least four members of the Senate Finance Committee.

Bills in the House are H.R. 654, introduced by Representative Pickle on January 5, 1981; H.R. 488, introduced on January 5, 1981 by Representative Roe; and H.R. 1415, introduced on January 28, 1981 by Representative Minish. Each bill is substantially identical to S. 141. There are now more than 144 sponsors of H.R. 654, including at least 17 members of the Ways and Means Committee and at least 50 new sponsors.

In order to prevent abuse, each of the pending bills has restrictive provisions on the sale of the corporation's common stock by the shareholder and the purchase by the corporation of its common stock.

At hearings before the Ways and Means Committee on January 29, 30 and 31, 1980, a number of witnesses testified in favor of then pending dividend reinvestment proposals. Their statements appear at pages 137-334 of the transcript of those hearings, Serial 96-75. The record contains (pages 146-263) a lengthy statement by Robert R. Nathan Associates, Inc., an economic consulting firm. The summary (page 146) estimates that by its third full year the tax incentive provided would more than double participation in qualifying reinvestment plans, expanding it to a total of $2.5 billion annually and generating an annual increase of $1 billion in fixed private business investment, a level of national output $2.7 billion more than it would otherwise be, and the creation of 50,000 jobs. We believe these estimates were, and still are, appropriate.

The Staff of the Joint Committee on Taxation had estimated in 1979 the maximum annual revenue loss at somewhat over $1 billion, but its estimates did not take into account any revenue offset or gain by reason of increased capital formation and economic stimulus. We understand that Nathan Associates estimates that after giving effect to the "feedback" associated with the increase in the national output attributable to increased investment and jobs, the net revenue loss is only $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 thereafter.

Our economy is suffering from a lack of capital brought about in large part by a tax system which encourages consumption and penalizes savings and therefore capital formation. Adoption of tax deferral of dividends reinvested in newly issued stock would substantially aid those companies which must sell common stock on a regular or recurring basis. AEP's DRP resulted in reinvestment in newly issued AEP shares of over $46.7 million of the dividends paid in 1980. Shareholder participation in the DRP has increased from 10.9% of the shareholders reinvesting $2.4 million in the first quarter of 1977 (when the DRP was put into effect) to 18.6% of the shareholders reinvesting $13.5 million in the fourth quarter of 1980. Projecting the latest quarterly reinvestment to a full year, the DRP will produce over $54 million in new capital for AEP.

We are convinced that if tax deferral of reinvested dividends were to be enacted, the amount of common stock equity capital raised through dividend reinvestment would at least double. Increased equity capital so generated permits the issuance of more debt securities. Furthermore, such treatment of reinvested dividends would help reduce the double tax on corporate earnings which now exists when the earnings are passed on to shareholders. The double taxation is by no means eliminated because a tax will still have to be paid (generally at capital gain rates) when the shares acquired by reinvested dividends are sold.

There is another likely effect of tax deferral of reinvested dividends which would help in raising common stock equity capital. Last year, the research departments of Goldman Sachs and Salomon Brothers estimated that such tax deferral would increase the market prices of the stocks on which the dividends are declared by 10% or more. Such an increase would enable the issuers to sell fewer shares in public offerings to raise the same amount of new capital, thereby preventing dilution of the stock and improving price-earnings ratios.

In addition to providing needed capital for corporations, dividend reinvestment furnishes shareholders an optional method, through the acquisition of additional shares on which cash dividends may be received in the future, of setting aside funds for producing retirement income to supplement Social Security, such as is now provided under IRA and Keogh plans. An alternative is to purchase stock in growth companies which pay out little of their earnings in dividends. Electric utilities must, however, offer a high dividend payout. Dividend reinvestment plans, with their election as to what amount of dividends, if any, to reinvest during the year, offer shareholders a flexible plan for adding to their assets for retirement income in years when the shareholders can so afford. Most of the reinvestment of AEP dividends in newly issued AEP shares has been by shareholders with small holdings of AEP stock (33% of the participants in the DRP own no more than 100 shares and 88% own no more than 500 shares).

In summary, tax deferral of reinvested dividends would help capital formation, somewhat alleviate the double taxation of corporate earnings, and furnish a saving incentive for stockowning individuals. It should be proposed as part of the tax reduction program under consideration by the Senate Finance Committee.

STATEMENT OF THOMAS WICKENDEN
MIDDLE AGED CITIZEN APPROACHING RETIREMENT YEARS
IN SUPPORT OF TAX DEFERRAL
FOR REINVESTED DIVIDENDS (S. 141 and H.R. 654)
SUBMITTED TO THE SUBCOMMITTEE ON
SAVINGS, PENSIONS AND INVESTMENT POLICY
OF THE
UNITED STATES SENATE COMMITTEE ON FINANCE
MAY 22, 1981

From the vantage point of a middle aged working person preparing for retirement years ahead strongly support tax deferral for reinvested dividends (S.141 and H.R. 645).

The Problem

Many working people approaching retirement years ahead feel it is prudent to try to lay aside some of their current income to provide for themselves during future years when they will no longer be able to work. Indeed, it has been a traditional American dream of hard working citizens to be self sufficient and independent as long as possible. Through middle life mortgage burning celebrations have been commonplace as working people enjoyed the privilege of owning their shelter- free and clear. Current tax laws seem to make these traditional values obsolete. The double taxation of dividends, and the granting of tax credit for interest owed while taxing monies earned at a high rate has made traditional savings for old age an impossibility. Now it is necessary to hire an expensive tax consultant who advises to refinance your home- get your equity out and into leveraged tax shelter schemes as the only way to assemble a store of value against the perils of old age years. Most older Americans would prefer to invest in high dividend paying, large, stable, relatively secure companies in basic American industries, and those companies need that investment.

The average age of our citizenry is increasing and the Social Security system is in less than sure condition. The tax deferral of dividends (S. 141 and H.R. 654) would greatly aid we middle aged Americans to cope with inflation, meet emergencies and provide a measure of self reliance for our retirement years ahead.

Conclusion

I strongly recommend the immediate adoption of the tax deferral for reinvested dividend legislation (S. 141 and H.R. 654). Clearly this legislation is in the best interest of and will provide significant benefit to all those persons struggling to lay aside some of their earnings now to cope with inflation, meet emergencies and provide a measure of self reliance when they are no longer able to work. It will also aid the companies upon whom we can depend for a portion of our income and the nation as a whole.

Thomas C. Wickenden

WILKENS AND NANOVIC ASSOCIATES
INVESTMENT COUNSELLORS
102 GREENWICH AVENUE
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May 5, 1981

The Honorable Robert J. Dole
Chairman, Committee on Finance
2227 Dirksen Senate Office Building
Washington, District of Columbia 20510

Mr. Chairman:

In light of The Senate Finance Committee hearings on tax reduction proposals which are to begin on May 13, 1981, I would like to give my support to the dividend reinvestment proposals as incorporated in S. 141.

If the purpose of the tax reduction is to encourage investment, and this has been stated many times by the administration, what better way than by the reinvestment of dividends? One problem with many tax cut proposals is that we don't know if the money will be spent or reinvested. This is obviously not the case with the dividend investment tax deferral because you don't get the benefit unless the investment is actually made.

Another advantage is a constant additional flow of capital to a firm thereby reducing the frequency of going to market with a new stock issue. This can be expensive, time consuming and disruptive to the market. This would apply especially to utility companies which have a constant demand for new capital, but are having increasing difficulties in raising funds because of high inflation and the regulatory lag in adjusting their rates. They find themselves having to pay very high dividends in order to have any chance to sell stock at prices reasonably close to book value at a time when they should be retaining more earnings in order to finance what is a very capital intensive business. A tax deferral on the reinvestment of dividends would seem to be especially appropriate in this case.

We are a small investment management firm whose clients are tax free institutions and would not, therefore, benefit directly by the passage of S. 141. However, we feel that tax reduction proposals should be designed to directly encourage investment and therefore strongly endorse the concepts of S. 141.

Sincerely yours,

Frank Wilkens

Frank Wilkens, Partner
WILKENS AND NANOVIC ASSOCIATES

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