TAX REDUCTION PROPOSALS

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

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FIRST SESSION

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WEDNESDAY, MAY 13, 1981

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

The committee met, pursuant to notice, at 10:43 a.m., in room 2221, Dirksen Senate Office Building, Hon. Robert J. Dole (chairman) presiding.

Present: Senators Dole, Armstrong, Packwood, Roth, Danforth, Heinz, Symms, Grassley, Long, Bentsen, Bradley, Moynihan, Baucus, Boren, Chafee, and Mitchell.

[The press release and the opening statements of Senators Roth, Wallop, Grassley, Symms, and Chafee follow:]

[Press Release No. 81-121]

FINANCE COMMITTEE ANNOUNCES HEARINGS ON ADMINISTRATION'S TAX REDUCTION PROPOSALS

The Honorable Robert J. Dole (R. Kans.), Chairman of the Committee on Finance, announced today on May 13, 14, 19, 20, and 21 the Committee will hold hearings on the tax reduction proposals in the administration's program for economic recovery.

Secretary of the Treasury Donald T. Regan will testify on May 13. The Committee will receive testimony from various invited expert witnesses and other representatives of the public on the remaining four scheduled dates.

The hearings will begin at 10:00 a.m. each day in Room 2221 of the Dirksen Senate Office Building.

The Chairman noted that the Committee had already received testimony on the spending reduction proposals contained in the administration's program and reemphasized that any spending reductions must be accompanied by substantial tax relief to encourage economic recovery and long-term growth. "Although there may be differences of opinion among Committee Members on some of the specifics of a tax cut, I think that I can say with confidence that the Committee continues to support a broad-based tax reduction for individuals and business. The administration's program may provide a unique opportunity to restructure our economy and I look forward to receiving testimony on the tax portion of that program."

Requests to Testify.—Witnesses who desire to testify at these hearings 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 May 7, 1981. Witnesses will be notifed 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.—The Chairman urged 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 Committee. The procedure will enable the Committee to receive a wider expression of views than it might otherwise obtain. The Chairman urged that all witnesses exert a maximum effort to consolidate and coordinate their statements.

Legislative Reorganization Act.—The Chairman 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 the 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) Written statements must be typed on letter-size paper (not legal size) and at 100 copies must be delivered not later than noon of the day before the witness is scheduled to appear.

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

(4) Witnesses should not read their written statements to the Committee, 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 Committee, are urged to prepare a written statement for submission and inclusion in the printed record of 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 Thursday, May 28, 1981.

STATEMENT OF WILLIAM V. ROTH, JR., U.S. SENATOR

Mr. Chairman, today the Committee on Finance begins 5 days of hearings on the President's tax reduction program. In my judgment these hearings will develop a sound foundation for the enactment of the most far-reaching tax-reduction program since the Kennedy tax cuts of the early 1960's.

Today, working men and women are being taxed at unprecedented rates on each dollar they earn. The inevitable results of penalizing additional effort are higher absenteeism, a refusal to work overtime and a surging underground economy.

Next year, 1982, the tax burden of the working men and women of this country will increase by $52 billion. This includes an increase of $22 billion in social security payroll taxes and $30 billion due to inflation or "bracket creep."

Unless tax rates are reduced and the growth of Federal spending is restrained, the economy faces continued inflation and recession. The high rates of taxation now imposed on the American people are strangling economic growth, choking off private initiative, pushing up prices, and retarding the savings and investment needed to increase productivity and create new jobs. The Reagan tax cut proposal will reduce the tax drag on the economy and increase the incentives to work, save, invest, and produce.

The President has proposed a tax cut for all Americans. He has proposed an economic recovery program to deal with the many problems facing our Nation and its people.

The American people are concerned with high interest rates. They are concerned with the very high rate of inflation. They are concerned about unemployment. In response to these concerns, the President is trying to put in place policies that will provide an environment of growth that will once again enable the United States to be a world leader.

In this regard I think it must be recognized that the United States is no longer competitive in world markets. One of the reasons that we are not competitive in world markets is that our chief competition abroad, the Japanese and West Germans, are replacing their plants at a much more rapid rate than are we. They are able to do so because their people save far greater than we do and in the case of the Japanese are taxed far less than we are.

The fact is that Federal revenue will grow roughly from $500 billion to $1 trillion by 1985 because of inflation or bracket creep and because of increases built into the social security program. The fact is that every American, particularly the typical working American, year in and year out has faced substantially increased taxes.

The typical American family of four that in 1976 earned roughly $16,000 because of the failure in the past to create an environment of growth must earn something like $25,000 or $26,000 to have the same purchasing power, buy the same food, the same clothing, and the same shelter.

However, because of bracket creep and the other taxes that the family of four finds their taxes have increased $1,400 during the last 4 years, which means that even if they are lucky enough to get the cost-of-living increases that purportedly keep them even they find that their standard of living has declined.

The future will also be bleak unless something is done now. It has been predicted that in the next 4 years that same family will have to make roughly $35,000 to

$36,000 to have the same purchasing power it has today at $25,000 to $26,000. It also means that they face a tax increase of $3,500. Their typical tax bill will jump from $4,500 to $8,000.

Mr. Chairman, last week we celebrated tax freedom day. What does tax freedom day mean? It means that on May 10 of this year, the typical American family worker began working for himself. Every dollar he or she had earned up to then goes to Government at one level or another. It is this kind of problem the President is trying to attack. He is trying to put in some long-term programs that will create an environment of growth.

I, for one, believe the time has come when we make certain that we decrease the growth of Government and that we begin recognizing the plight of the working people of America.

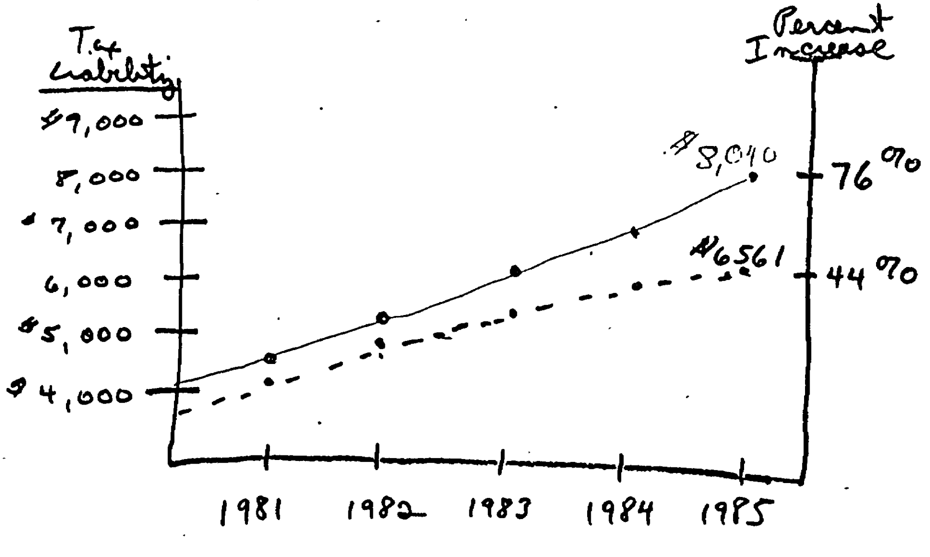
I, for one, believe that it is important to tell the American people now that they will have a tax reduction 3 years in a row of the kind proposed by President Reagan.

I would point out that if we do not do this, the typical American family faces a 76-percent increase in taxes and even after the Reagan proposal, will still face a 42-percent increase.

The President's program is an attempt to let the working people of this country keep more of their money, an attempt to offset the tax increases built into the current system, and for these reasons I believe it is imperitive that the Congress take favorable action on the program as swiftly as possible.

Thank you Mr Chairman.

INDIVIDUAL INCOME TAX AND SOCIAL SECURITY TAX BURDEN FOR AVERAGE FAMILY OF FOUR*



- - - - Reagan Tax Plan

——— Current Law.

* Assume family earns $25,000 and receive 10% cost of living pay increase.

STATEMENT OF SENATOR MALCOLM WALLOP

Mr. Chairman, the committee has an opportunity to review pending tax reduction proposals, and an obligation to act on a package of tax reductions for individuals and business that promises increased economic growth and employment, with lower inflation. There are many tax proposals that will be reviewed by this committee in the days ahead, each of which will promise some combination of benefits to the taxpayer and the economy. There are proposals that stimulate savings, and investment, while other bills offer increased employment or more equitable treatment for certain classes of taxpayers.

Nearly all of these proposals have merit, but there is only one proposal that has the unique characteristic of being comprehensive and having a clear mandate of support from the people. The President's Program for Economic Recovery provides a comprehensive blueprint for tax reduction for individuals and business. By reducing marginal income tax rates for all taxpayers, the President's income tax package will not only restore the incentive to work, but it will provide an incentive at the margin to both save and invest. An important change that I will propose during this committee's consideration of the tax cut package is an immediate reduction in the taxation of so-called unearned income. By reducing the maximum tax from 70 percent to 50 percent we can move billions of dollars out of sterile tax shelters into more productive investments. I would urge my colleagues to consider the economic benefits that would accrue to the nation if we remove this harsh disincentive to invest. The Accelerated Cost Recovery Program provides new incentives for economic productivity and sustained economic growth. The President's depreciation proposals offer new incentives for investment, and they will provide a degree of simplicity in the depreciation schedules that will benefit small business.

Our consideration of tax proposals are always torn between the principles of equity and efficiency. The Finance Committee must sometimes weigh what is a fair proposal for all income classes as opposed to what tax changes will be most efficient in generating widespread prosperity. My view is that the President has been able to merge to two objectives of achieving fairness and efficiency through his comprehensive program of across the board cuts for individuals, and investment incentives for business.

I have great doubts that this committee, in all its wisdom, will be able to develop a more equitable, or effective program for putting this nation's economy back in order. During the days ahead this committee will have an opportunity to consider other proposals to cure our economic woes, but our central question should not be whether these proposals are positive or equitable, our question should be whether these various tax proposals are more effective or equitable than the President's comprehensive Program for Economic Recovery. Although I am committed to keeping my mind open to all proposals, at this stage of the Finance Committee's deliberations, the President's tax program has my full support.

Opening Statement of Senator Grassley

These hearings on the Reagan Administration's tax plan mark the beginning of a new era for American taxpayers. The package proposed by the Administration has the dual goals of promoting economic growth and controlling runaway inflation. This bold plan exemplifies the President's commitment to allow each American to retain a greater percentage of his or her income. Americans should be given the opportunity to retain some of their earnings and to select the investment they prefer for these earnings. Many commentators have suggested that Americans will not save any of the money they retain if these tax cuts are enacted. This assumption does not give the American people much credit. The vast majority of my mail expresses concern with the low amount of savings in the United States and urges the Congress to pass larger savings exclusions and increase the limits on Individual Retirement Accounts. Americans are anxious to save, but past federal policies which have led to double-digit inflation have not been conducive to inspiring people to save. If we in Congress can control inflation, I am certain Americans would be anxious to save more.

Critics of the Roth-Kemp tax plan have hailed it as inflationary. No one has ever given me a good reason why its more inflationary for the federal government to keep and spend each taxpayer's money than it is for the taxpayer to have that privilege. Seasoned politicians have said that they would prefer to give a tax cut for one year at a time, because it makes such a favorable impact on constituents. Having just moved to the Senate from the other body, I can understand and sympathize with the desire of my colleagues to enact a tax cut at least every two years. Nevertheless, the serious economic condition of our nation requires we look beyond our own narrow interests. I believe a three-year tax reduction plan provides an important degree of certainty which is necessary for the major task of rebuilding our economy.

The President's depreciation proposals are also an important component of this rebuilding process. One of the major ingredients of increased productivity is the age of an industry's physical plant. The Reagan proposal will provide an inducement to industry to invest in a more productive America.

For these reasons, I support the President's plan. I would like to thank Senator Dole for beginning work on this measure so quickly, and I am grateful to be part of this important initiative.

STATEMENT OF HON. STEVEN D. SYMMS

Good morning. It is a pleasure to have you here this morning Mr. Secretary to begin the process of implementing the historic changes in economic policy that the President has recommended, and which many of us have supported for many years.

In the past, it has seemed that our tax system has tried to compensate, on a piecemeal basis, for the flaws in the system, it has tried to redistribute income, and at the same time, has tried to use the tax structure to facilitate the functioning of the economy.

President Reagan has taken a long-term approach toward solving our economic problems which is essential to any plan intending to create an environment which is productive and stable. The President has recognized that the priority and purpose of our tax policy should be to facilitate the functioning of our economy by altering the incentives for individuals and corporations in the system and rely on the market to direct the funds to their highest use.

The Reagan program for economic recovery will lead to lower inflation, faster economic growth, lower unemployment, increased productivity and the restoration of hope for a better future for all Americans.

Each part of the economic recovery program has been carefully crafted and reinforces the effects of other policies in the program. The President's tax proposals for individuals and for businesses are an essential part of the economic program. They are not inflationary because they are not going to be financed by inflationary money creation. The tax reductions will be more than paid for by spending reductions, additional revenues from economic growth, and higher levels of private savings and investment.

I am deeply committed to the passage of the President's tax proposals because in my opinion, the tax package is essential to the success of the entire program. The successful implementation of the President's tax package will signal a victory, not just for the President and his Administration, but for every taxpaying American citizen.

STATEMENT BY SENATOR JOHN H. CHAFEE

We are fortunate to have Secretary Regan here this morning to discuss tax policy with the Senate Finance Committee. We have spent the last few weeks making tough decisions on budget cuts, and it appears our deliberations over tax cuts may be even more difficult. Nevertheless, the President's economic goals, which I support, cannot be accomplished without dealing directly with both our tax and budget problems.

I have one serious concern with the Administration's tax package, and this is a major point I want the Secretary to take home with him.

It is this: we must enact a substantial tax incentive for individual savers to accompany any reductions in marginal tax rates. If necessary, and I think it probably is, the rate reduction should be trimmed to accommodate the revenue loss from a targeted savings incentive.

I am sure the Secretary will hear this theme echoed by many Members of Congress, and he may ask why.

It is simply because there is no evidence, historical or otherwise, to indicate that a reduction in tax rates will result in a dramatic increase in personal savings during a period of double-digit inflation. In fact, the most ardent proponents of the Reagan-Roth-Kemp plan point out that a three-year, 30 percent rate reduction will barely keep most taxpayers in the same tax bracket they are in today. Inflation will negate any real changes in marginal rates and much of the incentive to increase saving.

This is not an argument against major tax rate cuts during the next three years. If anything, it is a case in their favor, but it is also a case for additional tax incentives targeted toward increasing long-term saving.

As Chairman of the Subcommittee on Savings, Pensions and Investment Policy, I have seen that supply-siders and supply-side skeptics alike can agree on one thing: personal saving in the United States is much too low, and it is among our most serious economic problems. Savings dropped to 4.7 percent of personal income during the first quarter this year. With the pressure to borrow still running strong, we are again watching the prime interest rate climb toward 20 percent.

It would be unwise, I believe, to allow enactment of a tax cut as large as that proposed by the Administration without some assurance that it will increase saving and give us a real supply effect. Let us take a common sense approach.

Basically, what I propose is to make the Individual Retirement Account, or IRA system, universal. Every American with earned income, even government workers and those with existing pension plans, should be allowed to open an IRA and take a tax deduction of up to $2,000 a year for contributions to his or her account. Alternatively, the same deduction should also be permitted for additional voluntary contributions to a pension plan.

Professor Michael Boskin of Stanford University has analyzed this proposal and has estimated it would stimulate $28 billion in new long-term savings in 1981 alone.

If adopted, a universal IRA system would provide an immediate incentive for savings. In the long run, it would ease the financial strain of retirement years in a time of growing pressure on the Social Security System. Widespread use of IRAs would generate new assets for savings and loan associations, banks and credit unions, in turn, would mean more funds not only for industrial expansion and modernization, for also for home construction.

Emerson once observed that "nothing astonishes men so much as common sense and plain dealing." I propose that Congress astonish our citizenry and commit this act of common sense.

The CHAIRMAN. The committee will come to order.

This is our first opportunity in the committee to formally review the administration's tax plan.

I would just say we have heard much about it, read much about it. There has been a lot of rhetoric over the weekend over what it may contain. As far as I can detect, there hasn't been any change in position. We will let that for the Secretary to define.

There is no doubt about areas of agreement in this committee. I think almost everyone believes we should have substantial tax reduction. Most everyone believes the taxes take too much income from American taxpayers. There are wide areas of agreement, I think, on the business side of the President's proposal.

There are some minor disagreements in the 10-10-10 proposal and the multiyear proposal. I say minor, based on maybe 50-50 support in the committee.

But, these are areas that can be addressed and I think will be addressed the next 30 days. I know you are here to tell us, not us to tell you.

So, I will ask that my statement be made a part of the record.

[Senator Dole's statement follows:]

STATEMENT OF SENATOR DOLE

We are pleased to welcome Donald T. Regan, the Secretary of the Treasury, to begin this Committee's hearings on the tax aspects of the Reagan Administration Economic Recovery Program. I know that the members of this Committee have many questions for the Secretary, and I appreciate his setting aside this time to respond to our concerns.

This is the first opportunity the Finance Committee has had to formally review the Administration tax plan. I believe we are all familiar with the arguments the Administration has made for its proposal, and there may be some disagreement on just how we ought to proceed. But there are some things we can all agree on, and I think they ought to be pointed out as we begin the deliberations that should lead to major tax legislation this year.

THE SCOPE OF THE PROBLEM

The first thing we all must acknowledge is the unprecedented growth of the tax burden in recent years: A growth trend that will continue unless we act promptly to out taxes at all income levels for both individuals and businesses. The combination of higher payroll taxes for social security, inflation-induced bracket creep, and new taxes such as the Windfall Profit Tax, has raised the Federal tax burden to an unprecedented peacetime level of 214 percent of the Gross National Product. Without action by this Congress to reduce taxes, and even making optimistic inflation assumptions, this tax burden will rise to 23 percent of GNP by 1984. The economy cannot tolerate such a high level of taxation and still sustain a reasonable level of growth. It is our job to make certain that taxes never rise to that level—and I believe we will do so.

The size of the aggregate tax burden is only part of the problem. The growth of the private sector is indeed constrained when so much of our wealth is absorbed by taxes. But the distortions caused by the combination of taxes and inflation further damage the economy by destroying incentives for productive growth. Excessively high marginal tax rates undermine individual work, savings, and investment. Taxation of illusory capital "gains" induced by inflation inhibits capital formation, particularly for new and innovative enterprises. In addition depreciation allowances that do not take account of inflated replacement costs inhibit new investment in plant and equipment. The result is a stagnant and unresponsive economy.

ECONOMIC RECOVERY PROGRAM

To its credit, the Reagan Administration seeks to tackle these problems head-on. Under the tax bill submitted to Congress by the Administration, individual tax rates would be reduced by 30 percent over a three-year period. As a partial consequence of this change, the maximum tax rate on capital gains effectively would be reduced to 20 percent. In addition, the maximum tax rate on so-called unearned income would drop from 70 percent to 50 percent. To boost job-creating new investment, the Administration proposes an accelerated cost recovery system to allow business to depreciate new investments in plant and equipment in a more realistic fashion, notwithstanding the ravages of inflation.

There is disagreement over some features of the President's tax plan, and there should be a debate over these issues. There will be a debate in this Committee. But before that debate begins, let us consider how far we have already come toward reaching a consensus. First, I believe we agree that significant individual rate reductions are needed. The President proposes them, and the distinguished Chairman of the House Ways and Means Committee includes them in his own tax proposal. Last year the Finance Committee approved a major tax reduction bill that would have made substantial reductions in marginal tax rates. So there is a basic agreement on this issue.

Secondly, there is a consensus on the need to drastically change depreciation schedules for tax purposes. Again, the Ways and Means and Finance Committees both have indicated their support for such a change, along with the President. We will have to work out the details of how different classes of investment are treated and how to phase in the changes, but we will be working from substantial areas of agreement.

There are other changes that could be cited where there appears to be widespread agreement, including cutting capital gains rates and reducing the maximum tax rate on unearned income. But the conclusion is inescapable that there is now more agreement than disagreement over the direction tax policy must take.

THE NEXT STEP

Of course, substantial points of dispute remain. Among other things, we have to determine how much tax reduction we ought to commit ourselves to now for future years. The Administration wants three consecutive years of individual rate reductions, while at last report Chairman Rostenkowski was holding firm for a one-year cut only. The advantage of a multi-year cut is that it provides individuals with greater certainty of their prospective tax liabilities, and makes it less likely that taxflation will obliterate the effects of whatever tax reduction we enact. A one-year cut, of course, is the way we have proceeded in the past, and it would leave us more options in the next two years. Maybe it is time we agreed to so limit some of our options—that is a major question we will have to decide. Further tax changes over the next few years would then require some offsetting revenue-raising measures and some restructuring of the tax code. Maybe that is what we need, and I look forward to hearing in detail the Administration's views on this question.

APPROPRIATE CONTEXT FOR DECISIONMAKING

As we proceed with these hearings and subsequent markup of a tax bill, we should at least resolve that the tax burden will not again be allowed to rise to such unprecedented levels. The President has stated his commitment to stability in the tax burden—it is a key element of this economic program. The president is also committed to bringing down the rate of inflation as swiftly as possible. Whatever action we take this year with respect to out-year tax reduction, we must understand that we will have to follow through in future years to maintain restraint over both taxes and spending. Too often in the past Congress has abdicated control over tax and fiscal policy to inflation, which automatically increases both revenues and spending levels. That is no longer an acceptable way to proceed—the American people have made that clear.

The problems of our economy, including the defects of our tax structure, are deep-rooted and demand a new approach. They were not generated overnight, and they will demand perseverance if they are to be resolved. If we keep those facts in mind, we may find our decisions are less difficult to make. The Reagan Administraiton has made an extraordinary effort to set the terms of the debate over tax policy. As I have indicated, a remarkable degree of agreement has already been achieved. Soon we will get down to specifics, and I welcome the counsel of Secretary Regan as to how we ought to proceed.

The CHAIRMAN. Are there other members who——

Senator MOYNIHAN. I would like to put one in the record.

The CHAIRMAN. If you would like to make a statement, it occurred to me we might do that, we will each have under the early bird rule, 7 minutes, if somebody would like to make a statement as part of that 7 minutes, it would not detain the Secretary.

But, I would like to recognize someone on the Democratic side.

Senator MOYNIHAN. Thank you, Mr. Chairman. I want to welcome my fellow New Yorker, the Secretary of the Treasury, and to say we do very much hope to learn more today about the President's tax legislation.

We fear that it is inflationary and we fear that this is the sense in the public and currently in the financial markets. We fear there is not enough emphasis on savings and investment. The administration had the idea that with a huge cut in personal taxes we would get an even larger return in taxes.

That explains the deficits in the budget that we now have and it explains the ever daily increase in reductions in programs that we could scarcely do without.

It was only a week ago, Mr. Secretary, in this committee in response to the administration's proposal that we abolished a section of the Social Security Act which provides as a matter of entitlement Federal assistance to orphans.

Now, we never heard about taking away from orphans in our last campaign and we can't imagine that you or anyone like you wish to do it, but we feel you may be involved in an economic policy that leaves you no options.

We hope to hear otherwise and certainly welcome you.

The CHAIRMAN. Mr. Secretary, if we might make one exception, Senator Roth whose name is associated with the tax plan I understand may have to leave to chair his own committee and would like to make a brief statement at this time.

Senator ROTH. Thank you. I would just like to make one observation, if I might this morning. Last Sunday was tax freedom day and by tax freedom day we mean that it is the first day the typical American worker begins to work for himself.

The past policies of ever growing government spending, of ever increasing Federal taxes, this period has grown longer and longer. As a matter of fact, tax freedom day last year was over a week earlier.

I think it is about time we recognize the plight of the working people of America. The people who are paying the taxes. The people who face substantially increased taxes if we don't do something about it here this year.

The typical American family of four faces an increase of 76 percent in their taxes. That is a jump from $4,500 to $8,000 if we don't adopt the long term kind of program President Reagan has recommended.

I would point out that it is this President, that it is this administration, that has recommended policies, long-term policies, to create an environment of growth and that it is critically important that the working people share in this growth pattern for America.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Secretary, as I understand you are willing to stay until as late as maybe 1 o'cock or 1:30 if necessary.

Secretary REGAN. That is correct, Mr. Chairman. I will stay as long as the committee wishes to question me. I will be at your disposal.

The CHAIRMAN. That would better accommodate your schedule than having a break.

Secretary REGAN. It would be better than to break and then return.

STATEMENT OF HON. DONALD T. REGAN, SECRETARY OF THE TREASURY

Secretary REGAN. Thank you, Mr. Chairman and members of the committee. It is a pleasure to be here today to discuss with you the President's tax program. This committee is quite aware of the need for a program for economic recovery which will expand national prosperity, enlarge national incomes and increase opportunities for all Americans. Your response to the expenditure proposals of the President has proved that it is possible for Congress to make the difficult political choices needed to control spending. You have not only moved with great courage, you have moved with great skill and care. As you begin to make decisions on the tax aspects of the President's program I urge you to continue the process of putting the economy back on the track to solid growth without inflation.

The central purpose of the President's program is to restore forward momentum to the American economy and to move it back into a course of steady growth.

The program aims to achieve more rapid expansion of our production capabilities as well as more efficient use of the capabilities at our disposal.

The key to achieving this objective is to give the economy back to the people. As the President has said repeatedly, the ultimate source of strength of this society is its people. We can restore growth to our economy if we first restore to households and to businesses their primary responsibility for decisionmaking and initiative.

The tax proposals which the President has presented and which I want to discuss with you today, are an essential part of the total economic program. We can reduce inflation through monetary policy and cut expenditures through budget policy, but ultimately it is the people who must restore growth through increased work, savings, and investment. We must, therefore, adopt a tax policy that reduces the tax barriers to their efforts. We must begin now and we must not detour from that path over the long run. We must reject the simplistic view that the way to get the economy moving is by pumping up consumption and by trying to fine tune aggregate demand in the short run. We have too long been captives of this view. Instead of shortrun stability and long-term progress, this approach has given us soaring inflation and inadequate long-term growth and productivity, real wages, employment, and output.

Individual tax burdens have been increasing steadily for some time now and individuals have been pushed into higher and higher marginal tax brackets. A family of four with a median income—about $25,000 in 1980—faced a marginal rate of 17 percent in 1965, but now faces a 28-percent rate. For a family of four with twice the median income the marginal rate is almost twice that of 1965: 43 percent now versus 22 percent then.

It is therefore vital that we act now to reduce marginal tax rates by 30 percent. We would like to have these lower marginal tax rates in place right now. This would make the benefits of increased savings, investment, and work effort immediately available. However, to facilitate the transition to a new lower tax structure, we have decided to phase these rate cuts in by 1984. But it should be emphasized that to attain the higher rates of growth in investment and real output that we are seeking, a 30-percent cut in marginal tax rates is absolutely necessary.

Only the full 30 percent, 3-year program announced and enacted into law will enable the economy effectively to plan for the future. It will produce immediate and beneficial responses by workers, savers, and investors as they negotiate long-term contracts and implement their long-term investment plans. It will enable both the administration and the Congress to move on to address other urgent national problems and other important tax issues. It will be far more effective than a hesitant, year-by-year approach which will leave the economy guessing as to whether the tax burden will rise or fall.

In 1978, Congress passed a tax reduction bill that it claimed would offset some of the impact of inflation on rising marginal rates. In fact, that law barely offset 1 year's worth of tax increase due to bracket creep and now 3 years later, we are again debating whether we should merely offset another year or two's worth of tax increases due to bracket creep. This type of approach has not proven successful in preventing marginal rates from rising and I see no reason to believe that it would be successful this time.

It is not even clear under what conditions proponents of a single year tax reduction would reduce taxes in future years. Some seem to imply that they want even further tax increases as a weapon to fight inflation if the economy does poorly. Others seem to imply that if the economy does well, they would not want to lower taxes for fear of rekindling inflation or increasing demand in an already growing economy. In effect, this type of logic requires that there always be tax increases unless there is both low inflation and low growth—a condition which has not occurred for many years, as high inflation and low growth have often accompanied each other. Indeed, the resulting increases in tax rates have linked high inflation and low growth in such a manner that each reinforces the other.

Tax reductions should not be perceived as a vehicle for determining demand in the short run. The President has emphasized that his program for economic recovery is a long-term policy rather than one that merely responds to cyclical movements. We simply cannot continue to increase the disincentive to save and work by raising marginal tax rates at the very same time that we are attempting to restore economic progress by asking Americans to increase their savings and their work effort.

Let me pose the problem of multiyear tax reductions in another way. If we must adhere to a schedule of tax changes for the future, why do we not adhere to one which calls for tax decreases rather than tax increases? In the past there was a myth that as long as the Internal Revenue Code was unchanged there was no tax increase. This myth allowed increased expenditures to be appropriated as if they were costless. Yet we all know that each of the expenditures cost money, money that was raised through increases in present taxes or future taxes. Imagine if you will, the revolution that will take place when we adopt a budget in which tax rates are not scheduled to increase over time. It will no longer be possible to increase expenditures and pay for them through a hidden increase in taxes. Adjustments from future budgets will be more honest. If more is spent, it will be by raising taxes directly, not indirectly. I believe that the Congress agrees with the President that we must begin to operate in an environment in which the costs of governmental action, as well as its benefits, are fully recognized.

The second part of the administration's tax program, accelerated cost recovery, will establish a new system for writing off the costs of business investments. This provision will increase incentives to invest, resulting in increased productivity and sustained economic growth. In recent years, the real value of depreciation allowances has been greatly eroded by inflation at the same time that the country's capital needs have become more urgent. Adoption of this proposal will reduce, substantially, the burden of Federal income taxes on the returns to investment in both plant and equipment.

The accelerated cost recovery system will also reduce the burden of accounting and tax planning for taxpayers and will remove sources of dispute between taxpayers and the Federal Government. This system will eliminate much of the complexity of depreciation rules that have built up in layers over the years through changes in law, regulations, and administrative practice. The proposed system makes a clean break with most of the present recovery provisions and yet, is built on familiar concepts and cost definitions.

The new system will replace the present complex provisions for determination of depreciation allowances. In the new system, classes of capital assets are broad and well-defined; cost recovery periods and accounting rules are certain and standardized.

Thus, ACRS substitutes easily identified asset classes, each with a standard schedule of deductions to be taken over a fixed recovery period.

Combined with individual rate reductions, accelerated cost recovery will provide the conditions for increased capital formation needed to provide jobs and improve the U.S. competitive position in world markets.

It has been urged that we balance the budget before proposing and enacting tax reductions. This is not a realistic option. The budget deficit cannot be dealt with in isolation because it is the economy's poor performance that has helped unbalance the budget. Unemployment automatically increases expenditures for income support and inflation automatically raises outlays for index transfer and entitlement payments. As President John F. Kennedy said when he proposed his tax reduction program two decades ago:

> Our true choice is not between tax reduction on the one hand and the avoidance of large Federal deficits on the other. An economy hampered by restrictive tax rates will never produce enough revenue to balance the budget, just as it will never produce enough jobs or enough profits.

Some have suggested that a greater share of the total tax reduction should go to business firms since they make investment. However, the personal tax reductions are as important to investment as are the business tax proposals. ACRS, alone, cannot finance the investment gains that we must have to get employment, productivity, and real wages growing again.

To be sure, ACRS will sharply lower the cost of plant and equipment and will greatly increase the rate of return and the desire to invest. But a large share of the money for that investment must come from private savers, and individuals must be willing to work and to learn needed skills. For that, personal tax rate reduction is essential.

The personal tax rate reductions the President has proposed are the best thing that could happen to business. They automatically reduce the capital gains tax rate for all taxpayers.

For top bracket individuals, they lower the maximum rate from 28 to 20 percent. They increase the rate of return on all forms of taxable investment income. They are the primary vehicle for lowering tax rates on millions of labor intensive small businesses. They increase savings. They improve work attitudes, lower wage demands and improve labor productivity. No business tax cut could do more for business.

We also recognize that there are a large number of structural tax matters that are of concern to this committee as well as to the President.

We are determined to provide constructive changes in this regard. We are committed to a second bill and the President has pledged to join with you in seeking additional tax changes.

Nonetheless, we must urge that all other structural tax changes of interest to Congress and the administration be taken up in a second legislative effort. Our first job must be to expedite passage of those tax changes proposed by the President that are focused exclusively on moving the economy ahead in the long run. Adding other structural changes, however worthwhile, to this tax package will detract from the changes we believe are essential to restoring noninflationary economic growth.

If the Congress decides to tack on these additional changes, there is little doubt that this would require limiting the amount of individual tax reduction. Thus, what Congress would give with one hand, it would take away with the other. Limiting the rate reductions would increase the disincentive to save, invest, and work relative to the President's proposal. This result would be at odds with the whole purpose of the President's plan.

Even some of the so-called saving incentive proposals are at odds with the President's program. There is a real danger in tending to favor various proposals according to the label that has been attached to each. As replacements for rate reductions, most of these savings incentives would, in fact, afford little incentive to increase savings; their principal effect would be merely to change the form of savings.

The President's tax program 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. Per dollar of cost, the program is the best savings incentive that Congress could adopt.

The President's proposal has a number of advantages over most types of savings incentive proposals. It avoids the problem of encouraging tax-deductible borrowing for the purpose of making investments in tax-preferred assets. Yet it does so in a manner that provides 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 for those individuals who switched their savings from one asset or account to another.

In conclusion, Mr. Chairman, it is clear that frequent policy shifts in response to short-term economic changes are not the solution to our problem. Indeed, they have been a major cause of these problems. As a result of such policies, our Nation has come to expect more inflation, more stagnation, more government growth, and a more directionless economic policy.

It is essential that these expectations be changed. This cannot be done without shortrun costs. Nevertheless, an economic policy focusing on fundamental structural reform will restore long-term strength and prosperity. This can be accomplished only through a consistent, stable set of policies maintained over a period of years.

I believe that the committee shares our view that individual taxes should not continue to take a larger and larger share of individual income and that depreciation allowances must be changed to allow faster cost recovery. It is my hope, and that of the President, that you will join the administration in seeking the rapid adoption of the President's tax program.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Secretary. If we operate our committee under an early bird rule and we limit the first round to 7 minutes, if that does inconvenience a member on either side who must be at another meeting we will be glad to make exceptions.

I think Senator Chafee hit the door first. I will go second, we hit the door at the same time.

Senator CHAFEE. Mr. Chairman, can I just say since we seem to have three parties on the Finance Committee these days—divided between Democrats and Republicans and other groups that are not here—I will take their time.

The CHAIRMAN. They are coming back.

Senator CHAFEE. You would know, sir.

The CHAIRMAN. There will be other members here sometime, hopefully for the vote. We are not going to report the bell out today, Mr. Secretary, so——

Secretary REGAN. I understand, Mr. Chairman.

The CHAIRMAN. We would like full discussion to balance the week, maybe next week. That underscores, I think, some real concern on both sides of this committee about the President's proposal. I have said, candidly, that as of now there is not enough support on this committee for the proposal. There is not enough support if you combine the support on both sides, the five of you, and I haven't done a total analysis.

I guess my questions would be broad in the first round. Is it accurate to assume that the President intends to stick to the plan that you have just discussed?

Secretary REGAN. That is an accurate statement, Mr. Chairman. The President sees no need to change his program. He has proposed it. He has brought it forth. It is a proposal that will, in our judgment, effect the ends that he is seeking with his entire package. We have seen no other program that accomplishes the same objectives and the President simply feels that—seeing nothing that is any better—his program is the one that is up and the one he wants to stick with.

The CHAIRMAN. Has there been any effort at this early stage, and maybe it is too early, I think it is, to sort of prioritize the multiyear? Is that the most important or is it the rate or is it the accelerated recovery program? The multiyear, is that anything over 1 year? Is that multiyear?

Secretary REGAN. It is very hard, Mr. Chairman, to pull this tax package apart and say that if you do this piece of it this way and that piece of it that way, that you will still get the same effects. What we feel is necessary is that it be multiyear. We are suggesting, first of all, that the size of the tax cut is the first thing that is desirable. The 30 percent is desirable, but we are practical people. We know that that cannot be done in 1 year.

Therefore, we would suggest to you that it be spread over the 3-year period as being the most logical.

Second, the tax cut has to be at the margin. If it is not at the margin on the last dollar that is earned, we don't think that it will have the same effect in producing incentives to produce more savings, to get people to work longer, to work harder, to do the little bit extra in order to earn the extra money.

Therefore, you have those three pieces—the size, the multiyear, and a cut at the margin—that are essential to the individual portion of this tax cut.

The CHAIRMAN. Then another question I think that concerns many members on this committee and I think on the Ways and Means Committee is reflected in the bill introduced or at least discussed by the chairman of the Ways and Means Committee, Congressman Rostenkowski.

I think you indicated, again today, that there will be a second tax proposal and that it is accurate to infur from that all the additions on the Ways and Means bill that has been discussed would not be acceptable in the first package?

Secretary REGAN. Now, let me make it clear at the outset, Mr. Chairman, I have not seen Chairman Rostenkowski's proposals. I have read them as reported in the press, but we at Treasury have not taken those with any detail to examine them to see what their cost might be, what the effect might be on revenues, and the like. So I am in no position to discuss his proposals at this time.

The CHAIRMAN. But, on the general principal——

Secretary REGAN. But, on the general question, the President recognizes your concern, he said this on the night of February 18, when he delivered his message to the Congress.

He promised he would be back as soon as this first tax bill was passed with proposals for a second bill. We at Treasury are currently working on those many items.

We will have—call it a shopping list or whatever you want to call it—a list available for the President of many different things that have been brought up by yourself as well as by other members of this committee and other people regarding changes that should be made in the tax code. We will have priced those out. We will then fashion these into a second tax bill and present that bill to this committee.

The CHAIRMAN. Would that be hopefully for action this year?

Secretary REGAN. Yes, sir, we would assume that if the Senate sticks to the timetable that has been outlined, which is to have the tax cuts on the President's desk prior to the August recess, that we would have that tax bill immediately upon your return from recess.

The CHAIRMAN. I think finally, how do we pay for the things we would like to do in that second package?

Secretary REGAN. That is a good question, Mr. Chairman. That is one item that we are now going to work on, now that we have seen the budgets that have been passed by both the House and the Senate last night—to take a close look at what can be done.

Obviously there are such things in the tax expenditure field. I know, although I have excused myself from it, that one of the things the House is discussing right now is the so-called butterfly spread and whether or not to close that so-called loophole.

The other things that are being looked at here is how to phase some of these things in so that the initial impact is not as great as it might be in the out years.

There are various ways that we can come up with now in order to finance it as soon as we know what the second package will be.

The CHAIRMAN. I think my time has expired. I am not certain how strong those assurances could be made, but based on precedent, it is difficult to restrain members from offering amendments to a bill that the President wants very much, which is the one we have just discussed. I think it has probably occurred to every member of this committee and probably most on the floor and many in the House, that if there is one the President is going to sign that is one you want to be onboard with with your amendment.

Hopefully that issue can be resolved, if not it could lead to some chaos in trying to put together the first package.

Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman. Mr. Secretary I have several concerns with the administration's package, but there is one particular point I would like to stress and that is, in my judgment, we really have to enact substantial tax incentives for individual savers.

I know you touched on that and the theory of the administration is just by cutting the rates, that we will encourage savers without any targeting.

I don't think there is any evidence, historical or otherwise, to indicate that a reduction in tax rates will result in a dramatic increase in personal savings during a period of double-digit inflation.

I would like to refer back to the quotes that are given from President Kennedy two decades ago. There is an element that is in this society now that was not present then and you will notice that it is never even mentioned and that is the inflation.

Most of the ardent proponents of the Reagan-Roth-Kemp plan or whatever we wish to call it, point out that the 3-year, 30-percent rate reduction will barely keep most taxpayers in the same bracket they are in today.

As a matter of fact, in the President's address to Congress, a week or so ago, he pointed out that it is not a tax cut, it is a reduction in tax increases and with this persistent inflation the incentives aren't there for personal savings, in my judgment.

Now, this is not an argument against major tax cuts. I think we ought to have them, but in addition I think we ought to have something in there to encourage the individual saver. I am chairman of the subcommittee, of this Committee on Savings, Pensions, and Investment Policy and we have had hearings on this. Obviously, and I am sure you are in complete accord, the personal savings in the United States are way too low.

What I have proposed, along with Congressman Moore in the House, is the extension of the so-called individual retirement accounts—the IRA's, with every American being able to participate up to the amount of $2,000.

In my judgment and the judgment of others, this would make very substantial contributions, some $28 billion in additional new savings, incremental savings.

I would urge and I would be interested in your reaction to that plan.

Secretary REGAN. First of all, Senator Chafee, let me say that we, like you, do regard the savings rate in the United States as deplorably low.

As you know, last year it was running just slightly above 5 percent, way below its more prevalent rate of 7 to 8 percent. In the first quarter of this year it was down as low as 4.7 percent. Something has to be done about it.

Our consideration is that if you give people a tax cut across the board, stop that rate of increase and particularly doing on a multiyear basis, that this gives a person a chance to say well, I can start to save now because next year my taxes are not going to increase even if I get a raise. The following year they are not going to increase because I will get a raise. I can then start an automatic savings type of plan.

We have tested that by looking at some of the polls that have been done. Not necessarily our own internal polls, but NBC poll, the ABC poll, Washington poll, New York Times poll and others. All of these indicate that more than 80 percent of the respondents in these polls are now saying that, given a tax cut, they would either save it or pay off debt, which is the equivalent of savings.

So this encourages us to believe that we are on the right track. Now, as far as the IRA's are concerned, like you, I believe we should improve the IRA's. I believe this will be part of our second package that will be coming to the Hill. Like you, I believe this should be for all Americans. I don't think it should be just for self employed

I would think that even those who have pension plans should be allowed to save some, maybe not as much as others who are not under a pension plan from some type of corporate endeavor. But, they should be able to set aside an amount that would not be taxed until such time as they start to utilize it.

After all, this would also help the social security problem. Remember that social security was originally designed as a supplement and we have failed to follow through on the other part of that, that is, have people more self-reliant as far as their pensions are concerned.

Senator CHAFEE. Well, thank you, Mr. Secretary. Do I have a little more time, Mr. Chairman?

Mr. Secretary, there is a philosophic point I would like to address here and I think that will probably echo through this hearing today, and that is what we are proposing or what the administration is proposing is a tax cut at the time that we are running a very substantial deficit. If you believe the administration's philosophy that Federal deficits cause inflation, inflation causes high interest rates, then shouldn't more attention be devoted to reducing the size of the deficit which is very substantial under the administration's budget?

Secretary REGAN. There is no evidence that we know of, Senator, that tax cuts per se are inflationary. Inflation is primarily a money problem: too much money chasing too few goods, if you want the simplified approach.

That means that inflation can be controlled by the money supply. As an example of this, last Saturday I chaired a meeting that Prime Minister of Japan, Mr. Suzuki, had asked for, in which we discussed with his party our economic affairs over here versus theirs.

To my surprise, he said that the budget that he had just submitted to the Japanese Diet was in deficit by one-third. If you compare that to the $700 billion budget that was passed by the Senate last night, that would mean our deficit would be over $230 billion, and yet they don't have the inflation rate that we do.

Now, if a deficit causes inflation, why isn't inflation sky high in Japan? They control the money supply and they have a large pool of individual savings out of which their government finances themselves. That is how they do it.

Senator CHAFEE. Well, I thought it was totally read around here that we had to get rid of inflation, we had to get rid of these deficits because they are causing inflation.

Secretary **Regan**. They don't cause inflation. What they do is to take capital from the private sector that could otherwise be used by the private sector to improve productivity, to increase output—things of that nature. In addition, as long as you have more demand for capital, including the Federal Government financing as deficits, you will also have higher interest rates as the supply remains even.

Senator **Chafee**. Thank you, Mr. Chairman. Thank you Mr. Secretary.

The **Chairman**. Mr. Secretary, we have a vote in progress. The next early bird is Senator Symms who has rushed over to vote and when he comes back he will proceed with questions so we won't waste any more of your time than necessary. Following that Senators Danforth, Heinz, Wallop, Packwood, Bradley, Moynihan, Baucus, Armstrong, Mitchell, Grassley, and others as they come back.

Secretary **Regan**. What about the new party, Mr. Chairman?

The **Chairman**. We will slip them in soon. We will be back in just a few minutes.

Secretary **Regan**. Fine, sir.

[A short recess was taken.]

Senator **Danforth** [acting chairman, presiding]. Mr. Regan, I would like to ask you really not so much about the specifics of the administration's tax program, but about the criteria that the administration is using and that we should use in judging the wisdom of any program for a tax cut.

What standards do we use to assess whether the particular program that is offered is a good one or a bad one?

The words supply side has been used as the modifiers for the administration's tax program. Should we be looking for something called the supply side tax cut as opposed to any other tax cut?

Secretary **Regan**. Well, Senator, if you wanted to study supply side economics so that you were current with all the terminology and the like, that would be one way of doing it.

I would suggest an easier and more practical method might be to just test the results of what we are saying. If we are saying that we want people to work hard, to save more, to invest more, within say after 12 months of the President's package being in place, that you take a second look and ask us about it. Has it succeeded?

I think in the 12-month period you will see that it is succeeding.

Senator **Danforth**. But we are going to have to, of course, pass a bill not on the basis of after the fact knowledge or hindsight as to how it has worked, but on the basis of our best estimate as to how it will work.

Therefore, the criteria as I understand it, are whether the tax cut will encourage work, savings, and investment; is that correct?

Secretary **Regan**. That is correct, Senator.

Senator **Danforth**. Now, just thinking in general terms and not about any specific program, would it be possible to design a tax cut which would be relatively weak in encouraging work, savings, and investment?

That is, if you were a gremlin and you were anxious to try to figure out something that was just a terrible tax cut idea, could you dream up one that did not provide very much encouragement for work, savings, and investment?

Secretary REGAN. Yes; I can, Senator. I can give you an example of it.

Senator DANFORTH. All right.

Secretary REGAN. The present tax code.

Senator DANFORTH. All right.

Secretary REGAN. I think the present tax code is an abomination. It doesn't encourage savings. It doesn't encourage investment. We don't have the investment and savings in the United States that we should have. Had the tax code been designed better, I think we may have accomplished that result earlier.

Senator DANFORTH. Would it also be possible to design a tax package now which is—a tax cut which is inflationary, that is, one that discourages or provides little incentive for work and investment and is a demand stimulative tax package?

Secretary REGAN. Yes; by increasing the marginal rates of taxes, you could certainly discourage investment even further in the United States.

Senator DANFORTH. Of course, when we pass a bill, we do not have the wisdom of hindsight. We have to do it on the basis of our best estimates.

Where do we go to find estimates as to the effect of a tax bill on work, savings, investment, on the rate of inflation? That is what we ask economists, don't we and run it through economic econometric models?

Secretary REGAN. Usually that is what is done. The current one we have at Treasury merely shows static loss. It does not show any beneficial effects or any reflow, if you will, from the effects of a tax cut.

Senator DANFORTH. But, in reaching our own conclusions here on this committee, what should we do? We should, I take it, on the basis of something, of some estimates or some figures somebody has given us, make a judgment as to whether or not the proposal encourages work, savings, or investment, or does relatively little for work, savings, and investment.

I take it your view is we should try to come up with that which maximizes work, savings, and investment?

Secretary REGAN. Senator, I would give you as an example of the difficulties of doing this at the present time, a difficulty which we are trying to overcome at the Treasury. The current models used at the Treasury were the models that were in use back in 1978, when the capital gains tax cut was first proposed.

That showed, as you know, that that tax cut which was going into effect on January 1, 1979, would result in an outflow or less income to the Treasury of about $2.5 billion offset by $900 million tax on induced gains for a net cost of $1.7 billion. It turned out to be less than $200 million in 1979 and in 1980, it likely turned positive.

Actually, that meant a reflow into the Treasury.

Now there are very few models that include the reflow at the current moment. I would suggest that the best that we have at the present moment is the one that we used from Clairmont, which is the basis for the President's original forecasts of what would happen to gross national product, to the Consumer Price Index, and other indicators.

Senator DANFORTH. As I understand your testimony, and also your statement on "Issues and Answers" last Sunday, you indicated that you had not yet seen any program that is better than the administration's, but you are at least willing to entertain any ideas that people would come forward with, with programs that are improvements or better options than the President's program; is that right?

Secretary REGAN. That is correct, Senator.

Senator DANFORTH. I take it that therefore the criteria that you would use in judging whether it is a better program or a worse program is whether it looks as though it is going to do a better job or a worse job in encouraging work, savings, and investment?

Secretary REGAN. That's correct, Senator.

Senator DANFORTH. Supposing somebody wanted to make that case to you? How would they go about showing it?

Secretary REGAN. Well, they would have to identify the specific type of tax program that they have. We would do two things with it. First of all, we would run it through out models at Treasury to see what the static loss might be so that we could see from that what the effect on the budget might be from strictly a static point of view.

Then we would have to enter into a judgmental step, if you will, to see what this would do for things such as work, savings, and investment. It would be judgmental though. There is no absolute figures we could come up with to prove a case one way or the other.

Senator DANFORTH. Thank you.

The CHAIRMAN. Senator Roth.

Senator ROTH. Thank you, Mr. Chairman.

Mr. Secretary, I think what some people don't understand is what the Reagan administration is trying to do is to put some long-term policies into effect that create an environment of growth.

That, as part of that program, it is important to reduce substantially long term, the tax burden on the private sector, including the working people of America.

Would you agree with that?

Secretary REGAN. I do agree with that, Senator.

Senator ROTH. Is there any other way, long term, that we can better insure that there is real tax relief in reducing over a multiyear, a tax reduction for the individual working people of America?

Secretary REGAN. I know of none at the particular moment, Senator. From our point of view, if you just have a 1-year tax cut, it leaves it up in the air as to what might happen next year.

If nothing is done in the following year, you get in a bracket creep again, which in effect is a tax increase.

We know that we are not going to eradicate inflation overnight. We know we are not going to do it in a period of 1 year or even 2 years. We can hope that we can get the rate of inflation down, but we will not eradicate it.

Therefore, bracket creep is inevitable. What we are saying is, in order to have people be able to plan, to avoid bracket creep so that they can start their investment or their savings program, that you should have the multiyear tax cut in place.

Senator ROTH. Well, make no mistake, much of the opposition that is coming to the Reagan tax package are from those who want to keep as much revenue in place as possible. And, of course, one of the ways of doing that is to argue that we should only have a 1-year tax cut.

But, I would just like to call your attention to this chart to the right and point out exactly what is happening to the working people of America.

The most substantial tax increases are going in effect during the next several years if we don't begin now to take steps to correct it.

As that points out, taxes will go up something like 76 percent in the next 4 years. After our tax reduction it will only go up 42 or 43 percent.

So, it is merely a start in the right direction.

Now I would assume that down the road that the Reagan administration is going to make further recommendations so that we can return more of this government revenue to the private sector; is that correct?

Secretary REGAN. Oh, I would definitely hope so, Senator. After all, these won't be the last cuts that this administration will ever propose to this Congress.

Senator ROTH. Would you agree that the situation is similar to the early 1960's. Jack Kennedy, when people argued against a multiyear tax cut said in return that the choice is not between cutting taxes and balancing the budget. That if we didn't do something then to create real growth you would never have enough productivity or enough gross national product to balance the budget.

Isn't that pretty much the situation we are in today?

Secretary REGAN. That is precisely what we are saying. As a matter of fact, I use that quote in my own statement.

We firmly believe that that is—well, except for a period in the 1920's—the only true example of what marginal rate cuts can actually produce in the United States. It is the only time it has been tried in at least post-World War II history.

Senator ROTH. Mr. Secretary, I would like to make one further observation. It was just 3 or 4 years ago where people were not talking about tax cuts, but how to increase taxes.

I would point out it was just a year or 2 years ago that many of the people that oppose the President's tax package, were really promoting supply side tax cuts. They didn't want to give across-the-board tax cuts, but they wanted to do something about demand.

Would you not agree that it is essential that in creating an environment to growth we get the wholehearted support of the working people, that it would be a mistake to just have business tax cuts, as some people are proposing, but that the working people should be given some relief so they feel they are participating in the President's program?

Secretary REGAN. The business cuts by themselves will not produce the results that we want in this country. The individual tax cuts should be described for what they really are. They do not reduce tax collections, but merely stop the rate of growth——

Senator ROTH. Absolutely.

Secretary REGAN [continuing]. In taxes.

Senator ROTH. It is not enough.

The CHAIRMAN. Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman.

Mr. Secretary, it is a pleasure to have you here this morning. I welcome you. I can't help but think, and I think Senator Roth will certainly appreciate this. Just a few short years ago, when people made statements, and I think you made an excellent statement this morning, and I support it. When people made statements like that in this committee and over on the other side of the Hill, it was considered certainly out of the ordinary, if not outright radical. Now it has become main stream. I think it is a very, very positive sign that we are at least heading in a direction to restore economic growth.

Senator Roth also made the point earlier, in his opening statement, about tax freedom day being May 10. I think the point that is often missed by the public, after it gets filtered through the media, and I say this with no offensiveness to the media in any way, that tax freedom day really what happens is, we should go back and talk about where people quit working instead of when they can start working for themselves, because it works just the opposite. Now that people have worked this long to pay their taxes, they can supposedly work the rest of the year for themselves. But, what I find out in the factories and the work places in the country, you can't get people, it is hard to get people who want to work the overtime shift on Saturday because they don't feel it is very profitable off on the margin to take that money home.

So, I think it is a very good point.

You made an excellent explanation of the reason why we need the 10-10-10. I would probably say that after that 3 years is over and this program is working, we will then have the record to show that it does work, that we probably need to do it again to start bringing those rates down even further to encourage more economic growth, but that is on down the road.

I have just two questions. One is, in your effort, I would hope you would be able, maybe you have given this some thought, you might care to comment on it, it is so often used in the media but the word inflation is misused. We live in a semantic jungle where they use the word inflation to mean rising prices, instead of monetary inflation and never discriminate rising prices meaning price inflation for monetary inflation.

Have you given any thought to what could be done to try to correct that misunderstanding the public has had so we could help get a little better area of discussion on this subject too?

Secretary REGAN. Well, I think that this is something that we are all going to have to work hard on because as we get into these economic debates it is clear that the subject of what constitutes inflation and how it comes about is generally misunderstood.

Senator SYMMS. Yes.

Secretary REGAN. I think also, Senator, that an awful lot should be done to improve basic education. I have long advocated this, that we actually start economic education at the high school level.

I think that by the time one gets to college, just as one should have had a couple basic courses in English or French or math or what have you, one should also have had a couple of basic courses in economics.

After all, there aren't many things that are more important to a person later on in life, than the economy of a country. And, not to study that as one goes through school, I think is wrong.

Senator SYMMS. I appreciate that very much. Maybe your people can help at least filter out some of the—you know, to help our friends in the media that are trying to report to the public what is going on, the difference between the wet sidewalk causing it to rain and the rain causing the sidewalk to get wet.

We do have a problem here where we have been printing money for many years, as you know, and it caused—the result is rising prices.

What I wanted to get at in my questions before I get diverted is on your economic cost recovery on accelerated depreciation. I think you made a very excellent explanation of why the 10-10-10 is needed on the marginal rate reduction.

Could you explain to me why there is a difference in the 15 years with a straight line write off, for nonresidential buildings such as offices and leased stores, and why it is 10 years for someone who owns the building?

Secretary REGAN. We originally had both under the 10-year plan. Real estate interests came to us to point out that there is a recapture provision in that 10-year period and that this would work against rental property.

Therefore, we put it out to 15 years, with no recapture. The proposal actually is more beneficial to people who are building to lease than would be 10 years with recapture.

Senator SYMMS. I think you went a long way on making it simpler than it now is, I agree. It is hard for me to understand why we wouldn't just—is there any reason why it shouldn't be 15-5-3 and have everybody be the same?

Secretary REGAN. Well, what we are trying to do there under the 10 years is to get new plants and rehabilitated plants. Both of them come under the 10-year program.

In order to get productivity, the faster we could let people recover their costs of building a new plant or rehabilitating an old plant, we thought the better to accomplish what we are trying to do.

That is why we put it at 10 rather than 15.

Senator SYMMS. One last question, Mr. Chairman, if I still have a little time. The chairman made a statement one time that I read in the press that it is very difficult for Members of Congress and that are on this committee in particular, to be a hitchhiker and let the car go by, the first ride, waiting for the second one.

I personally am very interested in seeing the inheritance tax abolished and the gift tax. I think that it is very antiproductive in this country. It is certainly detrimental to small business. It has caused the polarization of newspapers where we have several newspaper chains on them. All the family papers are gradually sold out.

Agribusiness consumes more farms and the family farms sell out to pay the inheritance tax.

What is going to be in the making in the future if we are successful and get your first package through the Congress? I am willing to give a little ground on that and support it, but it is going to be very tempting I think, for some of us to try to catch that train as it goes through town in the fear that there may not be a second train, by tagging on say the inheritance tax, repeal or reform.

Secretary REGAN. Let me refer to the first train, second train first. With Conrail being sold back you may not have that second train at all, maybe not even the first one.

I think the chairman referred to taxis in his simile.

Answering your question, the President of the United States wants to see the estate tax eventually reduced. I don't believe we can do it overnight or do it in the first—in 1 year. I think what we will have to approach is gradual. That will probably be part of our second bill.

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

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

Mr. Secretary, there are 47 Senate cosponsors of 10-5-3, and I am its principal Senate sponsor.

The administration supports an 18-15-10-5-3 bill. However, there are people who are critical of the 10 or the 10-15-18. They say that is too generous and costs too much money.

How do you reply to those critics?

Secretary REGAN. We have examined that, Senator. We don't think that the 10, in and of itself is that generous considering what our objective is.

Remember that the objective we start with is to do away with depreciation as we once knew it. Depreciation is built on original cost.

What we are looking for here is replacement cost. How do you get replacement cost into the hands of those who will replace machinery, buildings, what have you, in order to make for more productivity or more jobs?

We feel that the 10 is correct.

Now, when we get into rental property, however, because of peculiarities of the tax code, the 10-year category would probably not be as good for those who would wish to build for the purpose of leasing, to have 10 years, because we would have the recapture provision in there.

Accordingly, we have gone to the 15-year program.

Now, as far as 18 for residential, that program currently is written off, perhaps in 30 to 35 years. We think that going to 18 is remarkably generous and will result in a lot more housing units being built.

We don't think you have to go all the way to 10 years in order to build more housing.

Senator HEINZ. Another concern raised about 10-5-3 or 18-15-10-5-3 is that it will encourage migration from the Snowbelt to the Sunbelt by providing strong incentives to locate new plant and equipment in the Sunbelt.

Improvements in 10-5-3 have been suggested, such as increasing rehabilitation credits for existing structures and writing off in 1 year pollution control equipment.

Do you share the concern that accelerated depreciation might speed up this outmigration trend?

Secretary REGAN. Senator, we would like to be very evenhanded here. We don't wish to favor any particular section of the country by accelerated cost recovery.

We have been very careful in looking at the rehabilitation to make sure that its benefits are at least equal, if not better, than green field plant type of construction.

We think that our current bill does that. However, we are more than willing to listen or to discuss with you or with your staff anything that you think is missing in our bill that would unduly favor one region over the other.

But we don't think that at the present time that it does do that.

Senator HEINZ. I am glad to hear that, Mr. Secretary. We may wish to get into that with you.

I know that the administration favors the enactment of its entire tax package, including 10-10-10, even if that doesn't allow us to eliminate the deficit, even if it maintains the deficit, and even if it widens the deficit. Isn't that right?

Secretary REGAN. That is correct.

Senator HEINZ. The——

Secretary REGAN. But we don't think that will widen the deficit.

Senator HEINZ. Some of my friends would like to ask you the question, are you an old fashioned Democrat? but I am not going to ask you that question.

Secretary REGAN. Well, the answer to that—I will answer it even though you didn't ask it. The answer is no; I am an old fashioned Republican.

Senator HEINZ. If the deficit does stay large, the theory behind Roth-Kemp is that it would generate a significant enough new private savings to cover the increased deficit and I gather, a bit more besides.

What percentage of the tax cut must be saved for this to take place?

Secretary REGAN. Well, there is no precise percentage of the tax cut that we think need be saved. I will tell you why. What we are banking on is a much larger growth in GNP, so we have a larger economy.

Then, since these are incentive type tax cuts, and since they are multiyear so that planning can be done, people will start to go back to the original rate of savings. This will be particularly true if we can abate inflation so that individuals are not losing as much because of the ravages of inflation.

That being the case, we can get back close to the original savings rate of, well, we used to have 7-8 percent, but let's assume 7 percent. A 7-percent savings rate on disposable income, based upon the growth in GNP that we anticipate, will bring about $45 billion of additional savings, according to our estimates, in the first year.

Senator HEINZ. For this to happen, then our current 4-percent rate on personal savings must become a 7-percent rate?

Secretary REGAN. It is around 5 for the last 12-month period. But from that 5 to 7 is what we anticipate.

Senator HEINZ. So, in round numbers, that means 50 percent, a 40- or 50-percent increase?

Secretary REGAN. Fairly close to that.

Senator HEINZ. That is a considerable increase.

Secretary REGAN. About a 40-percent increase.

Senator HEINZ. That is about how much of the tax cut on an annual basis?

Secretary REGAN. Well, if you want to compare it with a tax cut, it would be a large portion of the tax cut. But it is not correct to calculate that percentage. In other words, we are not saying that the entire tax cut will be saved directly. There is a distinction there.

Senator HEINZ. Well, it would help.

Secretary REGAN. It would help.

Senator HEINZ. Thank you.

Senator PACKWOOD. I assume the theory of the President's tax cut is that if we take less of the gross national product in taxes, it will increase our productivity investment and savings and what not.

Secretary REGAN. Yes, sir.

Senator PACKWOOD. How do all of our major European trading partners manage to have significantly higher levels of taxation than we do, and still higher rates of savings, investments and productivity?

Secretary REGAN. A good question.

I think that the way that this happens is that their marginal rates are not as high as ours. It is very difficult however, to compare one country with another.

For example, were we to compare France with the United States or Germany with the United States, to look at all their taxes versus all of our taxes, it is a fairly difficult thing to do. Most of them have the valued-added tax. They tax, in the main, I think this way. They tax consumption. We tax savings and incentives. We tax over here, capital gains; some of them don't.

Senator PACKWOOD. All right. That eliminates the need for my next question. You are very right and your Treasury Department has done that study for me. The total tax rates are significantly higher than ours. Their taxes on capital gains, dividends, interest, almost anything that relates to capital formation is less.

As a matter of fact, if you take the major European countries, including Great Britain, and add up all the taxes on capital, all of the taxes on investment and savings, we are worst, of the major European countries, including Canada.

You are also right about consumption. They tax consumption significantly higher than we do.

Now, do you think targeted tax incentives work, and by that I mean, do you think if you have a higher capital gains tax you will have less investment in stocks than if you have a lower capital gains tax?

Secretary REGAN. You are eminently correct, in my judgment.

Senator PACKWOOD. The mortgage interest deductions for homes, you will build more homes with it than without it?

Secretary REGAN. Yes.

Senator PACKWOOD. Then why wouldn't we be better off in terms of encouraging savings and investment to target the tax cut, and I am talking about the individual, to target it as Europe does to savings, to investment, to capital formation and to increase the tax on consumption?

Secretary REGAN. Well, at the present moment, that is exactly what we are trying to do with the exception of increasing the tax on consumption.

What we are endeavoring to do by our tax proposals—by the marginal tax rate cut—is to provide for more savings and investment, because we are looking at the last dollar that you would earn.

In other words, it is that old, old analogy. If you are taxed 20 percent on Monday, 30 percent on Tuesday, 40 percent on Wednesday, 50 percent on Thursday and the like, how many days a week would you actually work?

That is what we are saying. At a particular point in time there is a disincentive for added work or for added savings.

Senator PACKWOOD. Mr. Secretary, I have tried to run the figures. I can't get them yet as to where we would stand vis-a-vis Europe, with Roth-Kemp.

But as best I can tell from my preliminary statistics, it is not going to change our position significantly when you add savings, capital gains, dividend income, as being one of the worst of the countries in the world, major countries in the world, still the worst, after the passage.

We will have lowered indeed, the total taxation in this country for maybe 23 percent to 19 percent, but we will still have the worst incentives on capital formation.

I am curious why we don't devise a tax program that targets in that specific direction rather than an across-the-board cut.

Secretary REGAN. Well, first of all you have to look at the equity of the situation. If we are just going to reward one particular thing and make the tax cut that way, you will still have other people who are not able to save, for one reason or another, and many people are not able to save. They would be at a disadvantage, vis-a-vis the people who are able to save.

Senator PACKWOOD. How are they able to save in Europe when they are taxed significantly higher than we are?

Secretary REGAN. Well, there are lots of people over there who are not able to save too.

Senator PACKWOOD. Well, how do they get all these savings?

Secretary REGAN. Well, first of all, people tend to retire differently in different countries, and have different patterns of saving for old age.

A large pool of savings in most of those countries is personal. The rate of corporate saving, for example, in Great Britain and France or Germany is much less than in the United States.

Senator PACKWOOD. Let me interrupt if I might, here, from the letter from Mr. Chapoton, of May 11:

> France, Germany and other European countries generally impose a higher overall tax burden on individuals than the United States.
>
> While they tax consumption heavily, mainly with the value added tax, this does not completely account for their higher overall tax burden.

More probably, are the very high payroll taxes such as social security. The combined effect of that falls largely on wage, income and a high payroll tax, means the average tax on wages is much higher in the European countries than the United States.

Secretary REGAN. Well, from the point of view of practical experience, I know that you can measure the number of stockholders that there are. For example, in France, when they absolutely targeted stock holdings by allowing a tax break for the first portion of whatever you put into investing. The number of stockholders increased—although I must say in the last couple of days people have been kind of whipsawed on this one, but that is due to a change in government.

Once France did that and targeted actual capital investment that way, then they got it.

Now, from our point of view over here, we think that we should bring our capital gains tax down. The maximim rate is now 28. It is coming down to 20.

In order to be in that 20-percent tax bracket on capital gains, you would have to have $215,000 of taxable income, not gross, on a joint return,

That means the average person in the United States will be paying a capital gains tax of less than 20 percent.

We think that our bill will encourage capital gains from that angle.

Senator PACKWOOD. I think it will, too. As a matter of fact, we are only fourth in the top seven. We are in the middle in terms of the tax on capital gains now. That is mainly because Germany, Japan, and Italy don't have any capital gains tax at all.

All I am saying, Mr. Secretary, is I think the tax is targeted in the wrong direction. I think you ought to have a multiyear tax program of 3 years. I think it ought to be targeted toward investment, savings, productivity, capital formation, and here I am talking about the individual taxes. Forget the business taxes for the moment.

But, I think you will get more for your tax cut out of those targeted European style incentives than you are going to get in an across-the-board individual tax cut.

Thank you.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Thank you, Mr. Chairman.

Mr. Secretary, let me make sure that I understand very clearly what you have said today in your testimony.

As I understand it, you said you strongly advocate the 3-year, Kemp-Roth tax cut.

You advocate 10-5-3.

Is there any room for compromise at all in the Kemp-Roth tax cut? Is the administration prepared to water down and back away from their commitment to Kemp-Roth?

Secretary REGAN. Let me put it this way to you, Senator, as I said previously. If there is a better way to accomplish what we want to do, that is to get incentives, to work, to save and to invest, we would be glad to look at that, to listen to it, to try to price it out to see if it is superior to the President's program.

As yet, we have not seen any such program. All we have heard is a lot of nay saying. Accordingly, we are saying that what we have is superior to anything else.

Senator BRADLEY. So, does that mean that you have rejected the bill that was reported out of the Finance Committee last year as not meeting the criteria you have established?

Secretary REGAN. We think that our bill does more than the Senate finance bill of last year to accomplish our purposes.

Senator BRADLEY. So, you would not compromise with the Senate Finance Committee and accept this bill of last year?

Secretary REGAN. Well, we have not seen that this is superior to ours, so we see no need to compromise at this moment.

Senator BRADLEY. Could you explain what you mean by, at this moment?

Secretary REGAN. Well, or at any moment until such time as it is proven to us that an alternative is superior.

Senator BRADLEY. How big will be the second tax bill that the administration is supporting this year?

Secretary REGAN. I don't know. The President has not stated which of the items he would prefer to have in the second tax bill.

Senator BRADLEY. Well, I know there are a lot of things like charitable deductions and a few other things that people want to see enacted into law. I make a quick calculation and come up with between $20 and $30 billion.

Now, is the administration prepared to accept the second tax bill of $20 billion?

Secretary REGAN. No. That is much too high.

Senator BRADLEY. What would be the level?

Secretary REGAN. We looked at a lot of other things that cost much less than that, Senator.

Senator BRADLEY. What would be the upper level?

Secretary REGAN. We haven't put a price tag on it as yet, Senator, so I am unable to answer.

Senator BRADLEY. Let me also see if I understood what you said earlier today. You said that deficits are not a problem as long as there is tight money; is that correct?

Secretary REGAN. No; I did not say that, Senator. I said deficits are a problem. I said they were not inflationary per se.

Senator BRADLEY. Deficits themselves are not inflationary. You used, I think, the Japanese example. You said the Japanese have a deficit of one-third of their budget which would be the equivalent of $230 billion in the United States, and yet, you maintain that because of high interest rates they are able to keep tight monetary policy.

Secretary REGAN. Yes.

Senator BRADLEY. Do you think Japan and the United States differ at all? When we raise our interest rates in this country, what happens to dollars abroad? Do they come into this country?

Secretary REGAN. They do as long as we have a strong dollar, and high interest rates.

Senator BRADLEY. That is right. Does that increase the money supply at all?

Secretary REGAN. It could.

Senator **Bradley**. So, how do you keep the money supply low by raising interest rates?

Secretary **Regan**. By the fact that in addition to making money more expensive, you also make less of it available. We are not monetizing any of the debt.

Senator **Bradley**. But, when money comes in from abroad, that has the effect of increasing the money supply.

So, what you are saying is that because we are an open economy, the only way higher interest rates are going to effectively counter inflation is to force the economy into a much deeper recession?

Secretary **Regan**. No; those two don't necessarily follow. You don't have to have that effect. Because if you get a dampening of expectations over here of what inflation might be, you don't have to have the same effects. Those interest rates can come down quickly, even in a period of a lot of influx of money.

Senator **Bradley**. Do you feel that at the moment Wall Street has confidence in the President's economic program?

If not, why not? And if not, how do you account for the higher interest rate?

Secretary **Regan**. There is no such thing as a Wall Street opinion. I have learned that in 35 years. There are many opinions that make up Wall Street.

If you are saying that because there are high rates of interest and bond prices have been falling, that that is as a result of dissatisfaction or disbelief in the President's program, I don't think that is correct.

My own reading, Senator, is that the bond markets have been in disarray for the past 2 years. Losses in bond portfolios have been tremendous. Bond buyers, and I am particularly referring here to money managers of large pension funds, buyers for large insurance companies, are in a state of shock. They are demanding a higher premium now because of what they have seen happen to their portfolios. They don't know what is going on.

They didn't believe that the Fed was trying to tighten in April, when in fact the Fed was trying to tighten. When they finally realized that, there was panic, and prices just literally plummeted. I think that is a temporary condition.

Once they realize that the Fed is tightening money, that money—and they see that the money supply, and I would hope on more than a week-to-week basis, certainly on a month-to-month, if not a quarter-to-quarter basis, is coming down, Wall Street would feel reassured.

Senator **Bradley**. You said earlier that within 12 months of the bill's enactment, we would know whether it is working by determining whether people are working harder or saving or whatever.

My question to you is, how will we actually measure whether the administration's tax policy is working or not?

Will we look at the savings rate?

Secretary **Regan**. I think you should look at the savings rates.

Senator **Bradley**. Will we look at the interest rates?

Will we look at wage settlements?

What you are saying is that this is a policy that will deflate inflationary expectations. If that is so, interest rates have to come down and so do wage settlements.

So, if next year interest rates are still high and wage settlements are still relatively high, how could you say the plan is successful and deserves to be continued?

Secretary REGAN. I would say that we would stick on that particular statement, that if inflation is coming down, if interest rates, in turn, are coming down, if gross national product is rising, and if the savings rate is increasing, then our program would have been judged a success.

Senator BRADLEY. What did you say about wage settlements?

Secretary REGAN. I didn't say anything about wage settlements.

Senator BRADLEY. You don't think that wage settlements are essential to getting hold of the inflationary spiral?

Secretary REGAN. They are essential if they are not part of our program.

Senator BRADLEY. Your program doesn't affect wage settlements?

Secretary REGAN. It affects them.

Senator BRADLEY. How?

Secretary REGAN. You have to remember, Senator, that we have decided that we aren't going to have an incomes policy in this administration. We are not going to interfere in the process of labor negotiations.

Senator BRADLEY. Fine. Well then, how does the administration's inflation policy affect wage rates? How do we get wage rates down?

Secretary REGAN. I would assume that both sides sitting at the table, seeing that inflation is coming down, would soften, at least labor would soften their demands and management would stiffen their backs about giving larger increases than are called for by the rates of inflation.

Senator BRADLEY. So you are saying that you are depending upon the rational expectations of all parties in this next year?

Secretary REGAN. Yes.

Senator BRADLEY. If the rational expectations prove to be less than rational, then you won't have combatted inflation?

Secretary REGAN. I won't say that we wouldn't because you know, as well as I, that there are other things that enter into the settlements rather than just inflationary expectations.

Senator BRADLEY. Well, let me say that I think you have clearly stated today that the administration does not have a plan at all for one of the central components of the inflationary spiral. You have also said that we can look to see if interest rates come down in the next year and if they do not come down dramatically, then it would be very difficult for you to declare the plan a success.

Secretary REGAN. That is your adverb, dramatically, Senator. I said that interest rates would come down.

Senator BRADLEY. How much?

Secretary REGAN. That—from the high ground they are in now, but to expect that they would come down let's say as dramatically as last year when the prime went from 20 to 11, in a period of 3 months, we think is too precipitous. We wouldn't want to see it fall that quickly.

Senator BRADLEY. It is important for us to be able to measure whether the plan is working. As you said, you are going to measure it to judge how well it is working. If interest rates are down by 50 percent, would you consider it a success? Would a 12-percent decline be a success?

Secretary REGAN. Well, I think that if inflation is in single digit figures by the end of 1982, we will have been very successful.

Senator BRADLEY. Interest rates?

Secretary REGAN. Inflation, on the CPI.

Senator BRADLEY. But what about interest rates?

Secretary REGAN. Interest rates will course down with them. As I said before in testimony before this particular group, 35 years of experience have taught me never try to predict interest rates, because there are so many variables in it, that it is usually fruitless.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Thank you, Mr. Chairman.

I would like to pick up on the point where Senator Bradley left off. We reported out what was a good tax bill last year. I don't think we have been disuaded from that general judgment. It is partly because some of the things that we hear from the administration do not seem to match the things this administration proposes to do.

You started out today saying we must reject the simplistic view that the way to get the economy moving is by pumping up consumption.

Then you put before us a tax proposal, with a large reduction. More than 80 percent of the reduction is personal, individual taxes which has classically been the way to increase consumption.

Now I know you say there will be a savings component and there will be savings, I am sure, but an 80 percent individual tax cut has got to have its primary effects on consumption.

One of the things that we wonder and we would just like to hear you about is that early in the political process that led to the campaign that led to the administration, you adopted a theory of taxation. I don't know if you did, sir, but a theory was adopted which held that you could make huge reduction in marginal tax rates without reducing Federal expenditures because there would be an almost instantaneous rise in revenue associated with expanded economic activity which some called supply side economics.

Now, as recently as last May, in Flint, Mich., President Reagan was saying, "And we would use the increased revenues from the tax decreases to rebuild our defense capabilities."

Now, is that still the view of the administration? That is crucial. Do you still think that there will be that kind of flow back? Because if you don't you committed us to an unending series of deficits.

If you do, you know you are at odds with the economics profession, including economists in your own administration.

Secretary REGAN. Senator, we do believe that if you will cut taxes at the margin, you will encourage people to work harder. You will encourage people to save. You will encourage people to invest. Because there is where you get the attitudinal factor.

Senator MOYNIHAN. Yes, sir, but consequence to revenues? A 30-percent consequence that the Chase model would give you or the Wharton model or the DRI or this huge 130 percent we were talking about that someone called Voodoo Economics. [Laughter.]

Secretary **Regan**. I noticed, by the way, that the Senator yesterday—I wanted to thank you for it—was trying to fee me and Dave Stockman from this thing. But manumission is not one of the things I require at this particular moment, Senator.

Senator **Moynihan**. You have sir. You are under a spell, not a sentence. [Laughter.]

Secretary **Regan**. I am not sure I know how to spell that correctly, but anyway, I would say, Senator, that from the point of view of the reflow, it has not been quantified precisely at the moment. There are econometric models, but as you know, as well as I, most econometric models are not precise by any matter of means.

Senator **Moynihan**. Would you not agree, Mr. Secretary, that none currently in use shows anything like the reflow which was being talked about a year ago?

Secretary **Regan**. But, if you noticed the assumptions that this present administration has for its economic scenario, I think the more you examine them and the further we go into 1981, the more they seem attainable.

We were told, for example, that in our model, our velocity could not possibly be what it was. Yet, at the very moment we were being taken to task for that, the velocity in the first quarter of this year exceeded what we said the velocity could be in 1982 or 1983, using our model.

The same thing with the size of what we said would happen to the economy as a result of what we were doing. It was even larger in the first quarter when we were being taken to task for saying the economy could ever do that.

Now, what we are saying here is that if you do give incentives to people and allow people to have their money, the chances are they will save it and will invest a good portion of it.

If you give it to the Federal Government to spend, there will be no savings.

Senator **Moynihan**. Mr. Secretary, you grant there is a third possibility which provides supply side tax reduction by results. To give people who have successfully invested, firms who have successfully invested, tax reductions on their earnings, in the aftermath of investments.

I would like to say, I think that that is what this committee is still looking for from the administration. I just feel that one of the reasons I have to say to you, one of the reasons we have had the cut of the day from this administration, this is turning into a butcher shop, is that you keep finding that your revenue expectations can't come near balancing the budget without yet further reductions in spending which you never really contemplated.

I don't ask you to answer that. Could I ask one last question, because before my time runs out, there is a possibility in this first bill, of recouping a large amount of money.

We understand that Assistant Secretary Chapoton testified before the Ways and Means Committee, that Treasury now favored legislation to limit commodity tax straddles, and such, like which would recoup, he estimated, as his predecessor, $1.3 billion.

Is it my understanding that would be your view?

Secretary **Regan**. That is the Treasury's position. I have recused myself from commenting on this because of my——

Senator MOYNIHAN. That is the Treasury's position?

Secretary REGAN. That is the Treasury's position.

Senator MOYNIHAN. So, it would be possible, if we were to incorporate that, that would really give us some revenues we could use. It is not that we have too much money, we just have spent too much. Is that right?

Secretary REGAN. To the extent that that is something that is taken out of the Tax Code, there will not be that loss of revenue.

Senator MOYNIHAN. Thank you very much, Mr. Secretary.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Secretary, the administration is proposing a sweeping plan, and it is not business as usual, we all know that. I think frankly, before any of us can really act responsively on the degree to which to agree with that plan, it would be helpful if we knew what the administration game plan is if this doesn't work.

What is the alternative? If, say, interest rates remain high or go up or if interest rates or inflation rates go up, for example, what next?

What is the administration's game plan? Is it going to increase across-the-board cuts, another 30 percent or will it target cuts or will it be some kind of incomes policy?

I am just curious, as you look down the road, what are the options if this doesn't work?

Secretary REGAN. Well, curiously enough, Senator, we have been devoting all of our time to trying to get this particular package passed. We are not even half way there yet. We want to see this in place before we start speculating as to the fact it might not work. We think it is going to work.

We are concentrating also on the second portion of the tax package.

Senator BAUCUS. I think you will agree that nobody really knows whether this is going to work. With all candor, I think the administration is drawing largely on hope, looking for analyses which to some degree bear out the administration's position. But there are many analyses which have different results.

I think all of us here in the Finance Committee as well as Members of the House, think that the administration is trying to find some solution that is going to lower interest rates and rates of inflation, increase savings, increase productivity and get the country moving again. But we are not precisely certain exactly which program will work.

So, we are now wrestling with the administration's proposal. The administration is faced with expectations and high hopes. I am just curious, therefore, because we do not have solid evidence to support the administration's program, what your next stage might be.

Secretary REGAN. Well, I think what you first of all have to do, Senator, is think through what the alternative is if we don't do this. If we don't do this we certainly have bracket creep. We have been having bracket creep for the last few years.

So, we know that if this doesn't succeed, we are back in the bracket creep again.

We know that if we don't get the savings, we are then going to have to find out why we didn't get the savings and what we will have to do to jilt the investor even more in order to target and get these savings better.

We think that what has been happening over the recent past has not succeeded because we see what the rate of savings is. We see what the rate of inflation is.

Therefore, we think this will work. As any doctor, prescribing a different medicine for the patient, you just have to observe the results before you can determine what is going on, and then make up your mind, what else could work.

Senator BAUCUS. I agree you have to find something new. That is why we are on this exercise, we all on this committee are trying to find some alternative. The present system hasn't been working.

But, I just feel it is helpful to us if we know what some of the alternatives are too.

Let me turn more specifically to the 10-5-3 side of the proposal. Is it the intent of the administration to subsidize business investment?

Secretary REGAN. No, it is not. What we are trying to do through our tax program is to target incentives for business to invest.

Senator BAUCUS. I ask the question because there are some analyses which will show that actually, 10-5-3 will give back to businessmen more dollars than they invest given certain interest rates, certain after tax interest rates which are in the realm of probability. That is, after tax interest rates are what—17 percent, pretax interest rates of say 21 percent?

If any of those rates are lower, then business will get a subsidy under several provisions of 10-5-3.

I am wondering whether you agree with that analysis and if not, why don't you agree?

Secretary REGAN. In recent weeks, Senator, we became aware of this long before articles appeared in the press on this subject. We are examining it closely. We are examining various industries—how this would affect companies within the industry.

This is, I would say, an unintended effect of what has happened here.

Senator BAUCUS. It is not your intention, therefore, to subsidize? That is, if it turns out that the effect of 10-5-3 will be to subsidize, the administration would then be in a position to agree to changing the bill to prevent that from occurring?

Secretary REGAN. That is correct, Senator. We are taking a very close look at that. We will be working with the staff of this committee if there is an unintended result here.

Senator BAUCUS. I have no further questions.

The CHAIRMAN. Senator Boren.

Senator BOREN. Thank you, Mr. Chairman.

Mr. Secretary, in last night's Washington Star an article quoted a senior Reagan administration economist stating that the administration will miss its interest rate target for calendar year 1981, the first acknowledgement that this part of the forecast is off the mark.

The same article quotes you as saying last week that you expect interest rates to remain high for several months and you predicted that the prime rate could top 20 percent.

Are you prepared to acknowledge that that portion of the administration's forecast, dealing with interest rates, was as the other economist said, "off the mark"?

Secretary REGAN. No, Senator, I am not. I don't know who the senior economic official is, but there has been no official change in the administration's position. As I suggested earlier, in talking with Senators Bradley and Moynihan, predicting interest rates is a hazardous profession. I think it is premature to say that.

Senator BOREN. Well, this article quotes you as having predicted what interest rates would do.

Secretary REGAN. I will stand on what I say, Senator. I said that at a time when the prime was around 18. It is now at 19.5, unfortunately.

I will stand on what I said. I do think it will be coming down from that area within a matter of a couple of months.

Senator BOREN. So the administration's forecast for a yearly average of 11.1 percent, on 3-month Treasury bills, which is what this article referred to, is in your judgment, still a sound, reasonable forecast?

Secretary REGAN. It is a reasonable forecast; yes.

Senator BOREN. You are not prepared at this time, even in view of what is happening to interest rates, to make any alteration?

Secretary REGAN. No; because let me point out again, Senator, what happened last year. Things turned around so dramatically when the prime, again, using my example, went from over 20 to 11, in a period of over 3 to 4 months. Things can happen dramatically in that bond market.

Senator BOREN. I want to switch to another question followup on some of Senator Packwood's questioning. There is, as you know, an interest and dividend exclusion which permits deduction of up to $200 per person, for interest or dividend.

Does the administration propose to terminate that or not to extend it or do you now propose to extend it?

Secretary REGAN. At the present time, we have not taken a position on that. I think that will be part of our second tax proposal.

We probably will advocate that it remain in effect.

Senator BOREN. Don't you think it is important if the whole objective is to save, to give people this incentive to save?

Secretary REGAN. Oh, yes. As I say, the only reason that I am not being stronger in my commitment to it is, is that as yet, the President hasn't decided which of the items he wants in that second bill. I am reasonably sure that is going to be one of them.

Senator BOREN. Well, if your statement makes clear with great emphasis and your questioning and your answers have focused on the need to encourage savings, and that's an important objective of the tax bill, of the proposed legislation, why then is that not included in this aspect of the bill if that is the objective?

Secretary REGAN. Because we wanted to have a very simple bill up front that could be assured of quick passage. That was our whole theory in doing it.

Senator BOREN. Is this a controversial item?

Secretary REGAN. I am not certain about that, Senator, as to whether or not. But, if we include that, then some other person, in either one of the branches of Congress could think that his proposal or her proposal was just as good as that one and might deserve equal treatment.

We didn't want to start choosing among which are the better ones.

Senator BOREN. Do you honestly believe that it is a greater incentive to the large masses of Americans, working men and women, to reduce their taxes by what relatively modest amount in dollar terms in the bill, that that is a greater incentive to savings, than to provide for an exclusion of interest earned on savings?

Secretary REGAN. There was another proposal regarding an IRA's. This is of great importance to a lot of people, their individual retirement account or something of that nature.

To many people, that is equally important.

Senator BOREN. I am asking you. Do you honestly believe that the average working man will have a greater incentive to save by a reduction in his personal income taxes, as opposed to providing this exclusion for interest earned on savings deposits.

Secretary REGAN. It is a hard one to answer. It is like picking among chocolates, you know, which is the better one, which do you prefer. I think that there are many good things. I think that this is an excellent one, Senator. I was for it when it passed in Congress and I am still for it.

My problems is, once I start putting in one that I think is better than some others, someone would want to joust with me and say that their proposal is better.

Again, we start cluttering up the bill.

Senator BOREN. Well, you are saying your objective is to save. I don't think this is picking between two chocolates. I think this is picking between a chocolate and a rotten apple. I don't think it is a very difficult choice.

I think if you ask the overwhelming majority of people what is a greater incentive to save, it seems clear to me that the exclusion is a far greater incentive to save than a $75 or $100 tax reduction which everybody I have asked says they are going to spend it.

Secretary REGAN. Well, incidentally, on that last point, our polls don't indicate that everybody is going to spend it. But, again, I will have to stick on what I said, Senator, we are not proposing that in the first bill.

Senator BOREN. Part of the reasoning you give for the accelerated cost recovery system is that due to inflation there is an overstatement of income for business and we have to provide more rapid writeoff and this system will reduce the burden of accounting and tax planning for taxpayers.

Do not those arguments apply with equal validity to inventory accounting?

Secretary REGAN. Yes, they do.

Senator BOREN. In fact, is it not correct that inadequate measurement of inventory overstates income to a greater degree than does the slower rate of depreciation now in effect.

Secretary REGAN. Yes, that is the so-called inflationary effect on profits.

Senator BOREN. Isn't that even more significant for small businesses than the depreciation problem?

Secretary REGAN. Actually, small businesses, for the most part do not use many of the rules that are in the code now because they are too complicated.

Senator BOREN. That is the last in, first out inventory count again. Do you not agree that some simplification of the regulations in that area to permit small business to take advantage of different inventory accounting measures would be a desirable step?

Secretary REGAN. I would agree with that, Senator.

Senator BOREN. My time is up. Thank you, Mr. Secretary.

The CHAIRMAN. Senator Grassley.

Senator GRASSLEY. Thank you, Mr. Chairman. Mr. Secretary, I want you to know that I am that part of the committee that is supporting the 10-10-10 on the accelerated depreciation. I think it is going to work.

I suppose that with a lot of suggestions coming before Congress, it is impossible to actually forecast how they will work, but it seems to me like there has been some precedent with a tax cut in the 1920's and the Kennedy tax cut and the capital gains tax cut of 1978, that have indicated that this sort of cutting of the marginal tax rate does a great deal of economic good.

I think most importantly in selling me upon the concept is that this tax cut of the last decade—and I suppose there have been four or five smaller cuts since then that have been those that have been short term in their nature, and have tended to promote consumption and not encourage savings.

When you want to reverse, I think that those are worthy goals that I want to pursue. I see this as one way of doing that.

Quite frankly, maybe some of us in the Congress here and other people in the country at large, may be putting a great deal of faith into this plan. There may be more faith than economic fact at this point.

But I think that the whole economic program has something to do with people in this country reestablishing faith in the system by which we do business, faith in the free market system, faith in the private sector doing things as opposed to the public sector doing them, and faith in the distribution of goods by free market forces as opposed to the politicians and bureaucrats making those decisions.

Maybe it is because we have gotten away from that faith in the system that the country is in such economic doldrums as it is in.

So, as naive as it might sound, there is some consideration of my part in this for the reason it will help reestablish some faith in the system that has made this country not only the most politically free, but the most economically free, and has brought the highest standard of living to any people in the world.

I think that people are slowly reestablishing that confidence. It may be built upon the Presidency of one man at this point and the confidence they have in him and particularly his bravery and his courage in moving forth. In doing things heretofore felt to be politically dangerous, he has rejected the idea of business as usual, or I should say politics as usual.

I think that if we stay with him we will be reestablishing a new beginning. I suppose though we all have to think sometimes that maybe what we want won't be done. I suppose the chairman of the committee expressed some of that in the first instance as he has polled this committee. Maybe there is not the support for this plan here.

So, I have been a longtime advocate for indexing which I don't think detracts from the program; hopefully it adds to it.

I guess I was wondering if the administration has thought in terms of support or nonsupport of indexing, where that ought to fit into the picture.

Could you give me your views on this, even though you have not been willing to talk about any sort of a compromise and I don't expect you to?

Would there be such a thing that the same long-term good could be accomplished, for instance, if we had a 1- or 2-year provision of this tax cut linked with indexing.

Maybe out in the long term, 1985, 1986, and 1987, there might be just as much economic good accomplished as there would be from the 3-year tax cut.

So, I guess I would ask if you would comment on indexing, if there is any thought to it, and particularly if it would fit into the long-term good you want to accomplish in case the 3-year tax cut is not successful.

Secretary **Regan**. There is a lot to be said for indexing, Senator. The fact remains, however, I am opposed to indexing. I think it is an indication that we are giving in to the inflationary fight. If you index taxes, why don't you index wages? If you index wages, why don't you index prices. You keep going on and on and on. Eventually, you end up with an indexed economy which nobody cares about inflation because everything is indexed.

I hate to start down that road. That is why consciously I did not want to see indexing in this package.

I think that the Congress of the United States is astute enough that if we do have inflation, if we are getting into bracket creep or better yet, if we have inflation coming down and we are having surpluses in the budget, that at that point in time they will see fit, rather than doing it indexing, to make further tax cuts for individuals and for business.

I would prefer to have—to see the Congress do it that way rather than bind them in to indexing in the out years of 1985, 1986, and the like.

Senator **Grassley**. I won't find fault with that except I would throw this out for suggestion and somewhat countering what you said, I think that within the administration, as well as some of us in the Congress feel that the present economic problems are caused by taxflation. In other words the more money coming in to the Federal Treasury, the more Members of Congress are likely to spend.

Consequently, we have gotten ourselves into an economic hole just because of the tax increases without Congress having to bear the responsibility of voting those tax increases.

Our taxes wouldn't be so high if we had to cast a vote on them. If indexing would limit the income of the Federal Treasury, hence reduce the dominance of the Federal budget and the economy as a whole, it seems me like there would be great economic good that would come from that.

Secretary REGAN. Well, as the Congress is demonstrating its courage this year to make cuts in the budget, I think that future Congresses will do likewise if they think that the budget needs cutting. I wouldn't want to tie their hands is what I am saying.

Senator GRASSLEY. Thank you.

The CHAIRMAN. Senator Long.

Senator LONG. Mr. Secretary, it was my privilege to speak yesterday on the Senate floor and to put a statement in the record, which you probably didn't find time to read. You are a very, very busy man. I hope you will find time to read it. I discussed the tax proposal which I introduced yesterday with 29 or 30 cosponsors. I am sure there will be more, having to do with employee stock-ownership.

I asked the White House if they would please make available to me some quotations from President Reagan. I know he has had some things to say on that subject and he favors the concept.

What he has said on the subject I think is more eloquent than anything I have ever been able to say. I call him as my best witness. If you find time, I would like you to look at that record of yesterday.

He said that—

> Over 100 years ago, Abraham Lincoln signed the Homestead Act. * * * We need an industrial homestead act. * * * The American dream has always been to have a piece of the action.

I asked if the White House would object to my quoting from what President Reagan said. The answer I got back, I am not saying I got it from the President, but from whoever his aides were who handle that was, "By all means." They would like very much for us to use the quotes. They really helped the speech.

I also quoted you, Mr. Secretary. You had some very good things to say on the subject. You have said: "I have to be in favor of more Americans owning their share in American industry."

I am very hopeful we can do something about broadened ownership and that it will help solve the problem that is plaguing you about social security costing so much. If Americans have a bigger capital estate, they won't need as much in terms of contributions from Government where we really are just taxing their younger relatives to keep them going in their later years.

You are going to do as well on this committee, Mr. Secretary, as you do in any committee. You have a great chairman. In fact, you have three great chairmen of Senate committees serving on this committee. [Laughter.]

Mr. Secretary, you have people on this committee who want to work with you. There is no new problem to these fellows. They have seen it around before. May I say I have been around, too. I have seen how some of these things happen.

I do think you ought to keep in mind that the legislative process is sort of like a football game where all 22 players are in motion. It is not one of those situations where you just kick the ball off at one end and run through a bunch of statues to the other end of the field. [Laughter.]

Things will happen as the process goes along. I just hope you will keep in mind that most of these fellows are sort of like Bob Kerr used to be. He used to say that he was against any combine that he wasn't in on. [Laughter.]

We very much want to be in on your combine before this thing is all over with.

Secretary REGAN. I get the message, Senator. [Laughter.]

Senator LONG. If the House just absolutely shatters things, that is not the end, all is not lost. Humpty Dumpty can be put back together again in the Senate. I just hope you understand that we know that when President Reagan signs the bill it will be the Reagan bill. Meanwhile there are a lot of people here who would like to play a part. They would like to be known for having carried the flag, or at least for having helped the chairman when he might have stumbled at some point, or for having done whatever might have been necessary.

We just want to be a part of this moving scene. I hope you will make room for those on both sides.

May I say, I have no complaints. You have been most considerate in calling on all of us, Democrats as well as Republicans, inviting us to make some input and so has your very able assistant.

You know, we cannot initiate revenue bills over here in the Senate. The Constitution says that bills to raise revenue must originate in the House. The House has been very unreasonable about that. They have said that bills to raise revenues also include tax cuts. The Constitution does not say that at all, but the heck of it is we can't get into court. If we send a bill over to the House that is just tax cut, they won't take it off the desk. They just leave it there for the whole 2 years.

Since there is no way we can pass a bill without proving in the courts that we have a right to initiate a tax bill, all we can do is amend, and that being the case, we sort of have become accustomed to amending bills.

Where you will want to foreclose us in one area, I hope you understand that you have to find a way to give us a chance that has real credibility later on.

Secretary REGAN. Well, Senator, I can assure you that this administration is well aware of the Senator's views. We will be working with the chairman and with you, as ranking minority member, to make certain that when we have a second bill, that you are very familiar with it, with its contents and we will have a lot of input into it.

Senator LONG. Let me say one further thing. This 10-5-3 proposal is generally credited as being the idea of a man who served very well in Government, a very fine, able fellow, by the name of Charls Walker, who was adviser to the President during the campaign. He still has a firm here in Washington, with some very prestigious clients and he is a great American, in my judgment. He is a talented person. He served as Under Secretary of Treasury, under a previous Republican administration.

Mr. Walker knew how to work with the Congress. If this committee or some committee was going to insist on amending a bill, I would suggest to him how it could be amended and ought to be handled in such a way the administration could support it.

I recall when we reported out the revenue sharing bill, we made some major changes. He suggested how it could be changed to meet with what the committee's desires seemed to be.

When we were through, he promptly announced that this committee had succeeded in reporting an even better bill than had come to us.

I think that showed good judgment and might serve as a good example for you to consider some time when someone has a good idea, as a part of the overall legislative process. You know, we are in business to legislate. If we don't do something people are going to think we are not necessary, and maybe they ought to have someone else up here. [Laughter.]

Secretary REGAN. I will make certain no one gets that impression, Senator.

The CHAIRMAN. Senator Bentsen.

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

I want to adopt the sum of what Senator Long has stated. I certainly want to work with the administration in trying to develop a good bill.

It may be, Mr. Secretary, considering the past successes of the last few months the administration has had in the Congress, I think you could work your will as far as Kemp-Roth.

But, let me say I understand as a good trader, you are not going to talk about your bottom line at this point. But what concerns me is, if you push too hard on Kemp-Roth you might win it all. [Laughter.]

I think you have won the hearts of Wall Street, but I don't think you have won their minds. I think the way they have responded with interest rates shows that they are mesmerized about the deficits they are seeing and they don't see the inflow of savings.

I don't see much difference in an across-the-board tax cut this time and the across-the-board tax cuts we have had in the past, insofar as what they will do for savings.

Now with all due respect, Mr. Secretary, I have had some experience too on estimates from Treasury in past administrations.

I recall I proposed one particular tax provision and was told it would cost a substantial amount of loss to the Treasury.

And then I recall next year they had a new Secretary of the Treasury who thought it was his idea, and all of a sudden the econometric model spewed out entirely different estimates in a much more favorable situation.

So administrations generally have a history of making some rather favorable estimates in line with what they are trying to accomplish. I understand. Congress is guilty of some of that itself.

I was original cosponsor of 10-5-3. But I think we found out it could be improved on. I helped on the drafting of 2-4-7-10. There is no question in my mind it can be improved on.

But what we should strive for is neutrality in the treatment of that equipment under the tax law. I would like for you to comment on what you think the true neutrality is on 10-5-3.

Secretary REGAN. Well, from the point of view of what we are attempting to do here, Senator, there are any numbers of ways we could accomplish it. The years in which we state the capital recovery should be made are our best judgment of what the appropriate years would be to recover fully the replacement cost of investment.

Now we, although I am not personally from Missouri, I am willing to be shown. If it is more effective to do it a different way, let's discuss that.

Senator BENTSEN. Let me discuss one point on that. You sat on a number of corporate boards. If you look at a depreciation schedule that is done by accretion or amortized or phased in, there is always a temptation for a board to say, well, there is going to be a little more next year. And 10-5-3 as proposed is phased in over 5 years.

What we did with 2-4-7-10, was to put it all in from the beginning. A corporate board that looks at that says, you know, maybe we better rethink our capital spending and rather than having the temptation to put it off another year. I wish you would really take another look at that kind of an approach which would obviously mean that you would have to change some of the 10-5-3 and its magnitude. I understand that, too.

Secretary REGAN. We are discussing this. We would welcome any organization or what have you which wants to comment on this. We at Treasury would welcome it, particularly while the bill is in its formative stage.

Senator BENTSEN. But, I think we can buttress that by putting a direct incentive in and so many of them have. The situation of Japan having what is the equivalent of $65,000 interest, tax-free.

We look at Germany that not only exempts many instances of interest earned on specific types of savings, but actually pays a subsidy on some types of 16 to 18 percent, quite the opposite of what we are doing in this country.

We look at the situation in England and France where they exempt major parts of interest earned on savings, long-term savings.

I really believe as part of this tax package we have to do something that specifically targets savings and creates an incentive for that. To try to have the kind of inflow of funds that can bring the rates down in this country; those two things coupled together will help us accomplish the very objective I think you are seeking.

Secretary REGAN. That is what we are looking at in our second bill, Senator, as to some of those targeted things where we previously mentioned. We know that IRA and Keogh plans, for example, not only are good for individuals, but they are very helpful to the thrift industries because most of the deposits do go into the thrift industries. The moneys from them follow and flow through to the industry.

We are looking at various other types of proposals. We know there have been all kinds of schemes to bring interest on savings up from where it is currently.

Now, the problem with that, as I see it, is having to shift from one form of investment into the other. In other words, if you are already saving in one type of mechanism, and then we target, say, just interest on savings coming out of a bank or thrift institution, you may just get a switch and no additional savings. That worries us.

The second thing that worries us is that you may borrow in order to accomplish this. In other words, you go out and borrow, the interest is tax deductible, and the savings can be put in a savings account. That literally does not help the total amount of savings.

These are the things that are making us a little cautious about up-fronting these type of things. We are exploring them further at Treasury now.

Senator BENTSEN. Mr. Secretary, we have had econometric model runs on major savings incentives and we have had some quite interesting results in how you bring down interest rates and how that would spill over on other interest rates. Obviously, we did have some transfer of funds. In that kind of an instance the money markets lost some of their funds and more of it went into thrift institutions. But, you had the $28 billion outflow from the thrift institutions last year.

In February, you had a $2.5 billion outflow, and that is the largest of any month in history. Some of those are going to go belly up. Some of them already have and have moved into stronger institutions. It has to be and I know it is, a matter of very deep and major concerns.

Secretary REGAN. Oh, yes, the thrift institutions are one of our front burner problems at the moment, Senator. We are watching them very carefully, and as you probably know, the regulators are circulating a bill at this particular moment to try to give some relief to the institutions as part of the deregulation of financial institutions.

I am working very hard there to deregulate these institutions to try to put them on an equal footing with some of the commercial banks in order to allow them to go after funds in a different manner.

Senator BENTSEN. But you run into a real problem with those long-term mortgages. Now, it used to be that they would turn them over on the average of every 12 years. Now they turn them over on the average of 8 or 9 years because of inflation and people selling homes more. But locked in to those kind of assets to say, OK, now go out and go after the market and offer fully competitive rates. That is what you are seeking and I would like to find a way to do that.

Secretary REGAN. Well, we are trying to increase the pool of savings. Let me bottom line it this way for you, Senator. Anything we can do to increase that pool of savings in the United States, we certainly want to do, because we recognize that is a deflationary way of handling things.

Senator BENTSEN. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. I think there may be other questions. Of course, we will have other opportunities.

Senator Danforth has additional questions.

I just want to ask the one that I read a lot about and maybe you see a lot of times, while this is a tax cut designed to favor the rich versus the poor.

As I understand the proposal, that is not an accurate version, but it is one made sometimes in the media and by critics of the proposal now suggested by the President.

Of course, on the House side, I haven't seen the language, but in the speech made by the chairman, there was an effort made to skewer it so that lower income would receive a greater share of the tax relief.

I have heard you answer this a number of times, but I think it should be a part of the record. I would appreciate your response.

Secretary REGAN. Well, Senator, from our point of view, a tax cut that is straight across the board is a fair tax cut. The cut is designed in such a way that those who are paying the most tax obviously will get the most tax relief. Those who are paying the least tax get less tax relief.

We are not trying to redistribute wealth. What we are trying to do is to stop the increase that there is in taxes across the board. That is why we have set the tax rate cut at this particular schedule.

From the point of view of incentives and the like, we recognize that what we are trying to do is to help those who can save, have more to save; that also will work

In the brackets from $10,000 to $60,000, 72 percent of the taxes are paid by people in those brackets. They will get 73 percent of the relief under this.

So, we think that the thing has been eminently set out to be even for all Americans, rather than to save any one class over another.

The CHAIRMAN. Thank you.

Senator Danforth.

Senator DANFORTH. Thank you, Mr. Chairman.

Mr. Secretary, at the top of page 7 of your statement, you indicate the projected revenue losses from the administration's tax bill.

Now it is my understanding that what the administration has in mind for the second bill is that after we pass this, perhaps just before the August recess, then we will proceed immediately with consideration to a second tax bill.

I want to press Senator Bradley's question a bit further. Given the estimated revenue losses on the top of page 7, and given the fact that we are going to have to start work on the second bill before the first bill is even in effect, aren't we going to have to look at some maximum amount of revenue to be lost by the total tax bills that we pass this year?

I wonder if you could give us a view as to what the maximum amount of revenue loss should be—I know it is a static figure. But, what would be the maximum responsible amount that we could incur this year?

Secretary REGAN. Well. Senator, as I indicated in my answers to Senator Bradley's questions, it is impossible for me to answer that at this point because I don't know precisely the items that would be in the second bill.

We have costed out from a static revenue loss point of view, at Treasury, any number of items—probably a list of 35 or 40 different proposals.

It would be from among those that the second bill would be chosen. I have to know the extent in order to be able to tell you.

Senator DANFORTH. Well, you see, here is the problem. I think it is pretty clear what the popular items are on this committee, tuition tax credit, estate tax, R. & D. tax credit, maybe further increase in the capital gains exclusion, employee stock options, corporate rate reductions, IRA's, charitable deductions——

The CHAIRMAN. Marriage penalty.

Senator DANFORTH [continuing]. Marriage penalty, and on and on. I mean, there are maybe 12 of them. I think it is pretty clear what they are.

I know it is hard to work with static figures. We have always had that problem. I know you are thinking about net figures, maybe we can gain some revenues by one proposal or another.

But, it seems to me, looking at these figures that we have at the top of page 7, if static figures mean anything at all, what this means is the second tax bill is going to be a very small tax bill.

If the administration is working on its proposals, as you have indicated that it is, for what should be in the second tax bill, if we were to pass the first bill and look at revenue losses of this amount, then it is not realistic to think about a meaningful second tax bill.

Secretary REGAN. As I indicated to Senator Bradley, $20 billion for example, would be way out of line. There is no way we could have a second bill of that nature.

Senator DANFORTH. How about $10 billion?

Secretary REGAN. Well, you are getting closer. [Laughter.]

Senator DANFORTH. Yes.

Secretary REGAN. What I am indicating there, Senator, is that lots depend upon how you introduce it.

Take the marriage penalties, as the chairman just mentioned. If you phase that in as either 5 percent of the total amount of the second earner's wages or put a maximum on it of $1,500. That is a cost of *x*.

If you tried to go in to where it would be $3,000 or 10 or 15 percent, you come up with a much larger figure.

So, we would have to be very precise on exactly what we are talking about on that.

Take the 911, 913 situation. Were you to exempt, let's say, the first $50,000, of income earned abroad you come up with *x* cost.

If you would exempt all earned income abroad, you would get a much larger cost figure.

So, therefore, in working this out, we will have to work with this committee to be very precise on what we are trying to do so that we don't come in with an enormous budget buster.

Senator DANFORTH. Mr. Secretary, just so we can have at least some indication of what would be available, I wonder if before we start the markup, we could have from Treasury, given the figures you start with, just working on 1982, 1983, 1984, and 1985, on the top of page 7, if you could prepare a chart to go along with this as to the range.

I know that there is flexibility, but just to give us some notion as to the range of additional revenue loss that we could anticipate if we were to pass the President's program.

Clearly, $20 billion in 1982 would be way out of the question. What would be in question?

Otherwise, I think a lot of us feel if we were to adopt a two-bill approach, then frankly, there would be no responsible way for having any kind of meaningful second tax bill.

Secretary **REGAN**. What I can do for the Senator is this, is to send up for the use of this committee, the cost of various items under various—well, I will use the word "parameters," if you will, that would indicate what it would be, and then work with the Senators to see which of these are in the minds of the Senators the ones that are of the greatest importance. From that we could get an idea what the cost would be.

Senator **DANFORTH**. Could we have that before the markup of the first bill?

Secretary **REGAN**. When is your markup, Mr. Chairman?

The **CHAIRMAN**. Well, I would like to do it right now. [Laughter.]

Secretary **REGAN**. I am with you.

The **CHAIRMAN**. It will be early June.

Secretary **REGAN**. We can have it for the Senator.

The **CHAIRMAN**. Depending on the House, the House schedule. We are not trying to put ourselves ahead of the House—early June.

Secretary **REGAN**. We will have it up here in plenty of time for that.

[Material was subsequently submitted by Mr. Regan.]

[Fact sheet, June 10, 1981]

SUMMARY OF H.R. 3849—ECONOMIC RECOVERY TAX ACT OF 1981

DESCRIPTION OF THE ACT

Individual tax relief

Across-the-board marginal tax rate reductions of 5 percent on October 1, 1981, with additional reductions of 10 percent on July 1, 1982, and 10 percent on July 1, 1983.

Marriage tax penalty relief in the form of a 5 percent exclusion up to $1,500 in 1982 and a 10 percent exclusion up to $3,000 in 1983 and thereafter.

Savings, investment, and productivity incentives

The accelerated cost recovery system (ACRS) announced by the Administration in February is modified. The 10-year, 5-year, and 3-year classes of property will be written off using rates that approximate the 150 percent declining balance method through 1984. For property placed in service in 1985 and 1986 and thereafter, these rates will be increased to 175 percent and 200 percent, respectively. All real estate will receive a 15 year audit-proof cost recovery period and will be written off using rates that approximate the 200 percent declining balance method. A liberalized leasing rule will be provided to facilitate the transfer of the ACRS tax benefits to companies which can utilize these tax benefits. The proposal does not allow a deduction for qualified progress expenditures. The complete system will be effective as of January 1, 1981.

The top marginal rate on investment income will be lowered from 70 percent to 50 percent, effective January 1, 1982.

The maximum contribution to an individual retirement account (IRA) will be increased from $1,500, to $2,000, up to 100 percent of an individual's earnings for the year. The maximum contribution to a spousal IRA will be increased from $1,750 to $2,250. Both of these changes will be effective January 1, 1982.

Individuals who are active participants in an employer-sponsored retirement plan will be able to deduct up to $1,000 per year of contributions to an individual retirement account. Active participants will be able to establish spousal IRAs with contributions up to $1,125. Both of these changes will be effective January 1, 1982.

The maximum deductible contribution to a Keogh plan will be increased from $7,500 to $15,000, effective January 1, 1982.

The $200/400 interest and dividends exclusion, which is due to expire at the end of 1982, will be made permanent.

To encourage research and development, a new tax credit equal to 25 percent of incremental wages paid directly for R. & D. will be introduced, effective July 1, 1981.

Americans working abroad will be entitled to an exclusion of $50,000 plus one half of the next $50,000 of foreign earned income, as well as a housing allowance, effective January 1, 1982.

The windfall profit tax credit for royalty owners will be raised from $1,000 to $2,500, effective January 1, 1981.

The 10 percent investment tax credit for rehabilitation expenditures will be replaced by a credit that is 15 percent for buildings that are at least 30 years old, 20 percent for buildings that are at least 40 years old, and 25 percent for certified historic structures, effective January 1, 1982.

Estate and gift tax relief

An increase in the credit against the unified estate and gift tax to $192,800 will be phased in by 1985, exempting 99.7 percent of all estates from the estate tax. This corresponds to an exclusion of $600,000.

The marital deduction will be unlimited, effective January 1, 1982, as contrasted with present law, which limits the marital deduction to one half of the adjusted gross estate or $250,000, whichever is greater.

The annual gift tax exclusion will be increased from $3,000 to $10,000 per donee, effective January 1, 1982.

Example of individual tax relief

The Economic Recovery Tax Act will provide substantial relief to all taxpayers. The following illustration shows the impact of the Act on a family of four earning $25,000 in 1980 and receiving cost-of-living increases for four years to earn $33,674 in 1984.

FAMILY OF FOUR EARNING $25,000 for 1980

Tax under current law		Tax reduction in 1984			
		One earner couple		Two earner couple	
1980	1984	Tax	Tax cut	Tax	Tax cut
$2,901	$4,738	$3,682	$-1,056	$3,297	$-1,441
[1] 11.6	[1] 14.1	[1] 10.9		[1] 9.8	

[1] Percent of income.

Impact on the budget

The Economic Recovery Tax Act will reduce the deficits for fiscal years 1981, 1982 and 1983, and will produce growing budget surpluses in fiscal years 1984 and beyond.

The following tables summarize the direct revenue costs of the Act and the Administration's original program, indicate the revenue effects of the elements of the Act, and show the effects of the major proposals on taxes paid by individuals, distributed by adjusted gross income class. The Economic Recovery Tax Act has a direct revenue impact of $2.1 billion in fiscal year 1981, rising to $149.6 billion by fiscal year 1984. These costs fall short of the direct costs of the Administration's original program—and therefore improve the budget balance—by approximately $7 billion in 1981, $17 billion in 1982, $9 billion in 1983 and $2 billion in 1984.

TABLE 1.—SUMMARY OF THE REDUCTION IN FISCAL YEAR RECEIPTS UNDER THE ECONOMIC RECOVERY ACT OF 1981 AND UNDER THE ADMINISTRATION'S ORIGINAL TAX REDUCTION PROGRAM

[In billions of dollars]

Program	Fiscal year—					
	1981	1982	1983	1984	1985	1986
Economic Recovery Act of 1981:						
Personal tax reductions	(1)	28.3	74.8	119.8	138.7	159.9
Business tax reductions	2.1	9.7	18.6	29.8	43.5	65.6
Total	2.1	38.0	93.4	149.6	182.2	225.6
Administration's original bill:						
Personal tax reductions	6.4	44.5	81.9	118.9	142.5	163.5
Business tax reductions	2.5	10.5	20.9	32.7	46.1	60.2

TABLE 1.—SUMMARY OF THE REDUCTION IN FISCAL YEAR RECEIPTS UNDER THE ECONOMIC RECOVERY ACT OF 1981 AND UNDER THE ADMINISTRATION'S ORIGINAL TAX REDUCTION PROGRAM—Continued

[In billions of dollars]

Program	Fiscal year—					
	1981	1982	1983	1984	1985	1986
Total	8.9	55.0	102.8	151.5	188.6	223.7
Reduced deficit or increased surplus resulting from substituting the Economic Recovery Act of 1981 for the administration's original bill	6.8	17.0	9.4	2.0	6.4	−1.8

[1] Less than $50 million.

Note.—Details may not add to totals due to rounding.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

TABLE 2.—REDUCTION IN FISCAL YEAR RECEIPTS RESULTING FROM THE PERSONAL TAX PROVISIONS OF THE ECONOMIC RECOVERY ACT OF 1981

[In billions of dollars]

	Fiscal year—					
	1981	1982	1983	1984	1985	1986
Across-the-board tax rate reduction of 5 percent on Oct. 1, 1981 with additional reductions of 10 percent on July 1, 1982 and 10 percent on July 1, 1983		25.7	64.4	104.3	121.1	139.0
Lower top rate to 50 percent on Jan. 1, 1982 and thereafter		1.1	2.2	1.1	0.8	1.0
Marriage penalty relief (5 percent exclusion up to $1,500 in 1982, 10 percent exclusion up to $3,000 in 1983 and thereafter) (Jan. 1, 1982)		.4	3.8	7.0	7.8	8.7
Phase-in increase in the unified estate and gift tax credit to $192,800, allow an unlimited marital deduction, and increase the annual gift tax exclusion to $10,000 (Jan. 1, 1982)		.1	1.9	3.0	4.0	5.8
Increase IRA limit to $2,000 ($2,250 spousal) and increase the percentage limit to 100 percent (Jan. 1, 1982)		.1	.2	.2	.2	.3
Extend IRA eligibility to covered persons with a $1,000 ($1,125 spousal) limit (Jan. 1, 1982)		.1	.7	1.0	1.3	1.4
Increase Keogh plan limit to $15,000 (Jan. 1, 1982)		(1)	.1	.2	.2	.2
Make permanent the $200/$400 interest and dividend exclusion			.8	2.5	2.7	3.0
$2,500 windfall profit tax credit for royalty owners (Jan. 1, 1981)	(1)	.8	.7	.6	.6	.6
Total	(1)	28.3	74.8	119.8	138.7	159.9
Persons tax reductions under the original Administration Bill	6.4	44.5	81.9	118.9	142.5	163.5
Cost of personal tax reductions under the original administration bill in excess of the personal tax reductions under the Economic Recovery Act of 1981	6.4	16.2	7.1	−.9	3.8	3.6

[1] Less than $50 million

Note.—Details may not add to totals due to rounding.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

TABLE 3.—REDUCTION IN FISCAL YEAR RECEIPTS RESULTING FROM THE BUSINESS TAX PROVISIONS OF THE ECONOMIC RECOVERY ACT OF 1981

[In billions of dollars]

	Fiscal year—					
	1981	1982	1983	1984	1985	1986
Accelerated cost recovery system	2.1	8.9	17.3	28.3	41.9	63.9
25 percent incremental credit for direct wages for research and development (July 1, 1981)	(1)	.4	.6	.7	.7	.7

TABLE 3.—REDUCTION IN FISCAL YEAR RECEIPTS RESULTING FROM THE BUSINESS TAX PROVISIONS OF THE ECONOMIC RECOVERY ACT OF 1981—Continued

[In billions of dollars]

	Fiscal year—					
	1981	1982	1983	1984	1985	1986
Allow an exclusion of $50,000 plus 50 percent of the next $50,000 of foreign earned income, with a housing allowance (Jan. 1, 1982)		.3	.5	.5	.6	.6
Investment tax credit for rehabilitation expenditures (15 percent for 30 years, 20 percent for 40 years, and 25 percent for historic structures) (Jan. 1, 1982)		.1	.2	.2	.3	.4
Total	2.1	9.7	18.6	29.8	43.5	65.6
Business tax reductions under the original administration bill	2.5	10.5	20.9	32.7	46.1	60.2
Cost of business tax reductions under the original administration bill in excxess of the business tax reductions under the Economic Recovery Act of 1981	.4	.8	2.3	2.9	2.6	−5.4

[1] Less than $50 million

Note.—Details may not add to totals due to rounding.

Source Office of the Secretary of the Treasury, Office of Tax Analysis

TABLE 4.—EFFECT ON FISCAL YEAR RECEIPTS RESULTING FROM THE ACCELERATED COST RECOVERY SYSTEM UNDER THE ECONOMIC RECOVERY ACT OF 1981

[In billions of dollars]

	Fiscal year—					
	1981	1982	1983	1984	1985	1986
Accelerated cost recovery system under the original administration bill	−2.5	−10.5	−20.9	−32.7	−46.1	−60.2
Modifications to the original administration bill:						
All structures at 15 years under 200 precent declining balance	−.2	−.8	−1.4	−1.7	−1.9	−2.2
Limit the 10-year, 5-year, and 3-year class to 150 percent declining balance through 1984, 175 percent declining balance in 1985, and 200 percent declining balance in 1986 and thereafter; allow taxpayers to elect the straight-line method	.6	2.9	5.0	7.1	8.8	3.3
Eliminate the deduction for qualified progress expenditures	.5	2.2	3.8	4.4	4.6	4.6
Liberalize leasing requirements	.5	−2.7	−3.8	−5.4	−7.3	−9.4
Accelerated cost recovery system under the Economic Recovery Act of 1981	−2.1	−8.9	−17.3	−28.3	−41.9	−63.9
Cost of the accelerated cost recovery system under the original administration bill in excess of the accelerated cost recovery system under the Economic Recovery Act of 1981	.4	1.6	3.6	4.3	4.2	−3.7

Note.—Details may not add to totals due to rounding

Source: Office of the Secretary of the Treasury, Office of Tax Analysis

TABLE 5.—PERSONAL TAX REDUCTIONS RESULTING FROM KEY ELEMENTS OF THE ECONOMIC RECOVERY ACT OF 1981, DISTRIBUTED BY ADJUSTED GROSS INCOME CLASS

[In millions of dollars]

Adjusted gross income class	Current 1984 law tax liability		Tax rate reductions		10 percent second-earner income exclusion [1]		Increase IRA and Keogh limits; liberalize IRA eligibility [2]		$200 ($400 for joint returns) interest and dividend exclusion		Total change in tax liability		Percent of tax
	Amount	Percentage distribution	Amount	Percentage distribution	Amount	Percentage distribution	Amount	Percentage distribution	Amount	Percentage distribution	Amount	Percentage distribution	
Less than $5,000	5	([3])	−117	0.1	([3])	([3])	([3])	([3])	−20	1.1	−137	0.2	([4])
$5,000 to $10,000	6,591	2.3	−1,906	2.8	−16	0.4	−5	0.4	−114	6.0	−2,041	2.7	−31.0
$10,000 to $15,000	16,752	5.8	−4,139	6.2	−78	1.7	−21	1.8	−159	8.4	−4,397	5.9	−26.2
$15,000 to $20,000	23,404	8.1	−5,702	8.5	−201	4.5	−44	3.8	−168	8.8	−6,115	8.2	−26.1
$20,000 to $30,000	59,955	20.7	−14,110	21.0	−1,070	23.9	−304	26.1	−436	22.9	−15,920	21.3	−26.6
$30,000 to $50,000	87,552	30.3	−20,553	30.5	−2,250	50.4	−342	29.3	−647	34.0	−23,792	31.8	−27.2
$50,000 to $100,000	52,547	18.2	−12,307	18.3	−657	14.7	−315	27.0	−289	15.2	−13,568	18.1	−15.8
$100,000 to $200,000	23,840	8.2	−4,987	7.4	−157	3.5	−113	9.7	−57	3.0	−5,314	7.1	−22.3
$200,000 and over	18,538	6.4	−3,470	5.2	−38	0.9	−23	2.0	−12	0.6	−3,543	4.7	−19.1
Total	289,183	100.0	−67,291	100.0	−4,468	100.0	−1,166	100.0	−1,902	100.0	−74,827	100.0	−25.9

[1] Includes outlay portion of the earned income credit

[2] Increase IRA limit to $2,000 and increase the percentage limit to 100 percent Extend IRA eligibility to covered persons with a $1,000 limit. Increase Keogh plan limit to $15,000.

[3] Less than $500,000 or 0.05 percent.

[4] Due to the refundability feature of the earned income credit the net tax liability for this income class is negative under the proposal. Calculation of a percentage reduction is not meaningful

Note.—Details may not add to totals due to rounding

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

Senator DANFORTH. Mr. Secretary, just one further point. I think what you have said is really encouraging and that is what the administration is insistent on is a tax cut which encourages work, savings and investment, but that the administration is not just absolutely closed minded about what constitutes such a tax bill.

You have a program you believe in, but you are willing to adopt a "show me" attitude and you are willing to listen. When you say it is a matter of judgment, not just economic models, but it is a matter of judgment, I find that very encouraging. There will be an effort to work with this committee, work with the Ways and Means Committee, work with Democrats as well as Republicans on this committee to try to develop the best possible notion of how to have a tax program which encourages work, savings, and investment.

Mr. REGAN. Well, that is what I said. I will repeat it once more, Senator. If we can be shown something that is superior or that does what we want it to do in a better fashion, and is approximately in the same cost range.

Senator DANFORTH. Or less.

Mr. REGAN. Or less. But does it more effectively. In other words, more bang for the buck, we are more than willing to take a look at that.

Senator LONG. Mr. Chairman.

The CHAIRMAN. Senator Long.

Senator LONG. Thank you, Mr. Chairman.

I would hope that you do in good faith what you are saying here. I believe you will. I think you are a man of your word, but it shouldn't be vetoed by somebody less than the President down in the White House.

It is one thing to have somebody in the Treasury in good faith come and tell us something. I have seen all too often situations where somebody down in the White House would just veto that. I would ask, "Who did it?" This fellow doesn't know who killed Cock Robin, but it happened down at the White House.

I would hope if you in good faith can help this committee do a job and we can help you do a good job in the best tradition of American statesmanship that we are not going to have it killed off by somebody down at the White House whose identity we don't even know. It might be just one man.

Please understand, if the President himself thinks you have a lousy idea and he is not going to go along with it, that I can understand. But for somebody to presume to speak for the President when he may or may not be speaking the President's own views on the matter, that is a little hard to take up here.

Mr. REGAN. I can assure the Senator that I have been working very closely with the White House staff as well as with the President in these tax proposals.

They have indicated to me that they want me to speak for the administration in these tax matters. You can be assured that when I speak, I will be very careful not to get too far out of line so that I will be speaking for the administration and so that you can rely on what I say.

Senator LONG. Well, I would like to think that you didn't give up all that income from a job that pays a lot more than your job now pays in order to explain to us just what some flunky down there thinks about matters.

Mr. Regan. I can assure you that we don't have many flunkies. [Laughter.]

The Chairman. Are there any other questions?

I might just say for a matter of information, some may have wondered, we have been passing notes around. The Pope has been shot. Now it is reported he is out of surgery. His condition is no longer termed grave, but it is still just as serious.

I would say to the Secretary that we appreciate very much your presence this morning, your attitude. I do hope and I believe you will find on this committee a willingness to cooperate. I don't see any reason to operate it any different than we have in the past. It has been a consensus group as long as I have been on this committee. There are certainly members on both sides who have a great deal of knowledge and expertise in the areas we are dealing in.

It is my hope we can coalesce around the administration's position. We are looking forward to that.

Thank you.

Mr. Regan. Thank you, Mr. Chairman.

[Whereupon at 1:10 p.m., the hearing adjourned, subject to the call of the Chair.]

For Release Upon Delivery
Expected at 10:00 A.M.
May 13, 1981

STATEMENT OF
THE HONORABLE DONALD T. REGAN
SECRETARY OF THE TREASURY
BEFORE THE COMMITTEE ON FINANCE
OF THE UNITED STATES SENATE

Mr. Chairman and members of the Committee:

It's a pleasure to be here today to discuss with you the President's tax program. This Committee is quite aware of the need for a Program for Economic Recovery which will expand national prosperity, enlarge national incomes and increase opportunities for all Americans. Your response to the expenditure proposals of the President has proved that it is possible for Congress to make the difficult political choices needed to control spending. You have not only moved with great courage, you have moved with great skill and care. As you begin to make decisions on the tax aspects of the President's program, I urge you to continue the process of putting the economy back on the track to solid growth without inflation.

NEED FOR A STRONGER ECONOMY

The United States economy is not growing fast enough. We need more jobs and more production for our people. We need a stronger economy to support a rising standard of living and to provide opportunities for a better life for all.

Since 1973, the U.S. economy has grown at a real rate of less than 2.4 percent, barely two-thirds the 3.8 percent real growth rate from 1950 to 1973 and far below the 4.5 percent growth rate achieved between 1962 and 1969. Simultaneously, the rate of growth in productivity has slowed dramatically. Employment in the manufacturing sector has virtually stagnated, a number of industries are in deep financial trouble, and the financial markets have been prevented from efficiently serving as intermediaries between savers and investors because interest-bearing assets have become among the riskiest of all investments.

THE PRESIDENT'S PROGRAM

The central purpose of the President's program is to restore forward momentum to the American economy and move it back onto a course of steady growth. The program aims to achieve more rapid expansion of our production capabilities, as well as more efficient use of the capabilities at our disposal.

The key to achieving this objective is to give the economy back to the people. As the President has said repeatedly, the ultimate source of strength of this society is its people. We can restore growth to our economy if we first restore to households and businesses their primary responsibility for decision making and initiative.

PROGRAM DESCRIPTION

The Administration's economic program has four components:

- A stringent budget policy to reduce the rate of growth in Federal spending;
- A noninflationary monetary policy, developed in cooperation with the Federal Reserve;
- A regulatory reform program to eliminate unnecessary government regulations; and
- An incentive tax policy to increase the after-tax returns for work, saving, and investment.

All of these policies are mutually reinforcing. Together they will provide the type of economic environment that America needs to create the jobs, investment, and improvements in the standard of living that must be achieved during the 1980's to meet our economic and social goals. The uniqueness of the President's program is in the long-term interaction of its components. Taken together they can produce a framework for real economic prosperity and reduced inflation.

TAX POLICY

The tax proposals which the President has presented, and which I want to discuss with you today, are an essential part of the total program. We can reduce inflation through monetary policy and cut expenditures through budget policy, but ultimately it is the people who must restore growth through increased work, savings and investment. We therefore must adopt a tax policy that reduces the tax barriers to their efforts. We must begin now and must not detour from that path over the long run. We must reject the simplistic view that the way to get the economy moving is by pumping up consumption and by trying to fine-tune aggregate demand in the short run. We have too long been captives of this view; instead of short-run stability and long-term progress, this approach has given us soaring inflation and inadequate long-term growth in productivity, real wages, employment and output.

30 PERCENT PHASED RATE REDUCTION

Individual tax burdens have been increasing steadily for some time now, and individuals have been pushed into higher and higher marginal rate brackets. A family of four with a median income (about $25,000 in 1980) faced a marginal rate of 17 percent in 1965, but now faces a rate of 28 percent. For a family of four with twice the median income, the marginal rate is almost twice that of 1965: 43 percent now versus 22 percent then.

It is therefore vital that we act now to reduce marginal tax rates by 30 percent. We would like to have these lower marginal tax rates in place right now. This would make the benefits of increased amounts of saving, investment and work effort immediately available. However, to facilitate the transition to a new lower-rate tax structure, we have decided to phase these rate cuts in by 1984. But it should be emphasized that to attain the higher rates of growth in investment and real output that we are seeking, a 30 percent cut in marginal tax rates is absolutely necessary.

Under the President's proposal, rates will be reduced from their present range of 14 to 70 percent to a new range of 10 to 50 percent. Compared with present law, tax rates will be reduced by 5 percent for calendar 1981, 15 percent for calendar 1982, 25 percent for calendar 1983 and 30 percent for calendar 1984. Adjustments in withholding will begin July 1, 1981.

Single-Year Versus Multi-Year Tax Reduction

There is no doubt that a large portion of the 30 percent tax reduction will be offset by bracket creep between 1981 and 1984. However, that makes a 30 percent reduction more urgent, not less, because only a 30 percent, multi-year reduction offers taxpayers the certainty that their tax rates will not be allowed to rise in the future. Only the full 30 percent, three-year program, announced and enacted into law, will enable the economy effectively to plan for the future. It will produce immediate and beneficial responses by workers, savers and investors as they negotiate long-term contracts and implement their long term investment plans. It will enable both the Administration and Congress to move on to address other urgent national problems and other important tax issues. It will be far more effective than a hesitant year-by-year approach which will leave the economy guessing as to whether the tax burden will rise or fall. A full 30 percent, three-year tax program is needed to restore certainty, incentives and real growth to the American economy.

In 1978 Congress passed a tax reduction bill that it claimed would offset some of the impact of inflation on rising marginal rates. In fact, that law barely offset one year's worth of tax increase due to bracket creep and, now, three years later, we again are debating whether we should merely offset another year's or two year's worth of tax increases due to bracket creep. This type of approach has not proven successful in preventing marginal rates from rising, and I see no reason to believe that it would be successful this time.

It is not even clear under what conditions proponents of a single year tax reduction would reduce taxes in future years. Some seem to imply that they want even further tax increases as a weapon to fight inflation if the economy does poorly. Others seem to imply that, if the economy does well, they would not want to lower taxes for fear of rekindling inflation or increasing demand in an already growing economy. In effect, this type of logic requires that there always be tax increases unless there is both low inflation and low growth -- a condition which has not occurred for many years, as high inflation and low growth have often accompanied each other. Indeed, the resulting increases in tax rates have linked high inflation and low growth in such a manner that each reinforces the other.

Tax reductions should not be perceived as a vehicle for controlling demand in the short-run. The focus of this program is on the long-run; it is not another futile attempt to fine tune the economy. Using tax policy to control demand is dangerous because it ignores the extent to which high and rising marginal tax rates hamper the ability of the economy to produce. The President has emphasized that his program for economic recovery is a long-term policy rather than one which merely responds to cyclical movements. We simply cannot continue to increase the disincentive to save and work by raising marginal tax rates at the very same time that we are attempting to restore economic progress by asking Americans to increase their savings and work effort.

Let me pose the problem of multi-year tax reductions another way. If we must adhere to a schedule of tax changes for the future, why do we not adhere to one which calls for tax decreases rather than tax increases? In the past, there was a myth that as long as the Internal Revenue Code was unchanged there was no tax increase. This myth allowed increased expenditures to be appropriated as if they were costless. Yet we all know that each of these expenditures costs money, money that was raised through increases in present or future taxes. Imagine if you will the revolution that will take place when we adopt a budget in which tax rates are not scheduled to increase over time. It will no longer be possible to increase expenditures and pay for them through a hidden increase in taxes. Adjustments from future budgets will be more honest: if more is spent, it will be by raising taxes directly, not indirectly. I believe that the Congress agrees with the President that we must begin to operate in an environment in which the costs of governmental action, as well as its benefits, are fully recognized.

ACCELERATED COST RECOVERY SYSTEM (ACRS)

The second part of the Administration's tax program, Accelerated Cost Recovery, will establish a new system for writing off the costs of business investments. This provision will increase incentives to invest, resulting in increased productivity and sustained economic growth. In recent years, the real value of depreciation allowances has been greatly eroded by inflation at the same time that the country's capital needs have become more urgent. Adoption of this proposal will reduce substantially the burden of Federal income taxes on the returns to investment in business plant and equipment.

Together with the other elements of the President's program, this legislation will provide the conditions for increased capital formation needed to provide jobs and improve the U.S. competitive position in world markets. The long-term economic strength of our country and the future standard of living of our people depend importantly on this program.

The Accelerated Cost Recovery System will also reduce the burden of accounting and tax planning for taxpayers and will remove sources of dispute between taxpayers and the Federal Government. This system will eliminate much of the complexity of depreciation rules that have built up in layers over the years through changes in law, regulations, and administrative practice. The proposed system makes a clean break with most of the present recovery provisions and, yet, is built on familiar concepts and cost definitions.

The new system will replace the present complex provisions for determination of depreciation allowances. In the new system, classes of capital assets are broad and well defined; cost recovery periods and accounting rules are certain and standardized. Thus, ACRS substitutes easily identified asset classes, each with a standard schedule of deductions to be taken over a fixed recovery period.

Business property will be included in one of five well-defined classes of assets, distinguished by different write-off periods:

- 3 years with an accelerated write-off schedule (and a 6 percent investment credit) for autos and light trucks, and for machinery and equipment used for research and development;

- 5 years with an accelerated write-off schedule (and a 10 percent investment credit) for other machinery and equipment including certain public utility property;

- 10 years with an accelerated write-off schedule for factories, stores, and warehouses used by their owners, and for certain long-lasting public utility property (10 percent investment credit for utility property, consistent with present law);

- 15 years, with straight-line write-off, for other nonresidential buildings, such as offices and leased stores, and for low-income housing; and
- 18 years, with straight-line write-off, for other rental residential structures.

Unlike present law, all of the cost recovery rules will apply alike to new and used property, and no estimate of salvage value is required.

The 5- and 10-year recovery periods will be fully phased-in over a 5-year period; the 15-year recovery period will be phased in over 3 years. However, the investment credit rules, the 3-year recovery period, and the 18-year audit-proof recover periods will begin with the effective date.

The Accelerated Cost Recovery System will be effective for property placed in service after December 31, 1980.

EFFECT OF TAX PROGRAM ON FEDERAL REVENUES

The individual tax rate reduction and the Accelerated Cost Recovery System proposed by the President will contribute to raising the levels of economic activity above those that would occur if present law were maintained, and the revenue effects of the tax cuts are estimated on the basis of these higher levels. The estimated revenue effects thus reflect the difference, at these higher income levels, between the revenue that would be obtained under present tax law and the amount that would be obtained under the tax changes proposed by the Administration. Thus, these direct effects overstate the total change in revenues due to the tax reduction program, since growth rates, pre-tax income and revenue levels would be lower under current law. The direct revenue effects of the President's program are described below.

EFFECT OF THE TAX PROGRAM ON FEDERAL REVENUES
(Dollar Amounts in Billions)

Direct Tax effects	Fiscal Year					
	1981	1982	1983	1984	1985	1986
Personal Tax Reduction	$-6.4	-44.2	-81.4	-118.1	-141.5	162.4
Business Tax Reduction	-2.5	-9.7	-18.6	-30.0	-44.2	-59.3
Total	$-8.8	-53.9	-100.0	-148.1	-185.7	-221.7

These revenue effects must be viewed in the context of the overall economy.

Economic effects:	Fiscal Year					
	1981	1982	1983	1984	1985	1986
Real GNP Growth Rate (%)	0.7	3.2	5.1	4.6	4.2	4.2
Inflation Rate (GNP deflator-%)	10.0	8.7	7.3	6.2	5.5	5.0
Revenues under New Tax Policy	$600.3	650.3	709.2	770.7	849.9	940.2
Revenues as Share of GNP (%)	21.1	20.4	19.7	19.3	19.3	19.5

This economic outlook contrasts sharply with the outlook underlying the Carter Administration's Budget proposal for Fiscal Year 1982:

Carter Administration Budget:	Fiscal Year					
	1981	1982	1983	1984	1985	1986
Real GNP Growth Rate (%)	0.4	3.0	3.5	3.7	3.7	3.7
Inflation Rate (GNP deflator-%)	10.4	9.7	8.6	8.0	7.2	6.4
Revenues under Carter Policy	$607.5	711.8	809.2	922.3	1052.6	1188.5
Revenues as Share of GNP (%)	21.4	22.1	22.4	22.8	23.4	24.0

In spite of our tax reductions, revenues will still rise by 28 percent through 1984, when budget balance is first attained, and by 57 percent over the entire period. Under the Carter Administration's outlook, Federal tax revenues would have to have risen by 52 percent to balance the budget in 1984 and would have increased by a total of about 95 percent by 1986.

It has been urged that we balance the budget before proposing and enacting tax reductions. This is not a realistic option. The budget deficit cannot be dealt with in isolation, because it is the economy's poor performance that has helped unbalance the budget. Unemployment automatically increases expenditures for income support programs, and inflation automatically raises outlays for indexed transfer and entitlement payments. As President John F. Kennedy said when he proposed his tax reduction program two decades ago: "Our true choice is not between tax reduction on the one hand, and the avoidance of large Federal deficits on the other.... An economy hampered by restrictive tax rates will never produce enough revenue to balance the budget -- just as it will never produce enough jobs or enough profits."

Many people at that time thought that President Kennedy and his advisors were wrong, just as some people today say that our Administration is wrong. But it is nevertheless true that in 1965, after the Kennedy tax rate reductions, the Federal budget deficit was only $1.6 billion. By contrast, the Federal budget deficit was $60 billion in 1980. This budget deficit did not result from tax cuts. Indeed, it occurred in spite of large tax increases. During 1977-80 individual income tax revenues grew much faster than the growth of the economy -- individual income tax revenues grew by 55 percent, while nominal GNP rose by only 38 percent -- and in spite of this tax increase there was still a large budget deficit.

BUSINESS VERSUS INDIVIDUAL REDUCTIONS

Some have suggested that a greater share of the total tax reduction should go to business firms since they make the investment. However, the personal tax rate reductions are as important to investment as are the business tax proposals. ACRS alone cannot finance the investment gains we must have to get employment, productivity and real wages growing again. To be sure, ACRS will sharply lower the cost of plant and equipment, and will greatly increase the rate of return and the desire to invest. But a large share of the money for that investment must come from private savers, and individuals must be willing to work and to learn needed skills. For that, personal tax rate reduction is essential.

The notion that business tax cuts promote investment and personal tax cuts promote consumption is oversimplified and wrong. The old categories of business vs. personal tax cuts make no sense at all. They should be replaced with a concept that distinguishes between tax changes which enhance the after-tax rate of return to labor and capital, whether for the firm, shareholder, bondholder, small saver or proprietor, and tax changes which primarily seek to redistribute existing income.

Labor produces the largest share of value in the economy. The personal tax changes have a profound effect on willingness to work and on wage and fringe benefit demands at the bargaining table.

Capital is owned by people. All saving and investment ultimately depends on the rate of return to capital after it reaches individuals as shareholders, bondholders, owners of small businesses, or holders of savings accounts.

The personal tax rate reductions the President has proposed are the best thing that could happen to business. They automatically reduce the capital gains tax rates for all taxpayers; for top bracket individuals, they lower the maximum rate from 28 percent to 20 percent. They increase the rate of return on all forms of taxable investment income. They are the primary vehicle for lowering tax rates on millions of labor intensive small businesses. They increase savings. They improve work attitudes, lower wage demands and improve labor productivity. No "business tax cut" could do more for business.

Finally, much of the individual tax reduction simply offsets an individual tax income caused by bracket creep. Viewed in that light, the net reductions in individual taxes do not loom large relative to the business tax reductions.

RATE REDUCTIONS BEFORE OTHER STRUCTURAL CHANGES

We also recognize that there are a large number of structural tax matters that are of concern to this Committee as well as to the President. We are determined to provide constructive changes in this regard. We are committed to a second bill, and the President has pledged to join with you in seeking additional tax changes.

Nonetheless, we must urge that all other structual tax changes of interest to Congress and the Administration be taken up in a second legislative effort. Our first job must be to expedite passage of those tax changes proposed by the President that are focused exclusively on moving the economy ahead in the long run. Adding other structural changes, however worthwhile, to this tax package will detract from the changes we believe are essential to restoring noninflationary economic growth.

If Congress decides to tack on these additional changes, there is little doubt this would require limiting the amount of individual tax reduction. Thus, what Congress would give with one hand, it would take away with the other. Limiting the rate reductions would increase the disincentive to save, invest and work relative to the President's proposal. This result would be at odds with the whole purpose of the President's plan.

Even some of the so-called savings incentive proposals are at odds with the President's program. There is a real danger in tending to favor various proposals according to the label that has been attached to each. As replacements for rate reductions, most of these savings incentives would in fact afford little incentive to increase savings; their principal effect would be merely to change the form of saving.

The President's tax program 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. Per dollar of cost, the program is the best savings incentive that Congress could adopt.

The President's proposal has a number of advantages over most other types of savings incentive proposals. It avoids the problem of encouraging tax-deductible borrowing for the purpose of making investments in tax-preferred assets. Yet it does so in a manner that provides 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.

CONCLUSION

In conclusion, adoption of the President's budget and tax proposals will cause substantial resources to be released by the public sector to the private sector. There will be a reduction in individual income taxes from 11.4 percent of personal income in calendar 1980 to 10.4 percent in 1984 -- rather than a rise to 14.5 percent as under current law. The ratio of total receipts to GNP will drop from 21.1 percent in fiscal year 1981 to 19.3 percent in fiscal 1984. Over the same period, spending will fall from 23.3 percent of GNP to 19.3 percent. And as a result, the budget should be balanced in 1984. Equally as important, by cutting Federal revenues as a percent of GNP, we will reverse the trend of putting decisions for the use of funds in the hands of Government and, instead, will restore those prerogatives of individuals as members of households and businesses.

It is clear that frequent policy shifts in response to short-term economic changes are not the solution to our problems. Indeed, they have been a major cause of these problems. As a result of such policies, our Nation has come to expect more inflation, more stagnation, more government growth, and a more directionless economic policy.

It is essential that these expectations be changed. This cannot be done without short-run costs. Nevertheless, an economic policy focusing on fundamental structural reform will restore long-term strength and prosperity. This can be accomplished only through a consistent, stable set of policies maintained over a period of years.

We are proposing a bold new approach in economic policy, and we cannot expect to solve our problems overnight. But with the help of Congress, I believe we can put into place a new policy for economic recovery that will give the economy -- and with it hope for the future -- back to the people.

Mr. Chairman, I believe that the Committee shares our concern that individual taxes do not continue to take a larger and larger share of individual income, and that depreciation allowances be changed to allow faster capital cost recovery. It is my hope, and that of the President, that you will join the Administration in seeking the rapid adoption of the President's tax program.

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EXHIBITS

Exhibit 1 - Marginal Tax Rates for Four-Person Families

Exhibit 2 - Individual Income Tax as Percent of Personal Income, 1970-1984

Exhibit 3 - Federal Government Receipts, 1980-1986

Exhibit 4 - Taxes of a Family of Four Earning $25,000 in 1980 and Receiving Cost of Living Increases for 4 Years to Earn $33,674 (Current Dollars)

Exhibit 5 - Taxes of a Family of Four Earning $25,000 in 1980 and Receiving Cost of Living Increases for 4 Years to Earn $33,674 (1980 Dollars)

EXHIBIT I

Marginal Tax Rates for Four-Person Families

(percent)

Year	One-half median income	Median income	Twice median income
1965	14%	17.0%	22.0%
1966	14	19.0	22.0
1967	15	19.0	22.0
1968	15	20.4	26.9
1969	15	20.9	27.5
1970	15	19.5	25.6
1971	15	19.0	28.0
1972	15	19.0	28.0
1973	16	19.0	28.0
1974	16	22.0	32.0
1975	17	22.0	32.0
1976	17	22.0	36.0
1977	16	22.0	36.0
1978	19	25.0	39.0
1979	16	24.0	37.0
1980	18	24.0	43.0
Current Law			
1981	18	28.0	43.0
1982	18	28.0	49.0
1983	21	28.0	49.0
1984	21	32.0	49.0
Administration's Proposal			
1981	17	27.0	41.0
1982	15	24.0	42.0
1983	16	22.0	38.0
1984	15	23.0	36.0

Office of the Secretary of the Treasury
Office of Tax Analysis

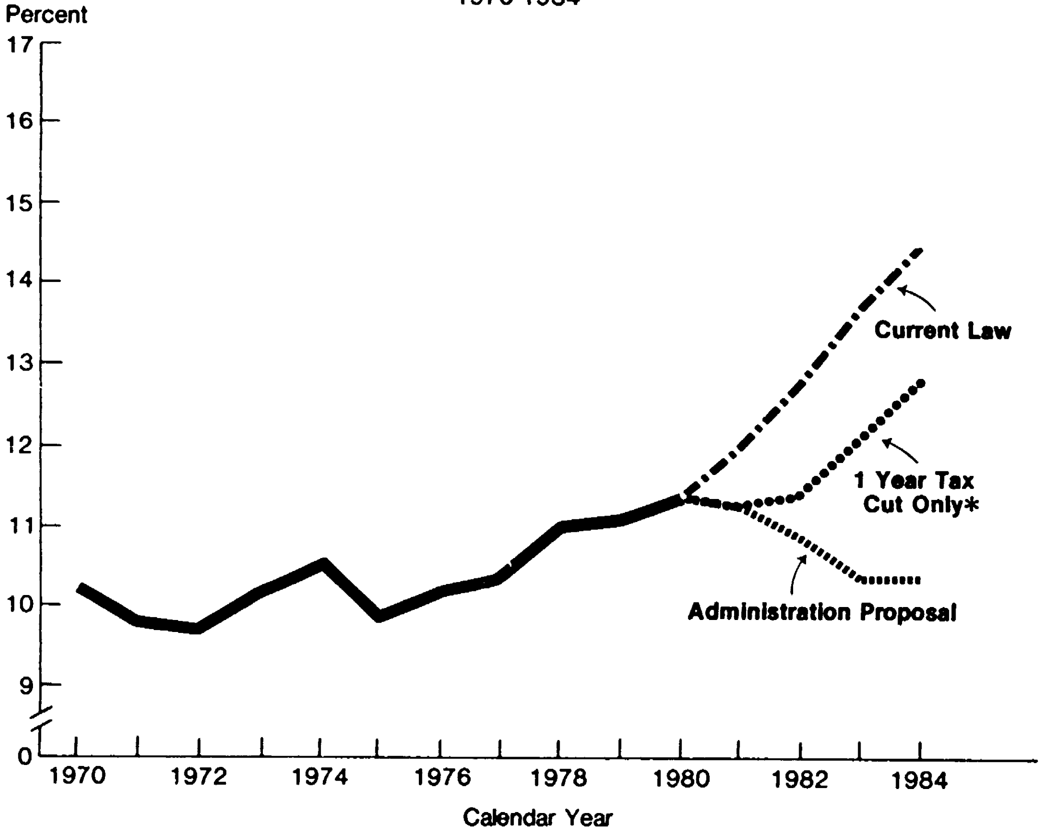
April 14, 1981

Note: inflation assumptions derived from the Consumer Price Index and the President's Budget.

EXHIBIT II

INDIVIDUAL INCOME TAX AS PERCENT OF PERSONAL INCOME

1970-1984



*(10 Percent, July 1, 1981)

EXHIBIT III

FEDERAL GOVERNMENT RECEIPTS

1980 - 1986

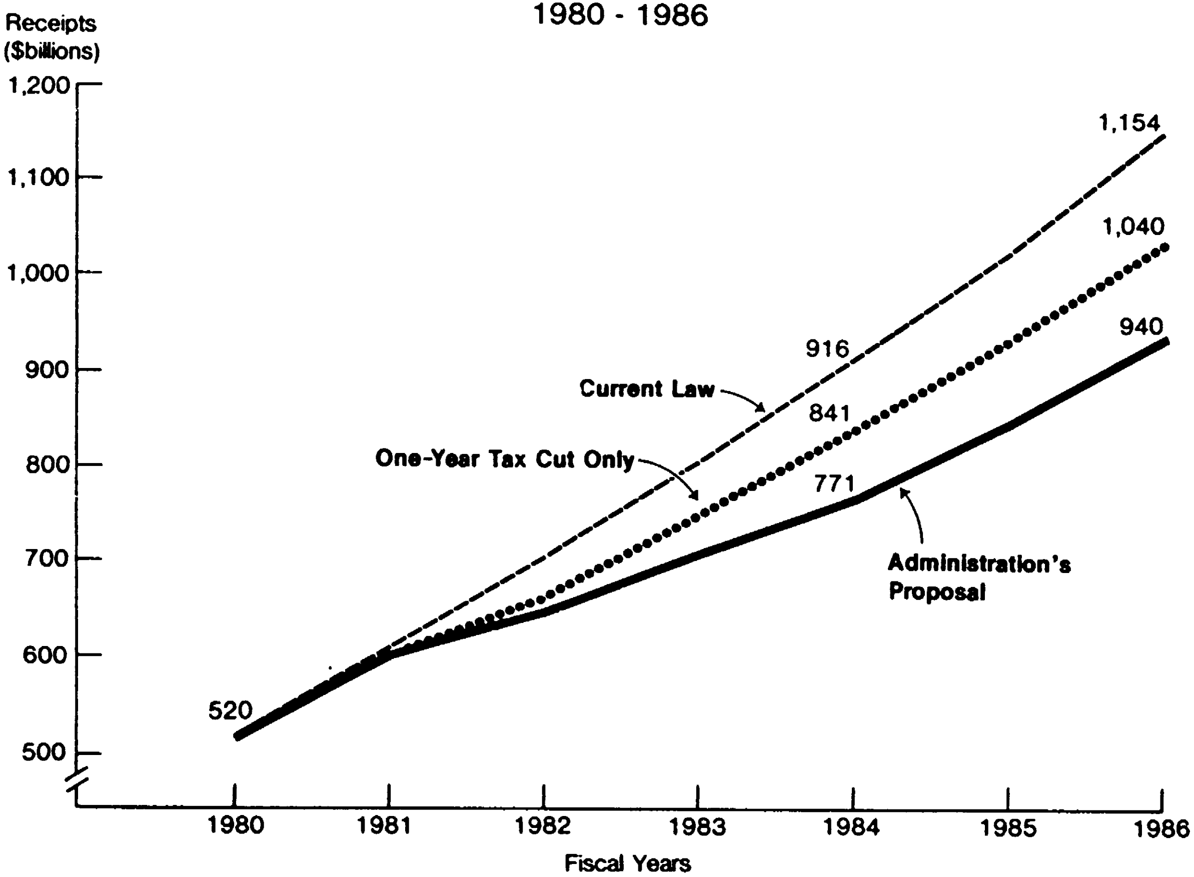


EXHIBIT IV

TAXES OF A FAMILY OF FOUR EARNING $25,000 IN 1980 AND RECEIVING COST OF LIVING INCREASES FOR 4 YEARS TO EARN $33,674

(Current Dollars)

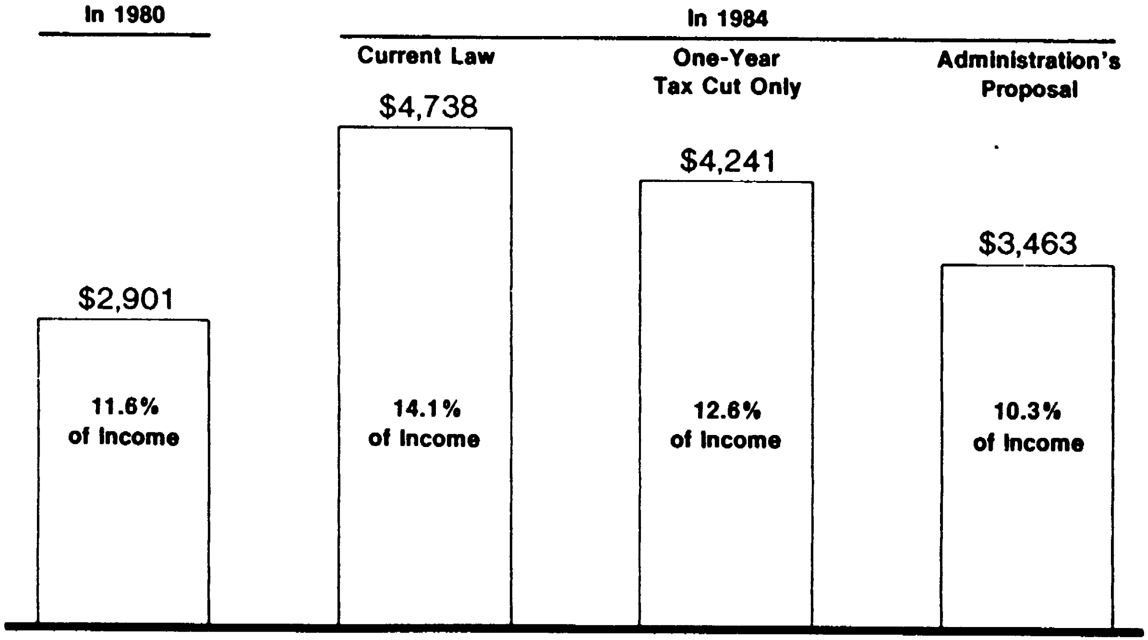
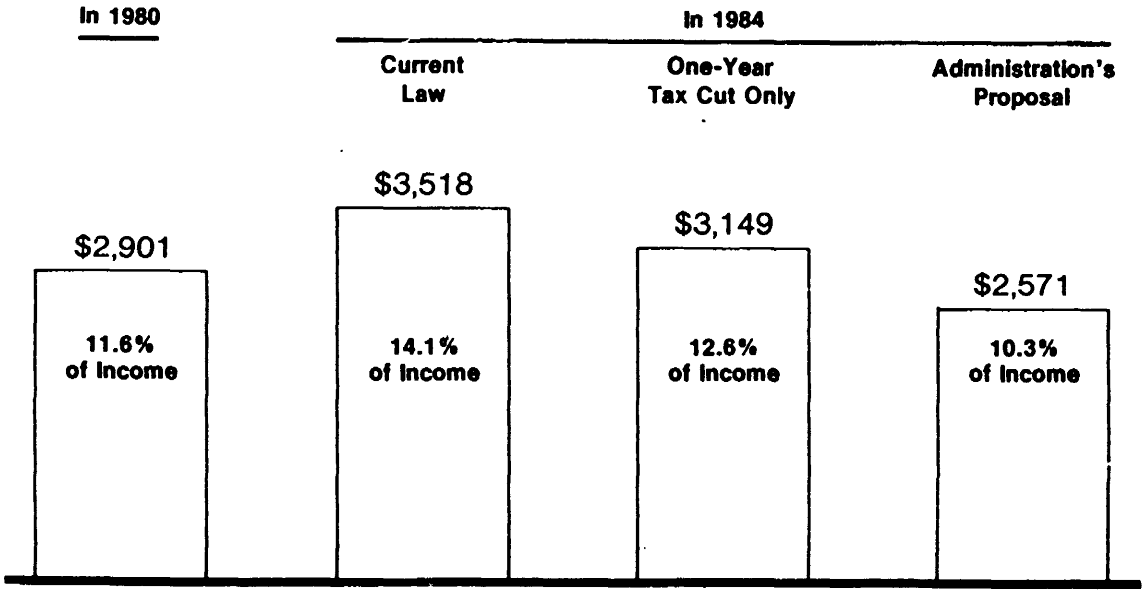


EXHIBIT V

TAXES OF A FAMILY OF FOUR EARNING $25,000 IN 1980 AND RECEIVING COST OF LIVING INCREASES FOR 4 YEARS TO EARN $33,674

(1980 Dollars)



TAX REDUCTION PROPOSALS

THURSDAY, MAY 14, 1981

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

The committee met, pursuant to notice, at 10 a.m., in room 2221, Dirksen Senate Office Building, Hon. Robert Dole (chairman) presiding.

Present: Senators Dole, Packwood, Chafee, Heinz, Byrd, Baucus, Grassley, Long, Symms, and Danforth.

OPENING STATEMENT OF CHAIRMAN DOLE

The CHAIRMAN. Today the committee resumes taking testimony on the President's proposals for tax reductions. This series of hearings opened yesterday with testimony from the Secretary of the Treasury, Don Regan, and will continue next week with numerous public witnesses.

Today, we have invited several economists with different backgrounds and points of view to give us an overall perspective on how these tax cuts will affect the economy and the Federal Government's finances.

The hearing will be divided into two panels, the second one will be heard this afternoon.

Our first panel is comprised of four economists. Dr. Alan Greenspan is a well-known business economist who has been associated with several Republican administrations. Professor Meiselman has done a great deal of work in monetary economics and is a member of the shadow open market committee that monitors Federal Reserve actions. Mr. Gary Ciminero put together the economic model used by Merrill Lynch economics, which gives quite good marks to the President's proposals, while Prof. F. Gerard Adams works with the Wharton model at the University of Pennsylvania, a model that yields quite different results.

I welcome all of you. Your written statements will be entered into the record in full, and I ask each of you now to summarize your statement in a few minutes of remarks, after which we will move to questions and answers.

We are ready to begin. I might just recite, for the benefit of those who may not be familiar with our witnesses, a short biographical comment on each of the witnesses this morning.

Alan Greenspan, of course as we know, is president of Townsend-Greenspan & Co., of New York City and was an adviser to President Ford and also an adviser to President Nixon. He served in various capacities in the Ford administration. He consults frequently with the Federal Reserve and Treasury.

David Meiselman is professor of economics and head of the graduate program in economics of the Reston, Va., campus of VPI, Unversity of Chicago and McAllister College. He has held economics positions in the Office of the Secretary of the Treasury, Comptroller of the Currency, and the House Banking Committee.

Gary Ciminero, vice president and macroeconomic forecasting manager for Merrill Lynch Economics, Inc. He constructed the Merrill Lynch Economics econometric model and manages forecasting simulations by the model. Gary is also a professor of economics, University of Pennsylvania known as the Wharton School and he manages the economic model built by Lawrence Klein with whom he is closely associated.

I understand you have an order in which you will proceed.

Mr. Ciminero, do you want to proceed or Alan, why don't you? You're an old hand here.

Mr. GREENSPAN. Why don't we just go alphabetically?

The CHAIRMAN. That would be all right. Adams.

All right, I think what we will do is have you each make brief statements, and then, operating under the early bird rule, we will hope you will have time to submit to a few questions by the members.

You may proceed in any way you wish. If you have written statements, the entire statement will be made a part of the record. You can summarize that statement to give us more time for questions, if you would.

Thank you. Dr. Adams.

STATEMENTS OF DR. DAVID I. MEISELMAN, PROFESSOR OF ECONOMICS, VIRGINIA POLYTECHNIC INSTITUTE, DR. ALAN GREENSPAN, PRESIDENT OF TOWNSEND-GREENSPAN & CO., INC. DR. F. GERARD ADAMS, PROFESSOR OF ECONOMICS, UNIVERSITY OF PENNSYLVANIA, MR. GARY L. CIMINERO, VICE PRESIDENT AND MANAGER, MACROFORECASTING MERRILL-LYNCH ECONOMICS, INC.

Dr. ADAMS. Let me begin by thanking you and the committee for giving us the opportunity to talk about the simulations on the tax proposals.

I have prepared a handout which I believe some of you have which is subject to minor typographical corrections. It says basically what I am going to say and consequently I will simply provide a brief verbal summary of what is in that document.

With the widespread consensus about the inadequate performance of the U.S. economy during the 1970's, we have turned our attention away from issues of business cycle stabilization and rightly concerned ourselves with longer run concerns about endemic inflation and low productivity growth.

We must, nevertheless, continue to be concerned with the short run implications of tax legislations in terms of inflation, unemployment, and budget deficit, lest the short run implications stand in the way of our long-run objectives.

My paper is concerned with some simulations that have been done with the Wharton model of the U.S. economy. Simulations, by the way, which are summarized in the table that has been attached at the back.

Let me make a very few comments on the use of the econometric models because there have been so many charges recently. Charges that the models back a supply side, that they do not recognize the impact of money on the economy, and that they do not allow for expectations.

Now, realistically models are far from perfect instruments. Their use does depend to an extent on the experts who work with them. But, many of these charges have little foundation. The models are vastly expanded and improved over the overly simple theoretical prototypes on which many of these accusations are based.

I might add, that at least in the case of the Wharton model, it is completely open to public view and anyone who cares to examine the equation structure of the model will see that it does contain a supply side, that it does have elaborate treatment of the monetary sector—money does matter—and that it does take into account information on anticipations.

Large scale models, like the Wharton model, remain the principal instrument for studying the macroeconomic impact of tax policy in a consistent, scientifically based framework.

Now, the simulations which we did fall into three simulations which you will see on the table. The first one which we call the "control" is a base forecast. It assumes implementation of the tax proposals for the year, the current tax proposals that have been proposed for the first year, but it does not include the second and third phases of the personal income tax proposal.

It does include something equivalent to the 10-5-3 capital recovery program beginning in 1981. Actually, I might add that that solution is not quite the 10-5-3; it is closer to the Senater Finance Committee version of the capital recovery program.

We have assumed that the administration will be successful in limiting Federal spending to somewhere near the targets proposed for fiscal 1982, but we have assumed that it will not be possible to achieve the targets for subsequent years, fiscal 1983 and fiscal 1984.

The forecast that one obtains is one of moderate real growth between 3 and 3½ percent in 1982 and 1983. You will notice that inflation eases a little bit to about the 8 percent level, but that is not as much as has been projected by some of the more recent optimistic forecasts.

It is very troublesome to note that we still have very high deficits in the $60 billion range and that given our assumptions of tight money policy by the Federal Reserve we continue to have very high interest rates.

Now, in comparison to this base forecast, the second one is an alternate, which we have called the administration forecast. That embodies as well as we could the full features of the administration program, in particular, all three phases of the personal income tax reduction program.

It has almost the same monetary policy, a little bit more restrictive but not much. It has the cuts in expenditures which correspond largely to the cuts in taxes.

The consequence is that we are making balanced reductions in both taxes and expenditures and it is for that reason that we find that real GNP, as it is forecast for 1982 and 1983, little different from what we have termed the control solution and the price level is little different from what we have called the control solution.

Budget deficits are also approximately in the same range and all of this reflects the balanced nature of the cuts.

I think the question that you will ask and the important question is about the supply side impacts. This forecast, at least, shows that there is little evidence of a supply side payout in terms of greater productivity or lower inflation.

This is, I might add, a very short period during which to expect supply side impacts. It might well be that as one looked out 4 or 5 years further into the future, that one would see certain impacts which one does not see here.

I am not sure that they would be large, but over this period supply side impacts are not apparent. That is true even though, of course, the forecast assumes lower levels of Government spending with correspondent impact on Government programs and also, of course, consequently, somewhat higher levels of private expenditures.

The risk, as we see it, is that there would be a 3 year commitment for a tax cut without the ability to impose or the will to impose corresponding reductions in expenditures.

To explore that option we have run a third simulation which is listed as the "Administration without 1982 to 1983 spending cuts." Now, these are really spending cuts that apply to fiscal years 1983 and 1984.

What we have done is simply to assume that the cuts proposed for fiscal 1981 and 1982 will take place, but that the additional cuts, $50 billion or so each of the next 2 years, would not be implemented because of the very heavy burden that these cuts would impose on the nondefense, nonsocial security parts of the budget.

If one does that, one gets the kinds of results that are shown under the "Administration without 1982 to 1983 spending cuts" on the table. The economy is held in check by the assumption of a strict monetary policy which continues to stick to the same aggregate monetary growth targets which have been assumed in the earlier solution.

The result is approximately the same real growth. The result is, again, very small for the deflator, but the result is a very strong upsurge of interest rates. You can see down on the bottom of the table with the prime loan rate reaching 20 percent in 1982 and 1983, that is an annual average of 20 percent and with long-term bond rates shown here over 20 percent, very high.

Those are very high real interest rates, not surprising, given the fact that in 1983 the budget deficit comes out to be $115 billion.

The long run implications of such potential high deficits and interest rates on investment and economic growth merit serious concern. It is for this reason that I would argue that an advance commitment to a tax cut in 1982 and 1983 would be very risky unless there is substantial certainty that further expenditure cuts would be implemented.

I have then added a menu on page 6 of this report of what might be priorities in tax legislation. I will simply summarize those by saying that I put high priority on significant reductions in business taxes.

These would be accelerated capital recovery, additional investment tax credits, perhaps some that are targeted on industries that have been impacted by the energy problem and by environmental controls with liberal carryforward and carryback provisions. Effectively I emphasize reduction in business taxes and put less emphasis on personal taxes because the business taxes provide far more bang for the buck than a reduction in personal taxes does.

Second, to provide additional savings and to ease the plight of the savings and loans, it might be useful to expand the program of tax sheltered retirement such as IRA or Keogh.

Third, if the budget permits, we might have cuts in remaining excise taxes which will reduce the cost-of-living adjustment on wages. We might have some adjustment for the high level of social security taxes, which would again benefit both the employers and the employees.

Finally, if the budget permits, we might have adjustments in personal income taxes to wipe out inequities and to lower high marginal tax rates. If we do lower high marginal tax rates, it is important to recognize that these reductions might be combined with efforts to wipe out some of the more glaring tax loopholes which have made effective tax rates on very high income considerably lower than the rates listed on the tax schedule.

Thank you.

The CHAIRMAN. Mr. Ciminero. Did I pronounce that correctly?

Mr. CIMINERO. I will be essentially summarizing the material already submitted to the committee and I will be alluding to exhibits, not by number, but exhibits that are attached to the printed testimony which I would like to have included in the record.

Mr. Chairman and members of the committee, as you know the Reagan administration program envisions a coordinated four-prong policy of economic initiatives in the areas of Federal spending, monetary policy, regulatory relief, and taxation.

At Merrill-Lynch Economics we have been and continue.to track the progress of various tax bills, budget bills, and the like as they go through the legislation process, continuously folding in what we feel to be the most likely course of policy events into our forecast simulations.

Similar to Gerard Adams point, we at Merrill-Lynch Economics also use a macromodel as a key forecasting tool and simulation tool in accessing the impacts of these kinds of policy changes.

However, the use of a macromodel itself without judgmental adjustment is something that we don't engage in very much. We judgmentally adjust both forecasts and the simulation results in order to implement new and radical departures from historical behavior or historical policy moves in order to judgmentally gage the impact of policy.

In the case of the tax cut simulations that I will be summarizing, the nature of those kinds of judgmental adjustments has been minimized, so that we have not attempted in these results to "bend" the model to account for some of the much vaunted so-called supply side effects that many attribute to the tax cut.

The results presented here are largely devoid of any grandiose assumptions that depart significantly from historical behavior in arriving at the results.

Any impacts that may be attributed to this tax cut that lie in the realm of the supply side—that is, incremental labor productivity of a very large magnitude or even incremental savings of a very large magnitude—would be in addition to the results shown here and would be an additional benefit.

We have attempted, in other words, to gage these impacts in a "low ball" manner.

Now, on the tax policy side, the program would reduce of course both individual and business taxes by the largest nominal amounts, I believe, ever proposed in the United States.

I guess there are essentially four key questions one should ask and are currently being asked before this committee.

I have organized my testimony around these issues. One is, aren't large tax cuts inherently overstimulative? Don't they imply equally massive increases in the Federal deficit? Won't this deficit lead to further inflation via both debt monitization, on the one hand, and perhaps, a super-heated economy resulting from the potential overstimulation, on the other.

Generally, the results presented here assume that the entire multifaceted administration program is implemented. The results shown here are that there is a good chance that the answers to each of these questions would be no. That they are not inherently overly stimulative, they don't imply equally massive increases in the Federal deficit and the deficit needn't result in continuation of current inflation rates, let alone acceleration of these inflation rates.

As you well know, the tax cut would be different in form from earlier ones in that it would set out to reduce marginal tax rates by identical 30 percent portions across all tax brackets.

This makes it quite unlike other tax cut proposals in the past which tended to, in addition to the agenda of cutting taxes themselves, also have as another agenda the shifting of the tax burden itself from lower to higher income brackets.

This program would essentially leave the distribution of tax burden unchanged across income brackets. It would thereby, of course, result in a larger absolute amount of tax cuts to those who already pay a larger absolute amount of taxes. In fact, the larger amount of tax cut would accrue to precisely those taxpayers that are in brackets that tend to have higher savings propensities.

This largely accounts for our finding that the savings aspect of this tax cut is quite large. Namely, that the tax dollars are tilted more toward the tax brackets which tend to save more historically.

Also, the after-tax rate of return on taxable savings, capital gains, and other investment components would increase sharply with the decrease in tax rates. This decline in aftertax rates of return would be across the board and would affect every taxpayer.

But, importantly, the reduction in aftertax rates of return would be higher for the upper brackets in percentage terms then the lower brackets, which would tend to instill incentives to save and invest rather than to spend more.

Of course, the obverse of this is that in raising the after-tax rate of return on investment, the reduction in tax rates would also decrease the tax advantage of borrowing which is the other side of the equation. That is, savings as identified in the national income accounts would sum up savings in the ordinary sense plus decreases in debt outstanding.

These incentives would tend to elicit more productive labor efforts while replenishing the engine of investment-led productivity gains, namely savings themselves.

The business tax cuts would also encourage capacity and productivity gains via increased investment spending. After all, the only way a corporation can take advantage of the faster depreciation writeoffs is by investing in new plants and equipment.

Now, the implied stimulus of the tax reductions would be largely offset by the fiscal drag implied in the proposed spending curtailments. We do not see this large tax cut resulting in anything like runaway growth.

Consider the fact that we are coming off of, in our view, the second year of a minirecession this year and that the growth rates over the next 4 years are only on the order of 4.1 percent coming off the trough of a recession. We don't view that as overly stimulative.

Namely, there is a fiscal drag implied in the spending cuts that have already been passed.

How would the Federal deficit fare? Well, of course, it would go up versus what would be the case hadn't there been any tax cuts, but only a spending curtailment.

Even large deficits do not create inflation in and of themselves. Our results show that the savings propensities more than offset the implied increased deficit from the tax cut itself leading to lower interest rates than would be implied from simply looking at the deficit in and of itself, plus the assumption that the Fed will concur in the administration's proposal to reduce monetary aggregate growth will also help in the realm of reducing the inflationary impact of the deficit.

I have also presented some evidence based on the Kennedy-Johnson tax cut of 1964 and on the tax cut and rebates of 1975 that show that the average savings rates out of those tax cuts are in the realm of 45 to upwards of 70 percent, in line with the results that we are observing in this tax cut. Namely, that around 50 to 55 percent of this tax cut would be saved.

In the sources and uses of funds analysis, we are able to show that the size of the deficit, representing a use of funds, declines from about $60 billion this year to $30 billion by 1984 and that private sources of savings would more than offset the implied funds used resulting from the increased deficit.

In short, our analysis generally supports the Reagan administration projections for both lower inflation and more rapid growth and it supports a contention that the sharp cuts in individual income tax rates would revive savings, help fund the deficit and spur investment growth rather than generating more inflation.

Thank you.

The CHAIRMAN. Dr. Greenspan.

Dr. **Greenspan**. Thank you, Mr. Chairman. I have a rather extended written testimony which I will summarize, but hope the full text appears as written.

The **Chairman**. Yes, the whole text will appear.

Dr. **Greenspan**. Mr. Chairman, if our individual income tax system were currently indexed would we, at this point, be advocating an increase in tax rates? Or put another way, would we be arguing for a suspension of the annual inflation adjustment to tax brackets?

I suspect the answer is no, which is another way of saying that we would at this particular point be acquiescing in an automatic change in tax brackets. This would not be significantly different from the President's proposed 3-year cut of 10 percent each year in brackets.

Perhaps the argument is that were we indexing our system, we might allow the bracket adjustment to occur this year, but would retain the ability to review it next year and the year after.

There is, however, no reason why, should the President's tax program be put into place, that Congress could not alter the tax structure a year or two hence if it thought such a policy was required.

Moreover, to delay the scheduled cuts in tax brackets is to increase the real tax burden. In fact, the whole discussion of the President's individual cut package, at this stage, resolves down to the question of whether the Congress by failing to adjust tax rates to offset bracket creep, favors a rise in the real tax burden.

The debate on taxes, however, is at root a debate on spending cuts. There is a broad political consensus in this country that the deficit must be elininated. Hence, the larger the tax receipts, the less the pressure on curbing spending growth.

It is control of spending which is the key to the revival of economic vitality in this country. The issue isn't taxes, it is expenditures. It is clear, certainly in retrospect, that our budgets have been overindexed with respect to both unemployment and inflation. We have been overly generous in our entitlement programs and have commited future tax revenues which we may never have.

Over the years we have put in place a set of entitlements which have engendered a rate of growth and Federal outlays which exceeds the rate of growth in our tax base.

Unless altered, such an imbalance must inevitably lead to an ever-widening deficit and an eventual inflationary breakdown.

Temporarily the deficit can be held in check by increasing real tax rates. But, eventually even that fails because we will finally arrive at a level of taxation beyond which the economy deteriorates and further Federal revenue increases are unavailable. Tax increases merely delay the evitable.

President Reagan has addressed the issue of excessive budgetary growth with an unprecedented program of reduction in budget authorities and outlays. Even this program must be viewed as the first stage of a budget revision process.

A second stage will be required to reduce the underlying outlay growth rate to a level capable of being financed over the longrun.

The markets seem to be saying that the actions taken to date on outlays are inadequate. Despite the increasing probability over the past several months, that the President's current expenditure cut proposals would prevail, long-term interest rates have continued to edge higher.

This, in all likelihood, reflects further upward revisions of the average expected inflation rate over the next 10 to 20 years.

A rate of expected inflation can be attributed to market concern that the President's tax program will be inflationary. If anything, the probability of the enactment of a 3-year, 10 percent annual cut in rates has regretably receded in recent months. While the movement in short-term rates can be attributed, at least in part, to Federal Reserve actions and some spillover effect to the long end of the market can be presumed, the overall upward drift in inflation premiums appears to require further explanation.

The issue narrows to the belief on the part of the financial markets, that either one, the President's budget cuts in the end will not prevail despite recent political progress or two, the cuts would not be sufficient even if the President should get all or at least most of his requests.

On the first point, concern about the outcome surely had to be greater 6 months ago than today. Whatever the probabilities of success, they clearly are higher today than 6 months ago.

One would have, therefore, expected at least some anticipatory market behavior. One must conclude that, rightly or wrongly, the markets do not trust the Reagan budget cuts to do the job of curbing inflation.

The root of the fear seems to have been focusing on the administration's presumed disinclination to address the so-called safety net, consisting largely of social security retirement benefits. These have been substantially exempted from this round of budget paring. Almost all of the programed reduction in outlays comes from little more than a fourth in the total budget. That is, what remains after defense, interest, and the safety net.

The requested outlays for the nonexempt programs falls from $193 billion in fiscal 1981 to $142 billion in fiscal 1984. This would slow the rate of growth of aggregate budget expenditures over the next 3 years to less than 6 percent annually in nominal terms according to OMB.

However, this is a one-shot adjustment process. Unless the underlying upward momentum of safety net programs is reduced, the rate of growth in Federal outlays would begin to accelerate again.

Thus, if there is no followup addressing the post-1984 expenditure growth levels, the President's current program would do little more than put a temporary tourniquet on our fiscal hemorraging.

Since inflation premiums embodied in long-term interest are reflecting average inflation rate expectations over, say the full decade, they are assuming that no further actions are contemplated by the Reagan administration to restore fiscal balance.

This is almost surely not the case, since the President has indicated that he will do whatever is in his power to get the budget under control and to restore fiscal balance.

Therefore, it is probably a mistake on the part of the financial community to assume that the President's program encompasses only the measures currently under consideration by the Congress.

His initiatives on social security, this week, may be a harbinger of significant further initiatives.

There is, of course, no certainty that the President's initiatives in the future will be successful. For the moment, the difficulty confronting the administration is that continued advances in interest rates by creating severe secondary financial problems for the thrift institutions and others could divert the longer term thrust of economic policy if the need to resolve short-term economic crises becomes pressing.

The problem with short-term economic crises is that their solution too often creates the next problem.

The current budget has to be only stage one of a much longer process to undercut inflationary forces. At some point, the markets should recognize the ongoing efforts of the administration, the Congress, and the Federal Reserve. At the point, interest rates should begin to decline on a sustained basis and a restoration of economic vitality for this Nation would then ensue.

Thank you very much.

The CHAIRMAN. Thank you. Dr. Meiselman.

Dr. MEISELMAN. Thank you. I will try to summarize my written comments. I would like to have the entire written comments submitted for the record.

The CHAIRMAN. The entire statement will be made a part of the record.

Dr. MEISELMAN. Thank you very much.

Many years of unhappy and worsening experience with the combined effects of inflation and the present Federal tax code have taught all of us about bracket creep and about how inflation magnifies the bias of the Federal tax code against saving, investment, and economic growth and imposes a wide range of unlegislated taxes on private capital.

Ever higher and more burdensome tax rates and the absence of economic growth, even during periods of high level employment, have contributed to widespread consensus that taxes are simply too high and that a stagnant private sector cannot or should not carry the ever heavier burdens of supporting the mounting costs of an ever expanding public sector.

However, the enthusiasm of some of our citizens for tax reduction is tempered by concern that tax reduction will both add to inflation and increase interest rates.

Both sets of fears are groundless. In fact, high tax rates are a factor causing record high interest rates. I believe that a program of assured long-term tax reduction, especially when combined with expenditure reduction would make an important contribution to lowering rates and to improving the conditions of many of our beleaguered financial institutions.

Charges that the administration's four-point program of tax reduction, expenditure reduction, deregulation, and slow and steady money growth will lead to more inflation and higher interest rates are simply wrong.

Moreover, those who claim that recent sharp increases in interest rates reflect a vote of no confidence in the administration's program by financial markets, are incorrect because they have the wrong culprit

In my judgment, the collapse of the bond market in recent weeks was the direct consequence of poor execution of monetary policy by the Federal Reserve.

Interest rates soared because of excessively rapid growth of money in March and April, mounting fears that the Federal Reserve is unwilling or unable to meet its own targets for money growth and that the Feds own targets are simply too high to slow inflation significantly, if at all.

I believe that the market's lack of confidence that Fed performance would be consistent with the administration's prudent call for slow, steady, and predictable growth of money, and widespread understanding that rapid, unstable, and unpredictable money growth could easily overturn the beneficial effects of the administration's program of tax and expenditure reduction and deregulation have been the major factors in the runup of interest rates.

Bond prices generally fall whenever the money supply increases sharply. Rapid money growth leads to more inflation and interest rates rise to discount the consequences of inflationary actions just as soon as such inflationary monetary expansions are recognized.

During the first 4 weeks of April money grew at annual rate that exceeded 20 percent. Before the end of April the Fed had already exceeded its target for the entire second quarter of the year. Little wonder interest rose.

There is other important evidence in the events of recent weeks that makes this point very clear. Note that interest rates shot up after it became increasingly likely that the House would support even larger budget cuts than the administration proposed.

Surely, more budget reduction could not drive up interest rates. Also, news of further slowing of inflation, the newly reported data on consumer prices, producer prices, and the GNP deflator would certainly not push up prices either. In addition, the Treasury was running a cash surplus and was retiring rather than issuing Treasury obligations.

What remains to explain the increase in rates is recent Federal Reserve performance and the lack of conviction of significant improvement of Fed performance in the future.

Talking about inflation, it is important to realize that we have to take into account both demand and supply. Aggregate demand is controlled by the quantity of money. There is a close and dependable connection between the nominal quantity of money, which is, or ought to be, under the control of the Fed, and nominal national gross national product which is the best measure of total spending.

On the other hand, aggregate supply or output depends on other factors, such as available inputs of labor, capital, raw materials, and the state of technology.

Output also depends crucially on incentives to put these means to efficient use. It also depends on increasing available inputs, such as capital, or improving our technology.

To sum up then, prices depend on the ratio of money to output. I have a chart on page 5 which shows how close that fit is. When money goes faster than output, aggregate demand exceeds aggregate supply, and we have inflation.

When money and output grow at the same pace, we have stable prices and this relationship, which I have summarized in the chart on page 5, may well be the most extensively tested proposition in all of economics with few, if any exceptions.

Thus, to analyze the impact of some public policy proposal, such as tax reduction, on inflation, one must ask how the proposed change will affect either, one, the stock of money and thereby demand, or, two, output.

Ignoring either the monetary or output consequences of the proposal means that we are likely to be in serious error.

It seems to me that tax reductions that lessen the disincentive effects of the tax system will cause output to increase. For a given stock of money, more output results in lower prices. Thus, supply enhancing tax cuts lead to lower prices. In turn, lower prices lead to lower market interest rates. In addition, tax rate reductions that lessen the tax bias against saving will cause interest rates to fall directly.

I want to consider another way the combined effects of inflation plus the present system of taxing interest receipts as ordinary income drive up interest rates and reduce saving.

It is now widely understood that market interest rates include an inflationary premium. So far, so good. However, there is a serious deficiency in this analysis, especially in interpreting current financial developments.

The problem is that there are no taxes in this analysis. Including tax considerations changes what happens in several important ways.

The main reason is that the inflation premium in interest rates is taxed as ordinary income when it may merely reflect a return of capital adjusted to offset the loss of principal.

If interest rates merely keep pace with inflation, real costs to borrowers may remain the same, but after-tax returns to lenders will fall. The difference is the tax paid to Government, which is effectively an unlegislated capital levy and a wedge between the cost to borrowers and the return to lenders.

For example, consider an individual in the 40-percent marginal tax break. In an inflation-free world when interest rates are 5, his after-tax rate of return is 3 percent. Two percent goes for taxes.

In a world of 10-percent inflation and anticipation of 10-percent inflation, consider what would happen if interest rates rise from 5 to 15 percent to keep real rates constant at 5 percent. Real interest costs to borrowers remain at 5 percent. But for the lender in a 40-percent bracket, his 15-percent nominal pretax yield becomes a 9-percent after-tax nominal yield.

With inflation at 10 percent, the lender's 9-percent after-tax nominal yield becomes a minus 1 percent real yield. The decline from a positive 3-percent after tax yield to a negative 1-percent real yield will induce lenders to save less.

Reduced real saving means that real interest rates end up higher, so some of the tax is shifted to borrowers. If bracket creep or higher marginal rates on interest earnings drive lenders into higher marginal tax brackets, these effects will be even more pronounced.

These mechanisms help to explain why the saving rate is so low and falling, and why, after a lag, interest rates have increased more than inflation, why real interest costs to borrowers are so high at the same time that after-tax return to lenders are so low.

This analysis shows how reducing marginal tax rates is a direct way to increase after-tax return on saving, which by increasing the saving rate will lower interest rates. The effect will be more pronounced as tax cuts are accompanied by expenditure cuts.

At the present time, the post-tax return on saving for many, if not most of us, is negative. Little wonder we save and invest so little and why most families have abandoned financial market rug dealers and diamond merchants to provide for their future and to protect their capital.

There is an important rule for taxes in our system. If more resources are to be channeled into the public sector, higher taxes depress private sector activity, thereby freeing resources and making them available for the public sector.

However, it would seem that tax rates have already become so high, largely because effective rates have been driven up by money induced inflation rather than being explicitly legislated by Congress, that the private sector is already too depressed for our own good.

Moreover, the depressive effects of high and rising marginal tax rates have differentially depressed saving, capital formation and risk taking more than consumption, and reduced work effort more than leisure.

High taxes have worked all too well in curtailing private sector activity. Instead, we need a reduction in marginal tax rates, especially those taxes that discourage investment, saving, risk-taking, and work.

We also need a reduction in marginal tax rates to undo some or all of the bracket creep of recent years. To achieve these results we need large, permanent, and predictable cuts in marginal tax rates. This is why I support the administration's 3-year reduction package.

If anything, the cuts are too modest and the horizon too short. Raising personal exemptions, widening tax brackets, and similar tinkering will have little or no impact on marginal tax rates and so, will be ineffective in achieving the desired results of lessening disincentives.

The 10–5–3 proposal will undo some of the bias against capital formation, growth, and jobs and I favor that part of the tax package, too.

Finally, I would also urge the Congress to do a closer and more effective job of monitoring the Federal Reserve, which may be independent of the executive branch but is certainly not independent of the Congress, and is responsible to the Congress.

The Fed has great authority but no clear responsibility or accountability or mandated goals, a very serious set of shortcomings perhaps unique in our system of Government, which may be the source of our inflation problems.

Thank you.

The CHAIRMAN. Thank you. Senator Heinz, I think you are the earliest bird.

Senator HEINZ. As long as you hold us to that, Mr. Chairman, it sounds all right.

The CHAIRMAN. Senator Byrd is the second earliest bird.

Senator HEINZ. Thank you, Mr. Chairman.

First, a point of clarification of what Alan Greenspan said in his testimony.

Alan, in your analysis of why the administration's program hasn't had more of a positive psychological effect you state that you believe that it is because the safety net has been placed off limits and that social security, in particular, is seen as a constant growth factor so that after 1984 the trend in the rise of the Federal budget is not significantly different than it is today.

It strikes me that there is one factor in your analysis that you omited, which indeed, really is programed to grow at a much higher rate than social security expenditures and overhaul them and pass them quite significantly and that is defense expenditures.

Now, we all recognize the need for a much stronger commitment to the national defense and the Senate and all of us are very much on record in that.

But, it does strike me as an alternative analysis that the market is worried that there may be an intent on the part of the Congress to write a blank check for the Department of Defense and even at the present levels there are some people who would say that what has been proposed by the President, if enacted, or by the Congress could be extremely inflationary for two reasons.

No. 1, weapons system, hardware, inevitably end up costing far more than the initial estimates. If you think a ship is going to cost $300 million to build, it ends up costing $1 billion to build. If you think an MX system is going to be $5 billion, it ends up costing $15 billion. Such is the nature of the Military Establishment.

Second, people have argued that you will create an overall rise in the general price level because the demands being placed upon the Nation's plant and equipment, its output means, will simply be so high that there will be such a stimulation in sectoral demands that all those products that have the same common source of production will experience, due to that demand, a significant price rise thereby an increased general price level.

Could it be that that is as much a worry as the safety net?

Dr. GREENSPAN. I think not, Senator. The reason is that what we are trying to explain is the changing attitudes that have occurred in the financial system in the last 6 months.

All of the issues relative to defense, I think are understood and have been understood for quite awhile by the financial community. The essential nature of the budget for the Defense Department, introduced by the President has been known for quite a good long time.

In fact, if anything, there has always been the judgment that what we would spend would be as close to what we could spend at a capacity level.

Now, there is no question that there is a problem in evaluating this. I would just take mild exception with your cost overrun analysis which I think is certainly true in direction. But most of the cost overruns we have run into from the Pentagon in the last decade have largely occurred as a consequence of overall estimates of inflation that were built into the Pentagon budget and into the program budgets which were clearly as wrong as they have been in the civilian sectors.

Overall, it is basically a bad forecasting record on the part of the budgeteers in the Department. But, I will grant you there is an updrift which everyone is endeavoring to correct. If you could get a program through and get everyone to accept a small price initial tag on it, you have a good chance of getting it through the Congress, whereas if you put the real price tag on it you are going to have some troubles.

I don't deny that that exists, but I don't consider it a significantly new issue for the financial community.

There is now a growing awareness on the nondefense side that something is amiss,

Senator HEINZ. Well, I am not sure. I think a lot of things are different today than they were 6 months ago so I am not sure that I would be inclined to agree with the fact that it is an established fact that defense expenditures were going to receive the level of support and commitment that they now have.

Let me move on because there is an overall issue I would like to address to the panel as a whole.

Varying points of view have been expressed on the 10-10-10, Roth-Kemp, the marginal rate reductions. I would like to focus on the business tax incentives for a moment, 10-5-3 or 2-4-7-10 as the case may be.

In the judgment of each of you, is what is proposed in the way of direct business investment incentive stimulation, if you will, sufficient? Is what the administration has proposed, 10-5-3, really enough if we want to see the economic revitalization that we would all like to see?

Dr. Adams, what do you think?

Dr. ADAMS. Senator, may I begin my answer by coming back to your earlier question? I think your point about defense spending is a terribly important one and I have just come from a meeting with business economists, 120 or so people who talk about our forecasts in our Wharton sessions. Certainly one of the main concerns that arose there was precisely the question of what is the inflationary impact of higher defense expenditures.

The issues were put in precisely the way in which you put them.

Now, to your basic question about the business taxes. There is no question that taxation, particularly taxation combined with high inflation rates, affects incentives and creates difficulties for business finance.

There is probably agreement even on the thought that with inflation the American consumer has at the margin come into personal income tax brackets which are higher than had been anticipated and, one can argue, which are too high.

The question at this point in time, is what do we have room to do? What alternatives can we choose? All our calculations suggest that if you are trying to get supply-side impact, by that I mean an expansion in the level of capital investment and the productivity of our industry and its ability to compete in world markets, then you get a lot more "bang for the buck" if you put the money into business tax reductions.

The 10-5-3 program is a significant step in that direction and in the absence of something else, I would support it. There are obviously some questions with regard to the 10-year depreciation for structures.

There could well be other steps, further expansions of investment tax credit, more favorable treatment of R. & D. expenditures, and perhaps some focused programs which recognize that certain industries have been heavily impacted by pollution control and other things of that kind.

Probably there should be greater emphasis on the carryforward and carryback provisions of these tax credits. If one talks in terms of proportions of the total tax cut, I would support a much larger share as a reduction in business taxes.

Senator HEINZ. My time has expired, but on the last statement, could I ask generally whether people agree or disagree that given a tax cut of a particular size, that we do or we don't get more bang for the buck if we give a bit more than proposed by the President which over the 5-year period is the 27 percent to the business side?

Dr. Meiselman?

Dr. MEISELMAN. I don't go along with the distinction you make between a tax cut that helps business and a tax cut that helps consumers because business is owned by all of us and produces for all of us. That is a distinction that I don't go along with.

Instead of trying to perceive particular problems of individual industries, I would try to aim for helping the system as a whole.

One of the reasons that I personally favor 10-5-3 or something along those lines, is that it would help reduce the bias of the present system against investment in producer durables. We don't have quite the same problem in R. & D. because they are expensed right away.

The CHAIRMAN. Senator Byrd.

Senator BYRD. Thank you, Mr. Chairman. First, I would like to commend each of you on a fine statement.

It seems to me, Dr. Greenspan, that you capsule this whole problem in three short sentences. That is, and I am quoting from your statement: "There is a broad political consensus in this country that the deficit must be eliminated. It is the control of spending which is the key to the revival of economic vitality in this country. The issue isn't taxes, it is expenditures."

To my way of thinking, that is the real issue. Then you go on to say President Reagan has addressed the issue of excessive budgetary growth with an unprecedented program of reduction in budget authorities and outlays, but even this program must be viewed as the first stage of a budget revision process.

The market seems to be saying that the actions taken to date on outlays are inadequate.

I don't agree with your assertions 100 percent. I do think the action has been inadequate. But, I think that also progress has been made. One would have found it difficult to conceive last year, for example, or 6 months ago, that the Congress would have gone on record in some of the votes both the House and the Senate have taken this year to reduce the rate of growth in many of these programs.

I am convinced that that would not have been done, had it not been for the courage and the leadership of President Reagan.

Progress has been made, but I agree with your interpretation of the public attitude that it is still inadequate.

Now, if there is to be a reduction in taxes, I think it should be an across-the-board reduction as the President suggests.

I have not made a decision on the precise form that a tax reduction legislation should take. I do think it should be an across-the-board reduction.

I do have some concern as to whether it can or should be as great on the personal side as the administration recognizes by the name of the 10-10-10.

What is the feeling, what is your feeling, Dr. Greenspan? Do you feel that it needs to be precisely that or do you think there could be some give and take to compromise as to how that is worked out?

Dr. GREENSPAN. Well, my own personal belief is that we should move as quickly as feasible to an indexed system to prevent the real tax burdens from rising as they now would in this country, because the vast proportion of taxable income is now moving into the area of the tax structure where brackets change rapidly. That means that bracket creep now becomes a very critical question.

We have a tendency to think, regrettably, in terms of nominal tax brackets. As a consequence we think that what the President is in fact advocating, is a tax cut. He is in fact, doing nothing of that sort at all.

As I read the legislation, it does very little to change the real marginal tax bracket incidence and is as close as one can get from a rough cut, toward indexing. In that respect, I support it, but I would agree with Dr. Meiselman. I would like us to go further, because we do need, even at these levels, reductions in real tax brackets.

I would hope that we will be looking at further tax cuts in the years ahead, beyond the 3-year program which the President has advocated.

Senator BYRD. Would you feel that that could be accomplished only if there is a corresponding reduction in expenditures?

Dr. GREENSPAN. Yes, sir. That is one of the reasons why I am strongly disposed toward some sort of indexing or failing that, something similar to the President's package. There is just no question that if we allow real tax brackets burdens to rise we will spend the money.

I am terribly concerned about that because anything we do which gives leeway for a continuation of the expenditure policies which we have gotten ourselves into, is detrimental to the future of the country.

Senator BYRD. What you are saying, I take it, is that the more money the Government has to spend, the more money it will spend.

Dr. GREENSPAN. Yes, sir. That is certainly accurate.

Senator BYRD. Let me ask you this. There is some sentiment, particularly I understand, on part of the members of the Ways and Means Committee in the House to go immediately to a reduction to the top marginal tax rate of 70 percent to take that down to 50 percent. Do you, Dr. Greenspan or any of you, have a feeling in that regard one way or the other?

Dr. MEISELMAN. Well, I would support that. There is very little revenue that is gained by that and it seems to me that has a root and a great deal of hostility toward anybody whose income to be higher than the average. I don't see that it gains either revenue or that it produces any desirable economic effect.

Senator BYRD. On the question of equity, it seems to me that the Government ought not to take more than 50 percent for individuals income. I believe that a person can go into any place in the United States and most working people would agree that the Government ought not to take more than 50 percent.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman. Gentlemen, there are many economic writers who are asserting that the 10-5-3 plan actually will subsidize business. I am wondering if any of you agree with that analysis.

Mr. CIMINERO. I would say it doesn't subsidize business investment. I would also say it doesn't even cut business taxes in the ordinary sense, since a dollar of investment is only worth $0.46 at tax credits at current rates. All this would do, is allow you to collect that $0.46 sooner.

Senator BAUCUS. The analysis is that with aftertax rates of 17 percent changing with inflation, 10-5-3 will end up providing more than a dollar-for-dollar return on tax deducted or pretax rates of roughly 24 percent or whatever it works out to be in the 46-percent tax bracket of most corporations.

Dr. MEISELMAN. Senator, if the dollar used today for capital formation doesn't get a higher return, we are not going to get any capital formation.

If we continue on the same path we have for many years, that is why this country has stopped growing.

Senator BAUCUS. Are you advocating a subsidy?

Dr. MEISELMAN. I don't believe it is a subsidy. It depends from where you start. Would you say that any tax cut is a subsidy if people pay fewer taxes? I think that is a confusion of nomenclature. I don't think that is a subsidy at all.

Senator BAUCUS. Yesterday, when I asked the same question of Secretary Regan, he seemed to be saying that the Department analysis is that yes, the 10-5-3 does seem to have this unintended effect, to use his words. He is not sure that as something that they have realized lately, they are studying it now, the degree to which the effect of 10-5-3 is to back subsidized business and they would agree to back off and find something different.

I don't want to put words in his mouth, but the implication and feeling I got from him was that it looks like 10-5-3 has a greater effect on subsidizing investment.

Let me ask another question, though. Some of these same economic analysts, particularly Jorgensen and Aurback, suggest that more a neutral approach would be to have a discounted first year write off.

I am wondering if any of you could comment on that approach.

Dr. MEISELMAN. I think there are many technical problems with that. How does one calculate a present value that is uniform across firms and across industries? In addition to that, what is the interest rate that you use, et cetera? I just don't know how that could be implemented.

Senator BAUCUS. Do any of the other members of the panel have an answer to that?

Dr. ADAMS. I would like to. There are really two issues involved here. One of them is the inflation impact on the recovery of capital in a system where we have historical cost depreciation. The other one is the question of subsidy to investment.

The first year recovery program, despite its difficulties, does offer one way and I think a good way of solving the inflationary impact given that we have a system of historical cost depreciation.

I would argue, in reference to your original question, that in addition to that we need to subsidize investment expenditure in a world where interest rates have risen to high real levels and where we are trying to develop the capital stock in competition with other countries who also subsidize their investment expenditures.

I would like to see, in addition to an adequate capital recovery program, a program of investment subsidy and if 10-5-3 does that than I am in favor of 10-5-3.

Senator BAUCUS. You are saying that if 10-5-3 does, in effect, subsidize business investment other countries do too and perhaps as they do, we don't do it enough. That is what you are saying.

Dr. ADAMS. Yes, that is correct.

Senator LONG. Would Senator Baucus yield for just a moment? I would like to follow that.

Senator BAUCUS. Yes.

Senator LONG. Assuming that we decide to subsidize or not to subsidize capital investment, that is my point of view to the second question. At whatever point we decide to encourage capital investment, would it not be simpler to have a first year recovery program rather than carrying that on the books for 4 or 5 years to write off?

I know it would be a lot simpler for bookkeeping purposes. I see you nodding. Do you agree with that Dr. Greenspan?

Dr. GREENSPAN. Well, there is a great deal to be said for the so-called Jorgensen-Auback——

Senator LONG. I am not talking necessarily about Jorgensen.

Dr. GREENSPAN. No, I understand.

Senator LONG. I think if you wrote it out you would write it differently. If I did, I would do it somewhat differently. I am talking about writing the whole thing off the first year, carrying forward anything you can't write off.

Dr. GREENSPAN. I would say that is a type of thing, which if we can afford it on the revenue side, would clearly be desirable.

I also wanted to comment on the whole question that Senator Baucus was raising and that is that you will find that no matter what you do on any of the accelerated depreciation programs; that there are peculiar distortions which sometimes look to be subsidies or not subsidies depending on where you start. There is not a single version that does not have problems associated with it.

The trouble with coming to the conclusion that therefore none of them work is that they all work. It is only a question of which is the least worst, so to speak.

However, it is also one of the reasons why I think we are missing something we should be looking at, namely a cut in the corporate tax rate itself. In that sense you get fairly significant impacts and that has much less of a distortion problem which everyone of the capital recovery tax proposals have had.

Senator BAUCUS. Let me follow up on the same point. If all of these accelerated depreciation methods work or don't work, subsidized or not subsidized, depending upon where you start and how you look at it, arguably why not have a more simple system for first year write offs?

Dr. GREENSPAN. There is a great deal to be said for first year write off.

Senator PACKWOOD [presiding]. Well, Senator, you say there is a great deal to be said for it, does that mean that it is a good idea, or do you think——

Dr. GREENSPAN. Well, it is a good idea if you want to accept the type of revenue losses occurring in the short run. The problem with first year write off is that you have the initial effect which is very substantial on the revenue side.

Senator BAUCUS. I understand that, but I also understand that the degree to which first year write-off subsidizes capital investment, it is less than 10-5-3 subsidizes capital investment.

Dr. GREENSPAN. Well, the question of what constitutes subsidization and what constitutes merely a lowering of the effect of tax rate is usually in many instances determined by your starting point. I am not sure I would argue one year, immediate year write off versus 10-5-3 on that issue. I think there are a lot of other issues that would have to be——

Senator BAUCUS. Well, after tax——

Senator PACKWOOD. There are a lot of people who have not been asked questions yet. We are going to have to keep moving along because Senator Mitchell is next and he has a vote. We may be able to finish before you have to go to the vote and others may want to leave now.

Senator BAUCUS. Is this going to be used for the whole—Senator Long took part of my time.

Senator PACKWOOD. Did Russell take part of your time again?

Senator BAUCUS. Actually this subsidy we are talking about is a criticism of the present investment tax credit.

The first year writeoff may eliminate the investment tax credit whereas the 10-5-3 with the investment tax credit is a combination of subsidies.

Senator PACKWOOD. Mr. Ciminero, I am curious—will you explain to me on your chart which is exhibit 6 which has to do with saving propensities relating to bracketed income. You mentioned it on page 3 of your statement and then you have a chart.

Does that simply mean that people that have higher incomes save more of their income?

Mr. CIMINERO. Yes. Unfortunately we are at a loss to get a very recent reading on savings behavior by income bracket in any definitive study.

One of the studies that I did cite here, shows that the marginal savings propensity ranges above 50 percent. These are manmade rates, not the average, which is maybe where some of the confusion comes up in terms of a 50-percent marginal savings rate versus a 6- or 7-percent average.

A marginal saving propensity is the split which a consumer would make between saving and spending on an additional dollar, if you will.

Senator PACKWOOD. In looking——

Mr. CIMINERO. What this says is that shortrun marginal saving propensity goes up quite significantly across income brackets.

Senator PACKWOOD. What is short run?

Mr. CIMINERO. Short run would be over a quarter or so. Long run would be over a year or so, longer than a quarter or so.

Senator PACKWOOD. And so long run, assuming this study is right, people in the upper income brackets at the margin especially, save infinitely more than people in the lower income brackets.

Mr. CIMINERO. On a taxpayer-by-taxpayer basis, yes. It is probably also true if you add all the taxpayers together. There is more saving in those upper brackets.

Senator PACKWOOD. So, if we wanted to increase savings, wouldn't we be wise to tilt any tax reductions toward upper income brackets?

Mr. CIMINERO. If that was the sole purpose I would guess.

Senator PACKWOOD. Well, it is one of the purposes we are trying to achieve, I think.

Mr. CIMINERO. Yes; it would improve the savings mix.

Senator PACKWOOD. OK. So rather than 10-10-10, something that tilted more toward higher brackets would induce more savings.

Mr. CIMINERO. Per dollar of tax cut; yes.

Senator PACKWOOD. Well, I am assuming that we have only so much money to lose in revenue and Dr. Meiselman refers to bang for the buck on depreciation, I am talking about the individual side. We have to try to get the most bank for the buck out of it and savings is one of the things that we are tilting for.

You indicate that if we tilted it toward the upper income brackets, dollar for dollar, we would get more savings.

Now, Mr. Adams, you make this statement on page 5. But, at a time when growth and productivity are of primary concern, the emphasis clearly should be on a reduction of business taxes which have more clearance, and focus an impact on capital investment.

Changing your focus now to individual taxes, assuming that what we want to get is savings, capital formation investment, can we get more bang for the buck out of something other than 10-10-10 or is that the best kind of tax cut that will get us the most savings, capital formation, and investment?

Dr. ADAMS. Well, my statement was based on a variety of experience with studies and simulations which would seem to suggest to get a direct impact and a sizable impact. It builds up to very large numbers through more favorable treatment of depreciation.

Senator PACKWOOD. I want to focus on the individual side. If what we want people to do is save money and buy stocks and invest.

Dr. ADAMS. On the individual side there is no doubt that, and I would go along with the others here, that at high income levels the share of income which is saved, the marginal dollar, clearly will account for more saving If you maKe the tax cuts at a high income person.

Senator PACKWOOD. By saved, you also mean invested, I take it.

Dr. ADAMS. No; I do not necessarily.

Senator PACKWOOD. I mean saved, put in a bank account.

Dr. ADAMS. Yes.

Senator PACKWOOD. All right.

Dr. ADAMS. The channel by which those funds turn up later in investment expenditures is a very tenuous one. It is one in which the tax regulations on business investment side intervene and that is one reason why I am hesitant to recommend the personal tax cut.

Senator PACKWOOD. I notice it is way down your list of priorities.

Dr. ADAMS. That is right.

Senator PACKWOOD. It is last out of five. But, again, we are going to have an individual tax cut of some kind.

Dr. ADAMS. Yes.

Senator PACKWOOD. Secretary Regan said yesterday that people respond to tax incentives. He even said the higher the capital gains tax, the less the people buy stock. The lower the capital gains tax, the more they will buy stock. Considering his background, that is an understandable statement, I think.

But, I am trying to balance off again, I have not heard anybody, including the President, say that they are trying to achieve anything other than more savings, more investment, more capital formation, more increase in productivity. Nobody quarrels with those premises.

You have talked about savings and indicated that if we tilted it toward the higher income brackets, we will get more savings. You limited yourself to that.

Now, let's talk about capital investment, the purchase of stocks, which is one of the engines of American economy. We would get more of that if we lowered the individual tax cuts and also lowered the capital gains tax? Instead of 10-10-10, if we tilt it toward 5-5-5 and some kind of even further capital gains tax reduction beyond what comes from the lowering of the rates from 70 to 50 percent.

Dr. ADAMS. I think you would get more of that. The question is how strongly and how effectively that will be translated by business enterprises into a higher level of nonresidential real investment and improvement in their capital stock. I think that may be slow and that may be only an imperfect process.

Senator PACKWOOD. But, in your estimation, in any event, we would be more likely to get more investment if we lowered the across-the-board cut and increased the capital gains cut, then we will get going 10-10-10.

Dr. ADAMS. We will get additional investment if we lower those taxes; yes.

Senator PACKWOOD. Thank you.

We have a vote in progress and we have about 7 minutes before they close the door over there, so I think I will depart, but Senator Mitchell can proceed.

One thing I wanted to ask very quickly. Right now there is a lot of momentum out there for the President's efforts, whether it is budget cutting, even tax deductions, and you are all acquainted with the process in the Congress that moves very slowly.

I think it may have occurred to some that with all the momentum, maybe we should not be talking about August 1 to have this on the President's desk, maybe we ought to be talking about sometime in June.

That would take a monumental effort by Congress to do that quickly but if anybody has thought about timetables. I know Dr. Greenspan I know you have been around and gone through some of these tedious, lengthly processes, do you think we could, the Congress could move quickly enough to complete action before our little self-imposed deadline of August 1?

Dr. GREENSPAN. No.

The CHAIRMAN. Well, that is what I thought. Does anyone think Congress can respond more quickly than they normally do? We should I think, in this case, but I am not certain we will do so.

Dr. MEISELMAN. I would hope they would give the uncertainty about the path of the economy policy in this country.

The CHAIRMAN. I have been trying to take the temperatures of members the past few days on the differences. I don't think anyone is really that far apart. Well, there may be a couple that far apart on it, when you come to think about it, but I think for the most part, we could reach agreement very quickly and informally but getting through the process is something else.

We intend to explore that to see whether there is some general agreement.

I am going to depart, but if Senator Mitchell can, he may proceed.

Thank you, Dr. Adams.

[A short recess was taken.]

Senator LONG. The chairman suggested to me that I just go on ahead and ask my questions I wanted to ask at this point and if anyone else wants to ask a question.

Let me just submit to you gentlemen here what the thoughts are about this matter and perhaps you, Mr. Greenspan as one who has substantial experience in the Government, might be in a better position to comment on it, but Dr. Adams might be helpful to us too.

There is no doubt in my mind that the income tax system has been used to a point that it is overused and in the top rate is counterproductive. It is producing less revenues than it would produce at a lower level. I am not saying that we ought to raise or cut taxes just to raise revenue for the Government.

I think we ought to have an efficient system. Anything that is counterproductive and defeats it own purpose should be changed.

After World War I, or II at least, we feel that wartime affects profits——

It was not only unjust, under the circumstances, a 90-percent tax on top of all the other taxes, but it was counterproductive anyway.

I guess that kind of tax, if you compare it to a net to bring the fish in, you don't leave one loophole for all the fish to swim through the net and then they found that biggest one in a hurry, pension plans.

They could just take money and put it into a pension plan for executives and it was almost unlimited. In fact, if there was no limit to how much they could put into a pension plan for their executives. That puts money there rather than pay it out in taxes and that is where all these big pension plans—there is about $30 billion sitting up in those plans—that's where it got started. They may have had other loopholes, but that was the big.

Some of the other things they did in terms of that excess tax that was sort of amusing—they tell the story about the three lobbyists down at the Mayflower Hotel seeking contracts. They sat around for a few rounds of drinks one evening and finally one of them said let me have the check. He said: "I have to go, we are in an excess profits tax situation. It won't cost us but 10 percent." The other fellow said: "Let me have it, it won't cost me anything. I have an expense account." The other fellow said: "No, let me have it, my company has a cost-plus contract, I will make a 10-percent profit."

That is the type of thing that was prevalent throughout the whole situation. It is the Government that is paying a fantastic price in order to pay the tax on the profit.

I don't think anybody here who would doubt if we had that excess profit tax today, it would be counterproductive. If we had that on top of all the other taxes we pay, people just wouldn't do business that way.

A man talking to me recently about what I thought about capital gains. I said if you had a very big successful operation, if talk about putting capital gains where you are talking about putting it, I think I might sell this business and then pay you the tax. He said that at the rate it is now, I wouldn't sell. I would trade. I will trade it to somebody for something else.

When the good Lord calls me home, I will put it into a foundation that could make a billion people anything.

That is the type situation we have. I know those who don't agree with me take the view that we ought to try to find every possible avenue where somebody can avoid paying a tax and close it down. We already have a tax law of 5,000 pages long and regulations behind that with probably 60,000 pages.

We are outnumbered and outgunned. We have 200 lawyers working for the Government down there and trying to draw up more tax laws. There are 20,000 of them out there figuring ways to get through that net. Their 20,000 are better qualified than our 200. We are training our 200 to join the 20,000 already. That is where they are getting their experience from.

It just seems to me that at some point we ought to recognize that we are costing ourselves money rather than making money by a situation that is too high.

Let me just give you an example here. For a corporation to make money in my State and just pay an 8-percent State income tax and an 8-percent personal income tax as well as a 70-percent tax on investment income and the corporate income tax of 46 percent, you would wind up making 14 cents out of every dollar earned if you phase it on through the way that we hope to tax it.

It would take an idiot to do that way. The capital can be made available for the transaction by simply borrowing the money, putting the money with the corporation. It is taxed that way, not to the corporation deductible to the individual.

It is taxed a lot less than the 86 percent, if he in turn is borrowing it from somebody else who has a favorable tax situation, such as a foundation or a bank or an insurance company and that is how the companies have been acquiring their capital. Not by equity. That is why when someone like Chrysler hits a couple of bad years, they belly up because they have no debt and equity position.

Otherwise, they could sustain a few bad years and keep on going. If the Government didn't come to the salvation of the company—a lot of folks don't think it should have—we would have lost billions of dollars because we have a tax system that eludes us into thinking we are making money we are not.

We are not taxing 70 percent of the money away or 86 percent in these high brackets. The study that Mr. Weidenbaum put in the record said that at the top level those people are paying us 44 percent. They are not paying us 70 percent of their income in taxes.

The point is that to put this thing on a realistic basis would make money for the Government rather than lose money to the Government.

Now, when we fought the capital gains battle a couple of years ago in 1978, I had letters on every Senator's desk where every man who had served as Secretary of Treasury, other than one, thought that the reduction we made in capital gains would have a favorable impact on the Treasury.

Furthermore, most men who had served with distinction as Chairman of the Federal Reserve thought the same thing.

Now, if I believe that, Senator Dole believes that—I believe he does—those men who have served as Secretary of Treasury believe that, 85 percent of them believe that, and most of these people who had served as Undersecretary of Treasury believe that, I think a majority of this committee probably believes that and I suspect a majority of the Ways and Means Committee believe that.

Why in the devil can't somebody find a way to feed those assumptions into the computer and the information that can be mustered to back it up and bring the answer out the other end to support that conclusion.

Dr. Turee believes that, for example. Why can't somebody acquire some confidence to find somebody who can put in the computer the assumptions and the numbers so it comes out the other end.

I was talking to a friend of mine who went with industry and who is in the computer business, providing computer services to people, rather than Government. He wanted a good lawyer so he went the business route rather than the Government route. Not an economist, just a good businessman and a provider of information by way of computers.

He said:

> Well, Senator, if you folks in Government don't have that confidence, why don't you turn it over to us in business? If the economists and the lawyers and the elected people can deal with it, why don't you let us business people have it?

That is no problem.

Can you explain to me why we can't demonstrate to people that the way a tax counterproductive, it is counterproductive?

Dr. GREENSPAN. I'll try, Senator. I think the answer to your question is very explicitly that we have had these prohibitive tax rates in the system for so long that we have very few actual observations that can be employed to statistically, conclusively demonstrate the effect.

That is not the same thing as saying that it cannot be proved or that, in fact, it is not so. I agree with you completely. I think that there is just no question that what we are doing to our tax system is not enhancing any particular economic goal that I am aware of.

It is strictly a social-political type of policy which is probably now quite obsolescent and clearly not the point of view of the majority of the American people by any stretch of the imagination.

Nonetheless, we do have considerable knowledge of what the impacts of the types of cuts that you are suggesting would have.

If we cut the capital gains tax rate, the revenue loss is likely to be negative, meaning we will gain revenue rather than losing it. There is just no doubt that the 70-percent marginal tax rate is causing individuals who ordinarily will save to put it in very peculiar types of things which do not enhance the productivity of this economy or perhaps even their own personal financial status.

We are many years overdue for a major overhaul and I would certainly hope that step No. 1 is to move that 70-percent rate down to 50 or less, if we can, on so-called unearned income. That, at this point has the most inhibiting effect on saving-investment so far as the individual tax structure is concerned.

If we ever wanted to put through a real, true supply side move, that would be the one which would gain the most support from economists and those who look at the issue of savings and investment.

Senator LONG. Dr. Adams.

Dr. ADAMS. Well, obviously I can't agree with fully with Mr. Greenspan, but I do agree with him to a very substantial extent.

The problem that I see here is not one of only of the difficulty of measurement, but also of the fact that we do have in our economy people who are reasonable, rational, and smart in how they employ their assets. We do have a system of taxation which has loopholes. I am not sure that loopholes is the right word here, but which has made it possible to avoid paying the very high marginal tax rate.

I suspect that many, many of the people on whom you are relying to do productive investment in the economy are not paying that high marginal tax rate. They have found ways in which to avoid it.

I suspect that it would be wise when it becomes possible to reduce the high marginal tax rate. I am not sure that now is the time and I am not sure that that is the central issue of the current problem, but I would certainly favor that when we can do so that we reduce that high marginal tax rate to a level where it makes more sense.

Senator LONG. Well, let just give you an example. I am paying in the 70-percent tax bracket and I am not the least bit embarrassed to report the percentage of my income I am paying in taxes. It is certainly above what is in line with the studies to which I referred and I think it would compare favorably with what people are paying who are making that much money.

But, starting right now for the rest of this year, every investment I'll make will be one calculated to show an ultimate profit and make money over and above taxes. Every one of them will reduce my tax liability and that is what people who are in that same tax bracket will be doing all year long.

Now, if your people don't know that, they ought to apprise themselves of it. At some point, if we can't do any better we ought to just ask the Treasury to do what it did when we wrote that first so-called tax reform law. Just pull out a bunch of tax returns and look at what those people are doing with their money and how they are using it. If we can, we better interview them and find out what kind of investment they are going to make if they have more money to invest.

I don't have the slightest doubt that it would show that: One, if the rates weren't so ridiculously high, they would be investing money where the Government makes more money out of it rather than less. Two, it would show that the Government would make more income if those tax laws took into effect what people do under those circumstances.

Just to give you one simple example, here is a contractor, very successful, one of the most successful in the Washington, D.C., area, told me some years ago if when I go into a business deal assuming it is successful, if I can't keep half of it, my answer is I am not interested. I think that is how most business people would look at that type of thing.

I just think at some point we have to try to face reality. We keep preceding under the assumption that by making a ridiculous situation more ridiculous we are going to collect more money. It doesn't. Does anyone have a comment on that?

Mr. CIMINERO. I would just like to comment that 2 years ago we did testify regarding the capital gains tax rate reduction. In that case, the revenue feedback effects could fairly easily be shown to overwhelm the expected tax cut static revenue loss.

In the case of reducing very high marginal tax rates, it is a little more difficult to show that, but it is not by any means impossible.

I think that a kind of study of the type you are discussing might be useful to get into in order to quantify what is going on here because I agree with other members of the panel that since the experiment hasn't ever been performed before in history we don't have any way of measuring it accurately in terms of our models.

But, certainly survey information and other kinds of information could go a long way toward verifying that fact.

Senator LONG. Did you want to comment, Dr. Meiselman?

Dr. MEISELMAN. I would just like to add one more point. It seems to me that for many of our citizens the main way to avoid taxes is simply to consume most or all of their income and that is exactly what has happened.

Most people do not have access to fancy tax shelters and what they do is simply consume everything that they earn because the rate of return on their saving is negative. After a while, they learn that and so they are penalized for the simple act of saving, so they reduce it or stop it.

Senator LONG. I would just like to make a statement very briefly if I may and I'm through.

In 1978, we voted down the populist oratory in the Senate and cut the capital gains tax rate at the top by about 50 percent, almost 50 percent.

The Treasury was estimating a revenue loss of about $1.8 billion. Their later figures show, even according to their static type estimates, they would assume that the revenue loss is about $100 million. It's wrong. We probably made about a $1 billion or $2 billion profit. But, assuming that they are right and it cost us $100 million a year, look what it did for the country.

To begin with, it brought another 3 million investors into the stock market. Isn't that right, Mr. Greenspan? You know that is correct.

In addition to that, now mind you if you only had to pay $30 a head to bring $3 million additional investment into the stock market, that would have been worth it. That is not talking about all the additional activity of the 25 million of them who were there already. The good Lord only knows what all we did for the economy because we did that.

What bothers me is we are not getting the support we ought to be getting from the people who have had the potential to bring together the information and show us that we have a counterproductive income tax system and it ought to be made productive. It is just that simple.

The CHAIRMAN. Senator Mitchell.

Senator MITCHELL. Thank you, Mr. Chairman. Gentlemen, yesterday in his testimony, Secretary Regan described as a major purpose of the President's program the encouragement of savings, and although I was not present during your testimony this morning, I have looked through the statements and I know, for example, that Mr. Ciminero finds savings as the engine of investment-led productivity gains.

Is there agreement among you that encouraging savings is a major objective of this program? Let me ask it negatively so we can get a short answer. Is there any disagreement that that is a major objective of this program?

Dr. GREENSPAN. May I just—it's an objective.

Senator MITCHELL. An objective.

Dr. GREENSPAN. I don't believe that tax rates go far enough to make a really significant difference on the savings side.

Senator PACKWOOD. I couldn't hear. Could you repeat that?

Dr. GREENSPAN. I am saying I don't think that the tax rate cuts go sufficiently far to make a significant impact on savings. It is that the savings issue is only an aspect of this type of program and we should unquestionably endeavor to encourage that.

I would scarcely argue that the President's program rests on that. The major thrust of the President's program, as I see it, is to substantially reduce the rate of growth in Federal outlays and prevent the real tax burdens from rising. Both are commendable, very important, and in my view, necessary, although not sufficient, conditions to restore economic balance.

I am a little concerned that we are overemphasizing the savings part on the grounds that the success or failure of this program will rise or fall on that issue. I don't believe it does or should.

Senator MITCHELL. You believe it is an aspect, not the major aspect.

Dr. GREENSPAN. That is correct, Senator.

Senator MITCHELL. Let me then ask you, you are aware that there exists an incentive to encourage savings in the interest and dividend exclusion.

The program as decribed by the Secretary of the Treasury calls for not extending that incentive, letting it lapse, at least as of now and maybe we will think about it later and substituting therefor this general tax reduction which will return to middle income and lower income taxpayers a relatively modest amount in dollars—a few hundred dollars a year or less.

Do you believe that eliminating the interest and dividend exclusion, which is an incentive designed specifically to encourage savings, and substituting therefor the general tax reduction which will produce the few hundred dollars is likely to increase savings, or will it decrease savings?

You are taking a specific incentive and substituting a general tax reduction. I would like to have each of you tell me whether you think that will encourage or discourage savings. That aspect of the program.

Mr. CIMINERO. Well, first, I just would agree with Dr. Greenspan that the thrust of my testimony wasn't that the tax cut's main impetus was to encourage savings. It is more or less an explanation as to how consumers would behave; also why the tax cut would not be overly stimulative because much of it is saved.

On your other question—namely, substituting for the existing "off-the-bottom" dividend exclusions, the proposed Reagan policy—I would say that it is very likely that the Reagan policy——

Senator PACKWOOD. I am sorry; I didn't hear that either.

Mr. CIMINERO. I would say that the substitution of the Reagan policy in place of the current regime of deductible amounts of interest and dividends would encourage more savings since the deductible amount of interest and dividends comes, again, "off the bottom."

The current deductible provisions do not alter the marginal tax rates of those who really save large magnitudes because, after all, those deductible amounts are very small. So it makes a minuscule difference in terms of someone who is in the upper income brackets that he can deduct $200 or $400 worth of dividends. It is just not going to change his behavior very much and tends to, in effect, give a tax break to those who tend to save less—tends to tilt the tax break incentive toward those who save less anyway, namely those who would worry about whether their dividends are $100 this year or $200 this year.

Dr. MEISELMAN. I would like to comment on that.

Senator MITCHELL. Yes.

Dr. MEISELMAN. If I have $100 or $200 or $300 worth of interest or dividends that are not included in the tax base, that doesn't necessarily mean that an individual would save more. He would just shift assets from other uses, especially if his marginal tax rates stayed the same.

Most people have some assets and they would largely shift them into the non-taxed form from the taxed form. It doesn't necessarily follow from that that people's saving behavior, that is the use to which they put their current income, would change in any significant way. Saving should not be confounded with savings, which are assets that have resulted from past saving.

Senator MITCHELL. What evidence is there to suggest that a fellow working in a factory who gets $100 tax reduction is going to save that?

Dr. MEISELMAN. If he gets a $100 tax reduction, if he just gets a $100 check in the mail from the U.S. Treasury, that is one thing. But, what is really important is cutting the marginal tax rate. It is the change in the rates that matters.

Senator MITCHELL. Do you think that is important?

Dr. MEISELMAN. It is the change in the rates that is important.

Senator MITCHELL. People think in terms of marginal tax rates?

Dr. MEISELMAN. Of course they do, even if people are slow to learn. We have been subject to bracket creep for so many years that even the slow learners know about that. They know what happens to their taxes. They know what inflation does to them.

It is crucial that we change marginal tax rates and not think of tax reduction merely in terms of getting a certain amount of cash from the Treasury. It is the change in the rates that change incentives, and people act on the basis of relative prices and alternative rates of return.

Senator MITCHELL. But you are suggesting then that this incentive is not an incentive. It is designed as a specific——

Dr. MEISELMAN. At most it is a very weak one with respect to current saving behavior, because you will largely get a balance sheet adjustment. If I could get $300 tax free in a savings account, I would take it out of someplace else and put it into a savings account. It doesn't mean that I would consume less and save more of my current income.

It is only if I am put into a lower marginal tax bracket that I would change my current savings behavior. What you are talking about is a change in my portfolio behavior, what I do with my existing assets, not decisions to add to my assets.

Senator MITCHELL. Dr. Adams.

Dr. ADAMS. I will be brief. I don't think I agree fully with that. After all, the marginal tax rate on that income being excluded carries a marginal tax rate of zero, but I don't have to save any in order to get it. All I will have to do is devote my current assets to that. I have some current assets. I just shift from one use to another use.

It is true, if I have no assets, then I would want to get some assets. Then, and only then, would I want to save in order to build up $200 of tax credits. That is true for any incentive so structured.

Senator MITCHELL. What you are saying is that you have to just keep increasing it. Any taxpayer will view it as an incentive only to the extent that he can benefit by an additional investment, an additional savings.

Dr. MEISELMAN. That is right, and that is what happens when you lower marginal tax brackets.

Dr. ADAMS. May I add one thing to that. It seems to me that it is terribly important not to think in terms of savings in too general a sense.

The dividend exclusion has a very specific impact in providing a special benefit to the wide holding of common stock throughout our economy, and a dividend exclusion has a particular benefit in strengthening the stock market, which Lord knows needs strengthening and I think there are very strong arguments to be made in favor of the dividend exclusion on that basis, in addition to other considerations about savings in general.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

Gentlemen, the objective of the Reagan program, as I understand it, is to reduce inflation and bring down interest rates, and I have always thought it Republican credo that the way to reduce inflation and bring down interest rates is to reduce the Federal deficit.

If the budget of this Nation were in balance, then inflation would come down. I was informed yesterday by Mr. Regan, Secretary Regan, that that is not so. That deficits per se are not a problem as long as we have tight money supply. As long as we have tight money supply, we have high interest rates.

First, do you believe we should get the budget into balance in order to bring down inflation and bring down interest rates?

Why don't I start with Dr. Adams.

Dr. ADAMS. Budget balance is certainly an important consideration. It is an aspect of fiscal discipline that we need to take into account. I am not sure that you can find a narrow and immediate relationship between budget balance and inflation.

I think you can see more between budget balance or imbalance and interest rates particularly at a time when we want to sharply limit the growth of money supply.

I would say budget balance is certainly a worthy objective and one that in times like these we need to put heavy emphasis on.

Senator CHAFEE. You know, I don't understand, here the Federal Government is borrowing 28 percent of all loanable funds in the market. Now, if you can't balance your budget, obviously your Federal Government is going out to borrow more. That drives up interest rates, does it not? Have I missed something here?

Yes, Doctor.

Dr. MEISELMAN. If you change nothing else, and you have the Federal Government borrowing more, if that is the only thing going on, then that would obviously drive up interest rates. You have to put it in context.

Senator CHAFEE. In context with what?

Dr. MEISELMAN. You have to put it in context of a printing press that has gone wild which has made the inflation. The most important factor that makes interest rates high now is the fact that we have a money-caused inflation.

Whenever the signs go out that the printing press is running faster, interest rates go up immediately.

Senator CHAFEE. Yes, but why are the printing presses running?

Dr. MEISELMAN. Senator, you should ask that of the Federal Reserve that are your charges and your responsibility. I am puzzled as to why they let the printing presses run so fast.

In my written testimony, I showed that there is no empirical connection between the size of the deficit and what happens to the printing press. There conceivably could be, but there isn't.

Right now, long-term Government bonds have a record high yield of over 14 percent. We have never had long-term rates that high.

To put it into context, if we have inflation of around 10 percent, and that is what the market discounts, then at least 10 percentage points is due to the inflation premium.

In addition to the inflation premium, there is much uncertainty about the future, much more than usual. Also, anybody who was foolish enough, unfortunate enough, or foolhardy enough to have purchased Government bonds over the past few years, has suffered terrible losses. So, we have driven large number of past and potential bondholders out of the bond market.

The factors contribute to an additional risk premium. How much is then left over to explain as stemming from the enormous amount of Government debt flooding the market. At most, there is only a couple of percentage points.

What you are doing is focusing on something, but it is not the major actor in the high interest rate drama. That is the reason why in coming before the Finance Committee at this time, I devoted a large fraction of my testimony, not to talking about the details of taxes which are certainly important, but in trying to point the finger at the main culprit in the high interest rate drama, which is the Federal Reserve.

Senator CHAFEE. Well, here is the problem before us right now. The administration is asking for a substantial tax cut. We won't argue whether it is substantial or not.

There are those that say why have a tax cut when you are running a substantial deficit? The administration has budgeted a deficit, whatever that word means, of $55 billion. The tax cut is about that same amount.

Now, suppose we said to you, what should we do? Suppose we say no tax cut will balance this budget, would the country be better off or should we go with this tax cut?

All right, Alan what do you say?

Dr. GREENSPAN. Well, first of all, I wish to deviate somewhat from my colleagues and reemphasize that in effect the deficit does matter. The only extent to which I would qualify that is to recognize that the way we keep our books doesn't appropriately capture the total affect of the system.

You eluded to the total borrowings as a percent of net funds raised. It is questionable whether it is the right denominator, but the total borrowings have to include not only the on-budget and the off-budget items, but it also has to include the significant impact which the Federal guarantee programs are contributing to aggregate borrowing.

A very large, but indeterminate amount of private borrowing is induced by Federal regulation. Consider a utility which has been pressured by the Environmental Protection Agency or other statutes to buy a scrubber. It doesn't matter to the financial markets whether that utility goes out on its own and borrows the money to buy the scrubber, whether the Federal Government guarantees its borrowing to do so, or whether the Federal Government on its own goes out and borrows the money and gives a subsidy to the utility.

In other words, the financial impact is the same or approximately the same. So, what I am saying is that there is far more to what we used to include in the Federal deficit.

But, having said that, I would still say it is necessary to get the on-budget deficit down and hopefully to zero. If one does that, by allowing real tax burdens to rise, which is what we would do if we did not cut nominal tax rates now, the results would be counter productive.

We would probably achieve the goal of a balanced budget. But remember that the primary purpose of a balanced budget in this context is the maintenance of a vital economic system. To obtain a balanced budget by allowing real tax burdens to rise, may achieve the balanced budget but it may well undercut the primary goal.

I would argue that yes, it is necessary to get our budget in balance, but to do so only in the context of holding real tax burdens unchanged. This is essentially what the President is advocating and that is why I support it.

Senator CHAFEE. Well, thank you. I would just like to say in conclusion that I see references to constantly to what Jack Kennedy did in 1963 or 1964. I think the situation is different because in the factors he was concerned with, inflation was not a factor.

My time is up. Thank you, Mr. Chairman.

The CHAIRMAN. Does anybody disagree with that last statement?

Mr. CIMINERO. I don't think that is relevant to this issue.

The CHAIRMAN. Senator Grassley.

Senator GRASSLEY. Thank you, Mr. Chairman.

Before I ask my question, I would like to respond to the challenge that was given to us to ask the Federal Reserve why they keep running the printing presses the way they do.

I theorize that the reason that that is being done is that the steeply progressive income tax has been a total failure to bring about the egalitarian goals that it was meant to bring about. The people who want to accomplish the wealth redistribution, a point I disagree with, are trying to accomplish this year through monetizing the debt.

In other words, inflation, in my judgment, is more of a redistributor of wealth than the progressive income tax is in America. It fits their goals perfectly since it can be implemented without a vote of the Congress.

Let me preface my remarks by saying that I support the President's program of a 3-year tax cut and accelerated depreciation. Yesterday I asked Secretary Regan if the President's goals could be accomplished with by opting for a 1-year 10-percent tax cut and index this cut. Wouldn't this achieve the same long-term goals?

I am suggesting that maybe 7 or 8 years down the road there won't be any difference between the outcome of where we are from a revenue and tax standpoint. The end result would be that we would have a consistent tax policy that people can predict.

So, Dr. Greenspan, I would like to ask you if you have given any thought to indexing. You opened your statement by talking about indexing. I have long supported indexing. The chairman of the committee agrees with these goals. Where would we be with a 1-year tax cut plus indexing as opposed to a 3-year tax cut with no indexing in your view?

Dr. GREENSPAN. The same place approximately. In other words, the Reagan proposal, at this particular stage, is relatively close. Not exact, but relatively close in type of change in tax brackets and individual income tax liabilities that you would get with an indexing system.

Senator GRASSLEY. OK, then can I ask you would either the President's program versus a 10-percent tax cut for 1 year plus indexing from here to eternity, have a more beneficial immediate impact or would there be a difference in their immediate impact? I am talking about the next 2 or 3 years as opposed to my original question where I was asking you to look down the road 7 or 8 years.

Dr. GREENSPAN. Well, Senator, as a long-term policy I would prefer the one in which you had permanent indexing because that would force the Budget Committees and the Appropriations Committees to recognize that what they have to spend is real revenues and not bracket creep revenues.

It would have to come to grips with something which is at the root of a major long-term financial problem, namely that the expenditure side of the budget is out of control. We have a set of laws which are inconsistent with a rate of growth in Federal outlays which we can finance.

Were we to think in terms of long-term tax availability based on indexing, in other words, real growth in revenues, we would be forced to relook at the problem we have in a much clearer manner and come to grips with the expenditure side which is where the critical action has to be focused.

Senator GRASSLEY. OK, I agree with that, but the point of my second question was, Assuming the goal of the President is an immediate revitalization of the economy, and now looking at a short-term goal as opposed to my original question which went to long-term impact, which in your judgment would have the most immediate beneficial, short-term impact? The President's 3-year, 10-percent tax cut plus accelerated depreciation or 1-year, 10-percent tax cut plus indexing, plus the accelerated depreciation?

Dr. GREENSPAN. I don't think I could make a really meaningful distinction between those two programs.

Senator GRASSLEY. Well, is it even worth our consideration? Maybe I am dwelling on something that shouldn't be dwelled on.

Dr. GREENSPAN. I would say the answer, Senator, is probably not. I think the real question is not so much do you induce indexing after the first year, but the only thing that would really be significantly different from the President's program would be to go along with this 10-10-10 and indexing at the end of that time, which he does not do.

Whether you put indexing in the second year or the fourth year, I am not certain makes all that much difference.

It is true that you would probably get slightly less reduction in revenue with the indexing starting in the second year, but that's merely to say that there is a modest real tax burden decline in the President's program.

I would not say that that is probably a significant difference as a major issue before this committee.

Senator GRASSLEY. Then, lastly and only as a commentary on the second paragraph of your statement, Dr. Greenspan, you really see this tax issue, in terms of a reduction of overall spending.

Do you see the decrease in the total level of income into the Federal Treasury as meaning that somehow indirectly that is going to lead to Congress spending less? In other words, you say we will not even have much larger deficits than we have had even with less income.

Dr. GREENSPAN. Yes, sir.

Senator GRASSLEY. OK. Thank you, Mr. Chairman.

The CHAIRMAN. Could I just ask one question? I think, Mr. Ciminero, in your statement you talk about savings. Maybe I should know more about your analysis.

What do you mean by savings? Is that actually taking it down and putting it in an account or is that paying your bills? How do you define savings?

Mr. CIMINERO. Savings in terms of the kinds of numbers that people are debating is the national income accounts definition which is total inflow minus outlays. If savings go up——

The CHAIRMAN. I don't understand that either.

Mr. CIMINERO. Total inflows minus outlays. In other words, what you have left over after you have spent on consumption, interest and so forth.

Now, what that amount can represent would be a mix of the normal kind of increments to your savings account or a reduction in debt. So, it is both, net reduction in debt or increased savings.

The CHAIRMAN. If in the process of getting your reduction, you have paid off some bills that were due, that would have an impact.

Mr. CIMINERO. Yes. It does I guess for a reason related to an earlier question. Both repayment of debt and savings, savings in the ordinary sense where you would increase the balance in some savings account, represent increments to sources of funds that are available in the economy.

That is the key issue regarding the savings behavior because it is those private sources that would fund, not only an increasing business investment, but also a declining Government deficit.

The CHAIRMAN. I think if we look at the President's recommendation we are talking about reducing the marginal rates and accelerated depreciation. That is pretty much what he wants to do. There was testimony yesterday they would like to keep it that way with no add ons.

But, I think as all the panel knows, that is pretty difficult to prevent that happening. It is hard to convince the members to wait and others who talk to members to wait until there is a second vehicle.

If, in fact, it could be a barebones effort and be what the President requested, is there any other addition, in the opinion of anybody on the panel, that should be made?

Just say we had the votes for the President's program as is, would it be the right thing to do to add on certain things and if so, which ones?

Dr. Greenspan, do you have an answer to that?

Dr. GREENSPAN. Well, if I had my choice, I would limit it to one thing, which is the elimination of the 70-percent unearned income bracket, immediately dropping that to 50 percent which I think is the type of tax change which is long overdue. Its revenue loss is zero, as best I can judge and it clearly would have many beneficial effects.

The CHAIRMAN. Dr. Meiselman.

Dr. MEISELMAN. If I could add one item, I would permit rollovers to be excluded from the capital gains tax. I think that is very important. The capital gains tax, as we all know, has terrible effects. It is not a capital gains tax. It is funny kind of transactions tax payable only when the gain is realized and converted into cash.

We all know how it distorts the allocation of resources. It freezes all kinds of uses of financial capital and physical capital. It has absolutely terrible effects.

The CHAIRMAN. Dr. Adams, you listed a number of things even ahead of the marginal rates. But, let's assume we didn't do it the way you suggested.

Dr. ADAMS. Well, I don't want to amplify really on what I have said already. I gave that as a list of priorities in some sense.

I think it is very important to recognize that simply making funds more available on the savings side even if that materializes, is really not going to solve the basic problem of rebuilding the capital stock of many of our industries.

That there is very strong justification for additional tax credits, which may be targeted in various directions, I would support the easing of the depreciation guidelines and I think a very large effort also has to be made to provide tax credits or some form of support which will increase the volume of research and development which is being done by American industry.

The CHAIRMAN. Mr. Ciminero, I think you indicated—well I have read your statement, and you didn't discuss anything in addition.

Mr. CIMINERO. Well, in terms of either additions or modifications, on the business tax cut side what we are really worried about here is business investment.

I think most of our studies have found that you get more bang per buck from an investment tax credit first, a reduction in profits tax rates, second, and perhaps very slightly below that in third place would be the accelerated depreciation proposal.

Some change in that mix might be appropriate. But, mainly having more of the tax cut going for a greater reduction on the corporate side.

The CHAIRMAN. Well, as you probably all know, there have been a number of views expressed by members on a number of things we would like to do in addition to those things suggested by the President.

It has been recommended we wait and have a second package, but we have to have some revenue along with that, some way to fund those things we would like to do.

That is the dilemma the committee faces. Either we take it off the individual side or we have certain "reforms." Some changes have been suggested, but not nearly in the magnitude we would think would be adequate to pay for the things—Federal estate and gift taxes, the marriage penalty or income earned abroad. I can think of 25 or 30 that are attractive and probably more that we haven't thought of.

Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman. Mr. Chairman, thank you for lining up these excellent witnesses. It has been very interesting to sit here and listen to the colloquy and I am happy to have all of you here.

Dr. Meiselman, Senator Chafee asked you some interesting questions about the Fed and you said that we in the Congress should do something about that. What should we do, put the United States back on a gold standard or take the Fed over? I feel a little bit helpless as a member of Congress.

What do you recommend I should do as a Senator? What would you do if you were sitting up here where Senator Chafee and I are?

Dr. MEISELMAN. Well, I think that it is very important that the Fed be held accountable for their actions. It seems to me, at the present time, that in many respects they are beyond accountability.

The Chairman of the Fed comes and testifies, and announces great intentions of doing better. He then goes back and does worse, with no penalty.

I think there ought to be a greater degree of accountability. I believe it would be very helpful if there were explicit guidelines from the Congress that would limit the ability of the Federal Reserve to flood the country with new paper money, not only for a short period of time, but over a longer period of time. I would favor strict limitations on the ability of the Federal Reserve to create too much money. So, I would favor a long-term monetary rule, not just a ceiling but also a floor.

Senator SYMMS. A bracket that they would have to stay within on——

Dr. MEISELMAN. That is right. Even if we would give them a couple of years to get there, we would get the rate of growth of money down and they would be required to achieve it.

On the basis of that, it seems to me you would give individuals, businessmen, and financial markets the kind of assurance that is needed to make long-term plans and to go out and do the lending that is necessary to make capital formation possible.

Now, there is no assurance that money growth will be slow and steady. If anything, Fed behavior has gotten worse, more erratic. The rate of growth of money keeps accelerating. Every season there is a new group of reasons things have changed, or why it is difficult to achieve slow, steady and predictable money growth. We now see some of the consequences of that.

The Federal Reserve is independent of the Executive, but the Federal Reserve is an agent of the Congress. The Federal Reserve reports to Congress and I don't think the Congress has done the proper job in carrying out the responsibility which belongs to the Congress under the Constitution.

Senator SYMMS. Thank you very much. That is excellent help, as far as I am concerned and I would like to talk to you more about this in the future.

Dr. MEISELMAN. I would be glad to do that, Senator.

Senator SYMMS. Off the record about it at sometime. I would just like to say that I am delighted to have you up here, but I hate to have you missing class today because I think the young people of the country need more of your kind of education.

Dr. MEISELMAN. I'm on leave this year.

Senator SYMMS. Now, Dr. Adams testified that he was not as enthusiastic about the 10-10-10 marginal rate reduction which I happen to favor. I personally think it ought to be for 6 years instead of for 3 years so we could have the long-term projections of what our tax policy is going to be and that would take care of Dr. Greenspan's indexing concerns and give us a chance to get back to a flat-rate income tax which I think would really be a stimulus to the economy and would generate growth in the future.

I think that if we just pass this thing this time for 3 years and then come back and do it again in 3 more years we would be getting close to the goals that we need to achieve.

My question to you, Dr. Adams, is why do you think it is better for Members of Congress to target areas where the money, where savings would be spent by giving a favor here, a favor there, or some incentive to put the money here and there. Why is it better to have the Members of Congress do that, than to have the individual Americans in the market do it and let them decide where to spend it? Don't you think that it isn't really on the margin that we are talking about? It isn't that $100 that the guy gets a month more money, but it is his overall income that counts?

Dr. ADAMS. Well, let me first say——

Senator SYMMS. I would like to hear all of you comment on that, if I could so try to be brief.

Dr. ADAMS. When I said targeted, I did not mean targeted in the sense that Members of Congress would target to particular——

Senator SYMMS. Well, if we give a break here or a break there instead of business tax or savings exemption, instead of just the straight 10-10-10 and let the people decide where the market is what I am saying.

Dr. ADAMS. Well, there are certain areas, for a good reason, where the market hasn't been very effective. Some of these areas have been areas where we have imposed burdens that are beyond the market. The areas of pollution control. Others have been areas where we meet foreign competition.

Senator SYMMS. Well, haven't those countries that have less market than we have, done a lot worse than we have? I mean to the degree that we have more freedom and more private property, than say the Soviets, we certainly outproduced them.

Dr. ADAMS. Well, that may be true. But, you see what has of course happened, has been that many countries have found ways to subsidize through cheap credit. I would primarily make my argument on the basis of bang for the buck.

I would, myself, strongly favor a program of indexing the income tax. The only reason I am not favoring it at this time is because I think given the kinds of problems that we have, we need to make the most with the limited flexibility that we have.

I doubt that doing that with a 10-10-10 program or with an indexing program imposed at this time, is going to give us the kind of bang for the buck that we are going to need.

Senator SYMMS. You are talking about a bang for the buck. Dr. Meiselman would you——

Dr. MEISELMAN. I am not sure what your question is.

Senator SYMMS. I guess I am out of time, Mr. Chairman. The question is why isn't it better for the market to determine where the money goes by giving people lower marginal tax rates than to try to have the Government, the politicians, the Congress, the Finance Committee or whoever target where those things would go——

Dr. MEISELMAN. But, it is better to let the individuals and the market determine. That is why I don't think there is any point to talking about subsidizing particular industries or particular end purposes. That is a road to disaster and waste.

Dr. GREENSPAN. I agree with that.

Senator SYMMS. In other words, do you disagree with my statement about 10-10-10 and then 10-10-10 more?

Dr. GREENSPAN. No, I don't. I would go further and I would say that rather than go 10-10-10 and then 10-10-10 that indexing the system will put that in place right away in a manner probably which would make a great deal of sense.

Senator SYMMS. Of course you see, my long-term goal would be to have one income tax rate that everybody paid on their gross income and not have all this complicated deal where we have to have CPA's and lawyers and complication. Then we would make judgments based on the value and let the market signal where we ought to be putting our money instead of having a tax shelter or something else.

Dr. MEISELMAN. Senator, would you permit the deductibility of savings so you have a pure consumption tax? That is what I would favor.

Senator SYMMS. Well, I wouldn't want to get into that today, but I just made a comment about that earlier. In the long run if we could ultimately reach that, then we could, in fact, have a system where the market could signal the producers when to produce more widgets or something else.

Right now, it is all distorted with inflation and we misuse the word inflation which I brought up yesterday. We call rising prices inflation and nobody knows what is going on.

It is like you said in your statement. I think Dr. Greenspan had it about the fact that there is a false profit out here because people think they are making profits that are only inflation or increasing of money and so forth.

Thank you very much, Mr. Chairman. I am sorry I expanded over my time.

The CHAIRMAN. Senator Danforth.

Senator DANFORTH. Thank you, Mr. Chairman.

Yesterday, when Secretary Regan testified he said that what the administration wanted was a tax bill which encourages work and savings and investment that the administration had seen nothing better than its proposal to accomplish those objectives, but that the administration would certainly be willing to listen to other options for accomplishing work savings and investment.

How do we proceed as the Finance Committee from this point? How do we develop a program, assuming that we agree with those objectives?

Let's assume that we all agree that we want a tax bill that maximizes work savings and investment. How do we put together such a program and how do we make the point with the administration other than just trotting out another theory?

How do you make the argument if you do have such a program? Is there some sort of agreement as to how we should proceed from here?

Dr. MEISELMAN. I think the administration's proposals are an admirable first step. I agree with my friend and colleague, Alan Greenspan, that, as admirable as it is, the proposals should be looked at largely as a way to index the tax system for some of what has happened in recent years.

Senator DANFORTH. I am not asking you for your views on a particular method at this point or for a particular proposal at this point.

If we agree with the administration that we want a tax cut that encourages work savings and investment, how do we develop one that gets the most bang for the buck in accomplishing that objective?

Do we just say to the administration well, we sign onto your proposal or do we say without the basis of anything other than our own judgment, no, we think that something for interest and dividends might be a better idea?

Is there a form of econometric model? Is there a method that we can use? Is there at least a basis for a rational argument? Alan.

Dr. GREENSPAN. I would start off by asking yourself, what is it that the President's tax program does for savings and investment and then start from that as a base. Then add and subtract as you see fit on the grounds that you disagree with them on the question of a standard which you are employing.

My own concern is——

Senator DANFORTH. I agree with their standards. Most of us do, so how do we judge whether or not it is the best method of accomplishing that objective?

Dr. GREENSPAN. Well, first of all, work, savings and investment are not in and of themselves, three different things. They really are what we would essentially call a basic supply side focus.

In other words, how does one free the productive mechanism so it can function. The first thing you would do is you avoid the rise in disincentives which is what a rise in the marginal real tax brackets would do if we left the tax statutes in place.

The next question: Does the President's program sufficiently curb the rise in real tax burdens? The answer is just barely, in the sense that it prevents further deterioration in these incentives which have been consistently dulled in the last decade by tax policy.

Senator DANFORTH. May I, again, just change the direction. I only have 7 minutes and what I want to ask is this. Can a series of proposals be quantified as to their effect on work savings and investment? That is, can economists measure the bang for the buck in determining of the relative efficacy of a series of tax proposals in encouraging work savings and investment?

Dr. **Greenspan**. I would say no, Senator. I would say no because what we can get——

Senator **Danforth**. So, there is no way of arguing with the administration?

Dr. **Greenspan**. Well, yes you can. You can argue on issues of degree. I think Senator Packwood was raising an issue earlier which I think is quite correct. Namely, he asked the question, "Do you in effect get increased work, savings, and investment by increasing the distribution of the tax cuts in to the higher income brackets?"

The answer to that question is yes. Can you very explicitly quantify it in useful numerical terms? I suspect not. I think that you will always get economists to give you numbers, but I wouldn't trust them.

Senator **Symms**. Could a panel of economists put together a proposal which in their judgment produces the most bang for the buck in accomplishing the objectives of work savings and investment?

Dr. **Greenspan**. I would suspect yes.

Senator **Symms**. Is it the view of this panel that the administration's proposal is the best alternative available for accomplishing this? Dr. Adams?

Dr. **Adams**. No, I don't believe so. I think that it is difficult to quantify these questions. I think they can be quantified. Indeed, some of them have been quantified and the evidence that I have seen doesn't strongly support that the administration's proposal gives you the most bang for the buck. I don't believe it does.

Senator **Symms**. You don't think it does. How about you Dr. Meiselman.

Dr. **Meiselman**. I am not sure what you mean by bang, but I think——

Senator **Symms**. From listening to you——

Dr. **Meiselman**. No, that is not a term I used. I think it is important that we reduce marginal tax rates to lessen the disincentive effects of taxes. Doing that directly, which is what the 10-10-10 proposal does, that is the most direct way to attack the desincentive problem.

As a consequence of reducing marginal tax rates, capital gains tax rates go down. This conforms to the view that the best tax reform is tax reduction.

As we have discussed, in many respects, the administration's package it is not even tax reduction. It is a rough way to index the tax system to get rid of a portion of past bracket creep. That is why I favor going farther than the administration's proposals.

Senator **Packwood**. Senator Danforth, your time is up. Let me pose you a premise. I don't want to play cat and mouse. I think that our tax system is tilted to heavily toward investment, taxing on investment and capital and not enough on consumption.

Alan, you indicate in your statement that our expenditure level is too high and our tax level is too high and that is a drag on the economy and yet every country in Europe that is our major trading competitor has infinitely higher taxes. I don't care if you take on taxes or expenditures in relation to their gross national product. Every one of them has higher savings rates, higher capital investment rates than we do.

I had the Library of Congress finish a study for me 3 days ago. Taking the major five different kinds of taxation, consumption tax on different amounts of income on $10,000 of income our consumption tax is $176. France's is $1,361. Germany's is $765. Italy's is $1,000. When you add that to the taxes on income and social security on $10,000 of income, ours is $987, France, $1,000, Germany, $2,000.

Basically, taxes on wage and social security are regressive taxes. You add that to the consumption tax which is a regressive tax and what you have in the European countries in an incredibly high tax on consumption.

When you come down to taxes on capital gains, taxes on interest income, taxes on dividends, the United States is worst on some, second worst on others, but consistently when you add it all together, we are the worst.

Dr. Meiselman, in your statement you made reference to Germany and Japan's incentives for savings. Indeed, they have them.

Interestingly in this report and I could not figure it out for a while, Japan taxes less than we do. They are at a 24-percent rate of taxation in relation to their gross national product as opposed to our about 32 percent. All the other countries are 39, 40, 42.

I finally figured out how Japan pays for the costs of the social services that the other countries pay for through government. They pay for them through business.

Japan's fringe benefit to wage dollar is about 67 percent. Ours is around 37 percent. They simply have business assume the costs of social services that governments provide normally elsewhere.

When you add that cost in, their total take, if you want to count it being run through business instead of through taxes, is infinitely higher than ours.

I want to ask you this partially because I do not think the Reagan tax program tilts in the right direction; 10-10-10 helps us on savings and investment only to the extent that it is a 10-percent cut at the 70-percent level and it is a 10-percent cut at the 14-percent level and indeed, that does tilt it a bit toward the upper income level.

But, we would get infinitely out of the same revenue loss if we tilted toward some kind of reduction in the 10-10-10 and a reduction in the capital gains tax and some kind of a savings incentive and maybe some consideration of a consumption tax.

That is the statement I would appreciate your comments on. Go ahead.

Dr. ADAMS. I would generally say there is a lot of merit to what you are saying. A consumption tax clearly is more targeted in the direction of stimulating savings then is the Reagan proposal.

I would like to see something like that combined with lower marginal tax rates on the investment. But, I would say there is a lot to be said for your statement.

Senator PACKWOOD. Dr. Meiselman.

Dr. **Meiselman.** I think it would be important to move to neutrality in the choice that people make between consumption and savings and the statistics that you allude to help to explain why we save so little relative to other countries.

Senator **Packwood.** Of course, they are not neutral. They tilt toward savings and investment.

Dr. **Meiselman.** Well, I am not sure they tilt or are closer to neutrality. We tax our saving more than they do and that is why we have less saving.

One way to move toward neutrality is to permit the deduction of saving before you calculate your income tax liability.

Senator **Packwood.** It may be semantics. That is hardly neutrality. That is tilting toward encouraging people to save.

Dr. **Meiselman.** Because otherwise under the present tax law——

Senator **Packwood.** I agree with that tilt, but I don't call it neutrality.

Dr. **Meiselman.** Well, under the present tax law if I consume a dollar or if I buy a washing machine or whatever, I pay a tax once which is when that dollar is first earned. After that, I pay no more tax. If I use the same dollar and I save whether I put it in the bank or buy a bond or whatever, that is taxed over and over and over again.

If you would premit the deductibility of that saving initially, then you would help to remove the bias against saving and investment. That would be a useful step in that direction. That is why I responded to Senator Symms the way I did.

I think at the present time, tax reduction as proposed by the administration, lowering tax rates is a partial step in that direction.

Senator **Packwood.** Alan?

Dr. **Greenspan.** In general, I would agree with you, Senator. I think that we must, however, recognize that the existing set of proposals merely hold the real tax bracket rates roughly where they are so that to start at that point, is sensible. Recognizing that if you have a lower reduction than that, you are acquiescing in some real marginal increases at many points of the tax structure.

I am not saying that it is necessarily a disaster, but I think it is important to recognize that.

In principle, I would certainly support a shift from taxes on marginal incomes to consumption. The only concern I have is that we may get the second and not the first if it becomes an issue which is acceptable in principle.

Aside from that, I would say that I would certainly agree with the general thrust of your remarks.

Senator **Packwood.** Mr. Ciminero?

Mr. **Ciminero.** I would generally agree. I guess it is a well-known phenomenon that a VAT—value-added tax—or consumption tax would have an intrinsically higher saving aspect to it than an equivalent amount of income or profit tax.

I would also add, however, that lower income tax brackets also save so there are supply of funds to be garnered there. Not so much from the fact that they put money in the bank, but from the fact that if you leave the tax situation go the way it is going, these lower bracket taxpayers are going to experience large tax increase, especially FICA, which could cause them to borrow more.

What this tax cut proposal would allow them to do is not draw down their savings, or would reduce the amount of borrowing they would have to do, in the face of the real tax increases that will occur if there is no rate cut.

Senator PACKWOOD. All I am saying in terms of the figures is that on the average Europe taxes about 10 percent more of their gross national product then we do and they save more and they invest more. There has to be an answer to how they do it.

Russell?

Senator LONG. I honestly think that this panel would be providing a service to the country if you would give answers to the questions.

What Senator Danforth is saying with something like this is to understand it. If you were the person writing that tax bill—I am not talking politics—could you say what that bill was going to be when it became law?

Looking at a bill that is tossed out with $53 billion of revenue loss for the first full year—it cost us $200 billion 5 years from now. If you were writing that bill knowing the potential we have to shave some of it off and put into something—that might claim a priority, would you write that bill precisely the way it is or would you include in it those items each of you think—the one that he would make it, the first add-on in terms of priority.

Now, Dr. Adams has already answered that question. I would like for each one of you to just answer the question. You can answer it yes or no, but you have indicated what you think your priority would be.

Dr. Meiselman, what would you answer on that basis?

Dr. MEISELMAN. I think in addition to the 10-10-10 I would favor elimination of capital gains taxes and lacking that, at least, permitting rollovers and serious consideration of either sharp reductions in or eliminating punitive taxes on estates and gifts.

Senator LONG. Dr. Greenspan?

Dr. GREENSPAN. Well, considering the fact that we have some limits on the amount of revenue losses, I presume you are saying in the context of those so-called static revenue losses.

I would support the 10-10-10. I would support, as I said before, elimination of the concept of unearned income which I don't think affects revenues at all.

I also would support a reduction, if not the elimination of the capital gains tax rate, which again, in my judgment, has no revenue implications.

I would like to, down the road, eliminate estate and gift taxes and a variety of other things, but not in the context of current revenue restrictions.

I probably would personally shift some of the accelerated appreciation money into a reduction of the corporate rate structure. But, I am also aware of the fact that any of these bills is a good bill and I am concerned that if there are too many individual versions of it, we may end up with none. So, granted that, I have and I do continue to support precisely what the President is advocating.

Mr. CIMINERO. I would support the 10-10-10 because it in part, answers the agenda of the fact that tax revenues as a percentage of GNP will just continue growing and probably should be reduced.

Probably 10-10-10 would probably over index slightly, at least initially. I think that is a fine way of proceeding with the tax cut in that it reduces each marginal bracket with the attendent effects that we pointed out.

On the corporate tax cut side, I would also see if some of those revenues could not be used for a rate reduction versus the accelerated depreciation and reduction in lifetime bases.

Senator LONG. Let me just say this. I have spoken to groups, business people who have supported the President and still support him, who are asking us to go along with the President's program.

When you just put this to them, not as a matter of whether you are for or against what President Reagan is for, just ask whether they favor it. If you tell them, I personally think that we ought to get rid of that 70-percent tax on investment income and my only difference of opinion with the President's is that I think it ought to go now.

I also think that the capital gains tax is too high and I think at a minimum to reduce it so the tax is only 30 percent of the gain rather than 70 percent. They would feel the same way about it. They are talking about the roll over that Dr. Meiselman mentioned.

I think that ought to be done and I think that rather than cutting the capital gains tax over a 3-year period, we ought to do it now.

My impression is that they just about want to tear the rafters down cheering for it. Those are the people who are strongest for programs.

The fact is that there is a lot of politics in this and while it may not be the most popular thing we can do politically, in my judgment, the best thing that we can do for the country is to put in this bill however we have to put it.

These two items that you gentlemen, at least most of you, have mentioned. One, we ought to stop the discriminations against invested income which means that you would drop to a 50-percent top rate on that just like we did earned income——

Two, we ought to do more about capital gains that the bill provides. But, I don't think it could be in there.

Now, let me tell you what I think is going to happen. This is not going to be a static ballgame. The players are going to move around on the field and it is not going to be 10 10 10 and 10 5 3 and that's all. It is going to be a variance with that.

When we go to put Humpty Dumpty back together again over here, we are going to put some other things in that you gentlemen have been talking about.

You write that down and see if it doesn't work out that way.

Senator PACKWOOD. Senator Danforth.

Senator DANFORTH. In 1981, the Federal revenues from the capital gains tax were $14 billion, from taxes on interest received $27 billion, taxes on dividends received $10 billion. Total tax from capital gains, interest, and dividends $51 billion. The President's program cost in 1982 $51 billion. Now then, let's just suppose and I am not proposing this, I am just talking. But let's suppose that we decided that instead of the President's program, we wanted a program which would repeal the capital gains tax and have no tax on interest received or dividends received. No tax on it. What would that do for the economy? Would that be bang for the buck?

Dr. **Greenspan.** Yes. If you're talking about the types of issues which relate to the specific impact on capital investment and economic growth there is question that if you very significantly reduced or at the extreme, eliminated all those taxes, it would be highly favorable.

However, let's remember that taxes on interest and dividends, reflect a peculiar calculation which is not independent of the way the tax rate bracket structure is set up.

I would be more inclined to bring the whole marginal tax bracket structure down for much the same reasons that I would tend to bring it down in the corporate area.

When we think of property incomes in terms of dividends or interest there is a tendency to forget that there is a lot of other property incomes around which you don't designate directly in that manner. A large segment of unincorporated business and farm income and a substantial part of the earned income part of our system is really property income.

In other words, bonuses, incentive payments, and a variety of other things which we tax as earned income is in effect, from an economist's point of view, property income. There is no question in my mind that if you reduced all those taxes to zero it would be very positive.

I am not sure that is appropriate tax policy because it defines property income which you want to reduce in a fairly narrow sense.

Senator **Danforth.** Anybody else——

Dr. **Meiselman.** I think that if we went along with that as much as it seems very appealing at first, we would still be left with an increase in marginal tax rates on labor income. We would not touch rental income and other kinds of property income which would be left permanently higher.

Also, if we are thinking about tax reduction we also ought to consider the positive effects of a cut in the corporate tax.

Mr. **Ciminero.** I would agree. Capital type income and capital income incentives are very important, but an important element here is labor productivity, willingness to work, willingness not to be on welfare.

Insofar as you allow these tax rates to go up through bracket creep, approximately I guess taxes go up about 16 or 17 percent if inflation is about 10 and gets translated into wages at 10 percent. If you allow this to happen you are merely increasing the gap that one must leap to go from nonworking to working, for example, and that is then true across the entire schedule of rewards for working harder among the working population.

Senator **Danforth.** I want to make it clear I am not proposing this. I just received the figures and what I wanted to point out is if we have a major tax cut now and we are trying do something useful for the economy the problem is that at the end of 3 or 4 years, we are really going to be right back where we are now as far as the effective tax rate is concerned.

If you go out 3, 4, or 5 years, you are going to be just about where they are right now as far as percentage of their income that is going to be taxed away.

We are making a mighty effort to stay in place and maybe we should be thinking about something that would be just terribly exciting which is aimed specifically at getting interest rates down, making money available for the construction industry, and for the automobile industry, and so on, which this kind of thing would do.

Do you have any comments, Dr. Adams?

Dr. ADAMS. Well, since I have been pushing hard on bang for the buck——

Senator PACKWOOD. In fact, could I interrupt just a second, Jack?

Dr. ADAMS [continuing]. To make my point. But, I think there are other considerations.

Senator PACKWOOD. Could I stop you just a second, Jack? I have to go at 1. If you will close this, I simply want to announce the 2 o'clock witnesses.

Dr. Martin Feldstein, Dr. Joseph Pechman, and Dr. Oswald Brownlee at 2 and if when they are done, Jack, you would close, I would appreciate it.

Dr. ADAMS. There are other considerations besides bang for the buck. As no doubt, you have in the back of your mind when you're saying that you are not advocating this.

Senator DANFORTH. Politically, I just couldn't do it, I don't think. But, it is just an example of something which would be very, very dramatic. Just from the standpoint of the economy, wouldn't it be a very, very useful thing?

Dr. ADAMS. It would be a line to go, I'm not sure that it's a line acceptable in terms of its impact on income distribution. After all, you can get all the investment if you pour all the money on the upper end of the income distribution and none to the bottom. Clearly, you don't want to have to take that it into account.

Senator DANFORTH. Senator Long.

Senator LONG. I just want to thank you——

Senator DANFORTH. Thank you, gentlemen.

[Whereupon hearing recessed until 2 p.m.]

[The statements of the preceding panel follow:]

EXCERPTS FROM THE TESTIMONY OF ALAN GREENSPAN[1]

If our individual income tax system were currently indexed as it is in Canada, would we, at this point, be advocating an increase in tax rates? Or put another way, would we be arguing for a suspension of the annual inflation adjustment to tax brackets? I suspect that the answer is no, which is another way of saying that we would, at this particular point, be acquiescing in an automatic change in tax brackets. But this would not be significantly different from the President's proposed three-year cut of 10 percent each year in tax brackets. Perhaps the argument is that, were we indexing our system, we might allow the bracket adjustment to occur this year but would retain the ability to review it next year and the year after. There is, however, no reason why, should the President's tax program be put in place, the Congress could not alter the tax structure a year or two hence if it thought that such policy was required.

Moreover, to delay the scheduled cuts in tax brackets is to increase the real tax burden. In fact, the whole discussion of the President's individual cut package at this stage resolves down to the question of whether the Congress, by failing to

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[1] Dr. Greenspan is president of Townsend-Greenspan & Co., Inc.

adjust tax rates to offset bracket creep, favors a rise in the real tax burden. The debate on taxes, however, is at root a debate on spending cuts. There is a broad political consensus in this country that the deficit must be eliminated. Hence the larger the tax receipts, the less the pressure on curbing spending growth And it is control of spending which is the key to the revival of economic vitality in this country. The issue isn't taxes; it's expenditures. It is clear, certainly in retrospect, that our budgets have been over indexed with respect to both unemployment and inflation; we have been overly generous in our entitlement programs and have committed future tax revenues which we will never have. Over the years we have put in place a set of entitlements which have engendered a rate of growth in federal outlays which exceeds the rate of growth in our tax base. Unless altered, such an imbalance must inevitably lead to an ever widening deficit and an eventual inflationary breakdown. Temporarily the deficit can be held in check by increasing real tax rates. But eventually even that fails because we will finally arrive at a level of taxation beyond which the economy deteriorates and further federal revenue increases are unavailable. So tax increases merely delay the inevitable.

President Reagan has addressed the issue of excessive budgetary growth with an unprecedented program of reduction in budget authorities and outlays. But even this program must be viewed as the first stage of a budget revision process. A second stage will be required to reduce the underlying outlay growth rate to a level capable of being financed over the long run.

The markets seem to be saying that the actions taken to date on outlays are inadequate. Despite the increasing probability over the past several months that the President's current expenditure cut proposals would prevail, long-term interest rates have continued to edge higher. This in all likelihood reflects further upward revisions of the average expected inflation rate over the next ten to twenty years. It does not seem credible that the rise in the rate of expected inflation can be attributed to market concern that the President's tax program will be inflationary. If anything, the probability of the enactment of a three-year 10 percent annual cut in rates has, regrettably, receded in recent months. While the movement in short-term rates can be attributed, at least in part, to Federal Reserve actions, and some spillover effect to the long end of the market can be presumed, the overall upward drift in inflation premiums appears to require further explanation.

The issue narrows to a belief on the part of the financial markets that either 1) the President's budget cuts in the end will not prevail, despite recent political progress, or 2) the cuts would not be sufficient even if the President should get all, or at least most, of his requests. On the first point, concern about the outcome surely had to be greater six months ago than today. Whatever the probabilities of success, they clearly are higher today than six months ago. One would have therefore expected at least some anticipatory market behavior. One must conclude that, rightly or wrongly, the markets do not trust the Reagan budget cuts to do the job of curbing inflation.

The root of the fear seems to have been focusing on the administration's presumed disinclination to address the so-called safety net, consisting largely of social security retirement benefits. These have been substantially exempted from this round of budget paring. Almost all of the programmed reduction in outlays comes from little more than a fourth of the ~~total budget,~~ i.e., what remains after defense, interest and the safety net. The requested outlays for the nonexempt programs falls from $193 billion in fiscal 1981 to $142 billion in fiscal 1984. This would slow the rate of growth of aggregate budget expenditures over the next three years to less than 6 percent annually, according to O.M.B. However, this is a one-shot adjustment process. Unless the underlying upward momentum of safety not programs is reduced, the rate of growth in federal outlays would begin to accelerate again. Thus, if there is no follow-up addressing the post-1984 expenditure growth levels, the President's current program would do little more than put a temporary tourniquet on our fiscal hemorrhaging.

Since inflation premiums embodied in long-term interest rates are reflecting average inflation rate expectations over, say, the full decade, they are assuming that no further actions are contemplated by the Reagan administration to restore fiscal balance. This is almost surely not the case since the President has indicated that he will do whatever is in his power to get the budget under control and to restore fiscal balance. Therefore, it is probably a mistake on the part of the financial community to assume that the President's program encompasses only the measures currently under consideration by the Congress. His initiatives on social security this week may be a harbinger of significant further initiatives. There is of course no certainty that presidential initiatives in the future will be successful.

For the moment, the difficulty confronting the administration is that continued advances in interest rates, by creating severe secondary financial problems for the thrift institutions and elsewhere, could divert the longer-term thrust of economic policy if the need to resolve short-term economic crises becomes pressing. The problem with short-term economic crises is that their solution too often creates the next problem.

The current budget has to be only stage one of a much longer process to undercut inflationary forces. At some point, the markets should recognize the ongoing efforts of the administration, the Congress and the Fed. At that point, interest rates should begin to decline on a sustained basis.

Even though inflation rates do not come down immediately (and I do not expect that they will), lower interest rates will generate a higher level of economic activity almost immediately in residential building, and with some lag, in plant and equipment appropriations and outlays. The moderately higher levels of economic growth which would occur as a consequence would tend to improve productivity and lower the rate of increase in unit labor costs. The latter, at least in small part, should tend to ease some of the inflationary pressures.

However, I do not expect the inflation rate to undergo a major retrenchment until actual federal borrowing, both direct and indirect, is brought down. I include not only the on-budget deficit financing, which the President is projecting at zero by fiscal 1984, but also the substantial off-budget borrowing, credit guarantees, and the indeterminate, but large, amount of private borrowing resulting from government regulation. The prospect of lower levels of borrowing as a percent of ongoing savings should be enough to bring inflation premiums down, and with them, interest rates. However, until aggregate federal credit preemption declines, and that decline is supported by a continuous reduction in the rate of growth of bank credit and the monetary aggregates, I do not envisage a significant reduction in the rate of inflation. But when inflation begins to fall, risk premiums, which are heavily affected by actual inflation, will decline and with it, what economists call the hurdle rate of return on capital investment. (The hurdle rate is that of return which a business sets as a minimum for acceptance of a proposed capital investment project.) Obviously, the lower the hurdle rate, the greater the block of potential investments which are likely to be authorized.

I should point out that in displacing federal borrowing with private borrowing to finance the increased private expenditures, we are not merely shuffling paper. Federally sponsored credit tends to be forthcoming almost independently of market interest rates, whereas private credit demands are far more interest rate sensitive. Thus, aggregate borrowing for private capital projects would be more consistent with lower interest rates than would be the case for equal amounts of federally sponsored borrowing.

Unless interest rates are brought down within the next six months to a year, our financial system, and hence, our economy, faces unacceptable dangers. The current period is unique in American history. We have never had inflation premiums of such a magnitude embedded in long-term interest rates.

The questions we have to ask ourselves are (1) how did interest rates become so high, and (2) what must be done to bring them down. Prior to 1979, inflation premiums embodied in long-term interest rates reflected the notion that the American economy was, by its institutional nature, insulated from inflation. While inflation periodically surfaced, until very recently it was always presumed that it was a phenomenon associated with war or its immediate aftermath. In fact, the price level in 1940 was actually a shade lower than in 1800. After brief episodes immediately following World War II and the Korean War, inflation came down and had virtually disappeared by the early 1960's. Price controls were imposed by President Nixon in mid-1971 when inflation was presumably raging at the intolerable rate of 5 percent. U.S. Treasury issues never exceeded a yield of 9 percent until 1979, and prior to the late 1960's, rarely exceeded 5 percent. Since the real riskless rate of interest fluctuates between 2½ percent and 3 percent, the inflation premium in long-term interest rates averaged 4 percent or less even during the periods when inflation temporarily spurted in the mid-1970's. The markets were in effect saying that the average expected inflation rate over the full ten-year maturity of a noncallable U.S. Treasury bond was approximately 4 percent. Since the presumed expectation of of inflation near-term was well in excess of that 4 percent, the implicit long-term inflation rate in the latter part of the maturity was well under 4 percent. In short, until relatively recently, the markets have always been saying that despite whatever short-term inflation expectations hovered in front of us, over the longer-term one could presume that inflation would disappear.

That point of view began to change in 1977 when, after a prolonged reduction in the rate of inflation from the fall of 1974 to early 1977, the decline seemed to have stalled out and, in fact, inflation showed evidence of beginning to creep back up again. The benevolent view that the U.S. was essentially insulated from long-term inflationary pressures finally came to an end with the publication of President Carter's budget in January 1980 (which he was forced to withdraw for a new budget shortly thereafter). The markets reacted to what appeared to be conclusive evidence that spending was out of control and that the U.S. henceforth would become inflation-prone as a consequence. With relatively minor changes in inflation projections and unemployment, the fiscal 1984 outlay estimate made in January 1980 was $165 billion above that made in January 1979. All in all, the average yields on ten-year maturities of U.S. Treasury bonds rose nearly 440 basis points between mid-1979 and late February 1980. Almost all, if not all, of this rise reflected a revision in the implicit long-term inflation forecast. Compounded over a ten-year period, the upward revision of the projected 1990 price level amounted to approximately 50 percent.

While inflation premiums have risen and fallen during the past year, they have continued to reflect an expected average inflation of nearly 10 percent for the next decade, a forecast which, if not significantly lowered, suggests very perilous times ahead for the American economy. It is important to recognize that while a psychological statistic, it is a real number based on rational perceptions. This inflation premium will not disappear as a consequence of eloquent utterances of optimism by the administration or of pledges of lowered money supply targets by the Federal Reserve. The markets are skeptical and deservedly so, and will react, in my judgment, only to hard evidence that federal expenditure and credit growth will slow. Promises are worth little. However, changes in legislation which significantly alter the implied proportion of federal borrowing (on-budget and off) to aggregate savings almost surely will alter the long-term inflation outlook and, by definition, reduce inflation premiums markedly for long-term bonds. This in turn will almost surely result in heavy refunding of short-term liabilities, thereby bringing short-term interest rates down as well.

STATEMENT BY DAVID I. MEISELMAN, PROFESSOR OF ECONOMICS AND DIRECTOR, GRADUATE ECONOMICS PROGRAM IN NORTHERN VIRGINIA, VIRGINIA POLYTECHNIC INSTITUTE AND STATE UNIVERSITY

Many years of unhappy and worsening experiences with the combined effects of inflation and the present Federal tax code have taught all of us about bracket creep and about how inflation both (1) magnifies the bias of Federal tax code against saving, investment and economic growth and (2) imposes a wide range of unlegislated taxes on private capital. Ever higher and more burdensome tax rates and the absence of economic growth, even during periods of high-level employment, have contributed to widespread consensus that taxes are too high, and that a stagnant private sector cannot, or should not, carry the ever heavier burdens of supporting the mounting costs of an ever expanding public sector. More and more taxpayers have come to believe that they are not getting their money's worth from government. They want lower taxes and less government.

However, the enthusiasm of some of our citizens for tax reduction is tempered by concern that tax reduction will be inflationary and increase interest rates. Both sets of fears are groundless. In fact, high tax rates are an important factor in the record low saving rate and record high interest rates. This is why a program of assured long-term tax reduction, especially whem combined with expediture reduction and slow and steady money growth would make an important contribution to lowering rates and to improving the conditions of many of our beleagured financial institutions. Charges that the Administration's four point program of tax reduction, expenditure reduction, deregulation and slow and steady money growth will lead to more inflation and higher interest rates are simply wrong. Moreover, those who claim that recent sharp increases in interest rates reflect a vote of no confidence in the Administration's program by financial markets are incorrect because they have the wrong culprit.

In my judgment, the recent collapse of the bond market was the direct consequence of poor execution of monetary policy by the Federal Reserve. Interest rates have soared because of excessively rapid growth of money in March and April which greatly exceeded the Fed's targets, mounting fears that the Federal Reserve is unwilling or unable to meet its own targets for money growth, and concern that the Fed's own targets are too high to slow inflation significantly, if at all. I believe that the market's lack of confidence that Fed performance would be consistent with the Administration's prudent call for slow, steady and predictable growth of money and widespread understanding that rapid, unstable and unpredictable money growth could easily overturn the beneficial effects of the Administration's program of tax and expenditure reduction and deregulation have been the major factors in the run-up of interest rates.

Bond prices generally fall whenever the money supply increases sharply. Rapid money growth leads to more inflation, and interest rates rise to discount the consequences of inflationary monetary actions just as soon as such inflationary monetary expansions are recognized. In the first four weeks of April, money grew at an annual rate that exceeded twenty percent and the Fed had already exceeded its target for the entire second quarter of this year. Little wonder interest rates rose.

There is important evidence in the events of recent weeks that makes the point very clearly. Note that interest rates shot up after it became increasingly likely that the House would support even larger budget cuts than the Administration proposed and after there was a marked reduction in the deficit and in net new Treasury issues. Surely, more budget reductions and a smaller deficit could not drive up interest rates. Also, news of further slowing of inflation in newly reported data on consumer prices, producer prices, and the G.N.P. deflator would certainly not push up rates, either. What remains to explain the increase in rates is recent Federal Reserve performance and the market's lack of conviction that Fed performance in the future would improve significantly.

There are many related threads in the connections between tax reduction and inflation, and tax reduction and financial markets. Some of these connections are among the most misunderstood in current publc policy discussion, including views of some prominent financial writers. Most of what we hear and read about the presumed connections between tax rates and the effects of rate reductions on inflation and on interest rates is simply wrong. Some of the flawed analysis stems from applying an invalid Keynesian theory which overlooks both the central role of monetary policy in the inflation drama as well as the impact of taxes on output, on saving, and on lending.

The Flow-of-Funds analysis used by some analysts in the financial and banking community to forecast interest rates may appear to simulate the suply and demand for funds, but it does not. The Flow-of-Funds analysis is flawed because it misses important elements in borrowing and lending decisions because it essentially ignores inflation and inflation expectations and the portfolio, or balance sheet, adjustments which are major factors shaping financial markets, interest rates and securities prices.

Inflation takes place when prices on average rise. Following the laws of supply and demand, inflation occurs when aggregate demand exceeds aggregate supply. Aggregate demand is controlled by the quantity of money, which is controlled by the Federal Reserve. There is a close and dependable connection between the nominal quantity of money and the nominal gross national product, which is the best measure of total spending, or demand.

Aggregate supply, or output, depends on other factors, such as available inputs of labor, capital and raw materials, and the state of technology. Output also depends crucially on incentives to put these means to efficient use. Output also depends on increasing available inputs, such as capital, or improving technology.

Prices, then, depend on the ratio of money to output. When money grows faster than output, aggregate demand exceeds aggregate supply. Prices rise. Inflation results. When money and output grow at the same pace, demand and supply remain in balance, and prices on averae are stable. The relationship between money per unit of output and inflation may well be the most extensively tested proposition in all of economics with few, if any, exceptions.

To see this relationship for recent years in the United States, turn to Chart 1, which shows the level of prices (the G.N.P. deflator) and the relationship of prices (1972 = 100) to the ratio of money to output (real G.N.P. in 1972 dollars). I use the old M_2 measure of money, which, unfortunately, has not been published by the Federal Reserve for the past year. Thus, the chart, which covers the period since 1960, ends in 1979.

The chart shows clearly that both money and output affect prices. The relationship between prices and the ratio of money to output is very close, indeed. As usual, prices depend on both demand and supply.

Thus, to analyze the impact of some public policy proposal, such as tax reduction, on inflation one must ask how the proposed change will affect either (1) the stock of money, and thereby demand, or (2) output. Ignoring either the monetary or the output consequences of a proposal means that we are likely to be in serious error.

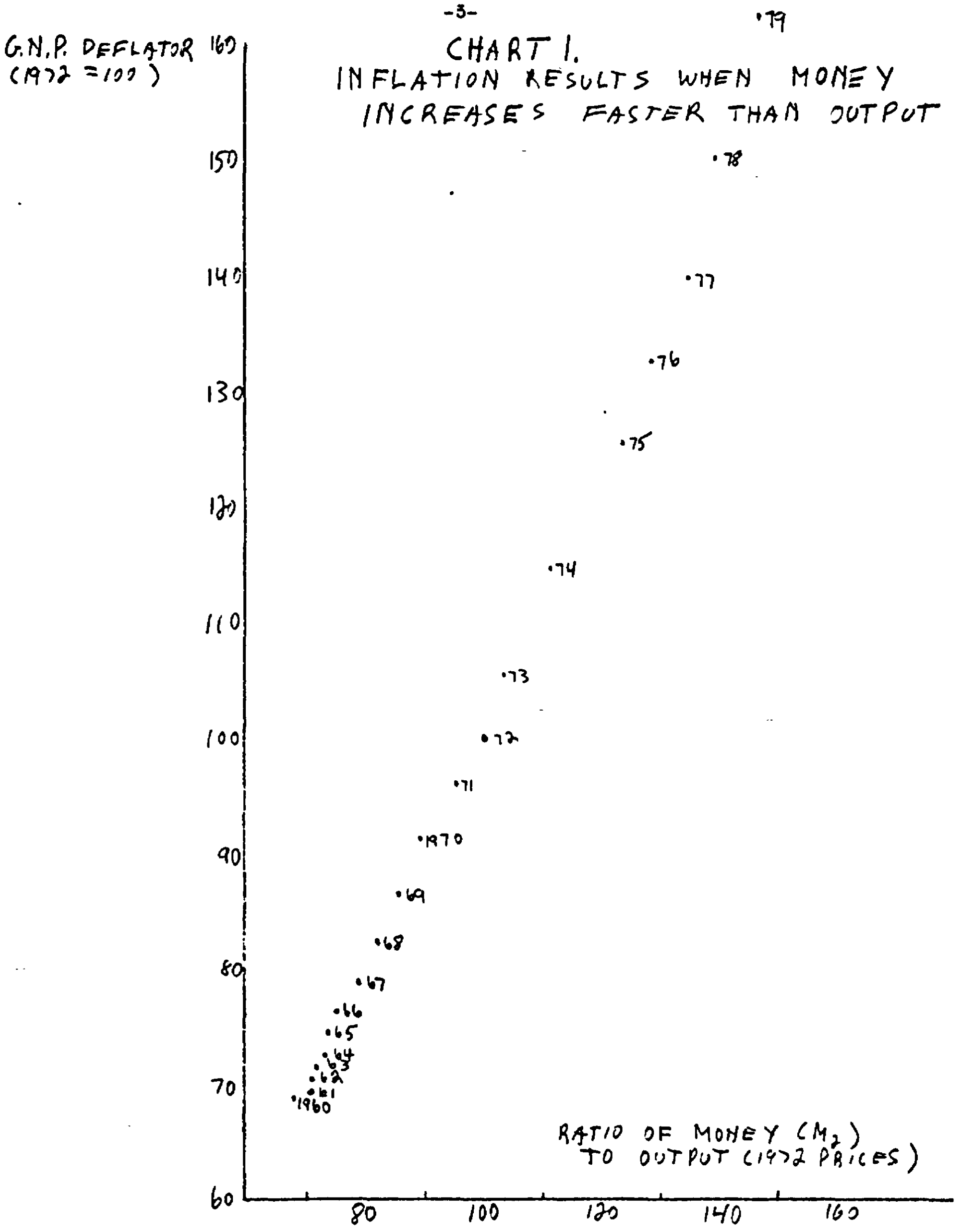

CHART I.
INFLATION RESULTS WHEN MONEY INCREASES FASTER THAN OUTPUT

Let me first deal with output, the supply side of the central relationship explaining inflation. Changes in tax rates, or other provisions of the tax code, will affect inflation if these changes alter output. Tax increases that penalize saving and investment or discourage work result in lower output and thereby in higher prices. It makes no difference whether such tax increases are explicitly legislated or increase because inflation (1) causes bracket creep, (2) creates illusory capital gains subject to tax, (3) causes businesses to pay taxes on fictitious profits that result from the requirements of mandated historic cost accounting, or (4) taxes the inflation premium component of interest receipts as ordinary income rather than as a return of capital.

Because different tax changes may have different impacts on output, one should not lump together all tax increases or decreases. Instead, careful analysis of the effects of proposed taxes on output is essential. (In the past, and to this day, most analysis, including analysis of the Congressional Budget Office, is flawed because it focuses on presumed aggregate demand effects and largely ignores supply.)

Tax rate reductions that lessen the disincentive effects of the tax system will cause output to increase. For a given stock of money, more output results in lower prices. Thus, supply enhancing tax cuts lead to lower prices. In turn, lower prices lead to lower market interest rates. In addition, tax rate reductions that lessen the tax bias against saving will cause interest rates to fall directly.

For example, consider some of what follows from adoption of faster depreciation. Initially, some businesses may pay less tax to the Federal government. Business cash flow rises, and before anything else takes place, Treasury receipts fall. Treasury borrowings rise, but these are fully offset by reduced business borrowing. Interest rates stay the same.

But, because profitability and the rate of return on capital have increased, there is now more incentive for capital formation. Business will invest more and produce more. Increased output will make prices lower than they would otherwise be. The inflation premium component of market interest rates will decline, causing interest rates to fall.

The increased post-tax rate of return on business investment resulting from more rapid depreciation will lead to an increase in real, or inflation-adjusted, interest rates. Because the inflation premium is by far the major factor in current record-high interest rates, it is likely that market rates would end up lower and real rates would end up higher as a result of the faster capital recovery provisions.

Increased output and increased real income will provide some of the saving to finance the capital expansion. In addition, higher after-tax returns will also induce more saving, especially saving channeled to financial markets. Increased after-tax returns will also draw resources out of tax shelters and into financial investments, further lowering market interest rates.

Consider another way the combined effects of inflation plus the present system of taxing interest receipts as ordinary income drives up interest rates and reduces saving. It is now widely understood that market (or nominal) interest rates include an inflation premium in addition to the real rate of interest. On this view, if interest rates are five percent when prices are stable and no inflation is anticipated, rates will rise to fifteen percent if the market expects ten percent inflation. The fifteen percent interest rate is seen as keeping both the borrowers and lenders in the same real situation. Real interest rates remain at five percent. The ten percent increase in rates compensates lenders for the loss in the real value of their principal. Real interest costs to borrowers remain the same. So far, so good.

However, there is a serious deficiency in this analysis, especially in interpreting current financial developments.

The problem is that there are no taxes in this analysis. Including tax considerations changes what happens in several very important ways. The main reason is that the inflation premium in interest rates is taxed as ordinary income even though it may merely reflect a return of capital adjusted to offset the loss of principal.[1]

If interest rates merely keep pace with inflation, real costs to borrowers may remain the same, but after-tax returns to lenders will fall. The difference is the tax paid to government, which is effectively an unlegislated capital levy and a wedge

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[1] A small fraction of the inflation premium compensates for the loss in the real value of the coupon (or interest payment). Following Irving Fisher, the nominal rate of interest equals (1) the real rate plus (2) the expected rate of change of prices plus the product of the two, all interest rates expressed in decimal terms (5 percent=0.05). I ignore this interaction term in this statement.

between the cost to borrowers and the return to lenders.[2] For example, consider an individual in a forty percent marginal tax bracket in an inflation-free world when interest rates are five percent. His after-tax rate of return is three percent. In a world of ten percent inflation and anticipations of ten percent inflation, consider what would happen if interest rates would rise to fifteen percent to keep real rates at five percent. Real interest cost to borrowers remains at five percent. But, for the lender in a forty percent bracket, his fifteen percent nominal pre-tax yield becomes a nine percent after-tax nominal yield. With inflation at ten percent, the lender's after-tax real yield becomes minus one percent.

The decline from a positive three percent after-tax real yield to a negative one percent real yield will induce lenders to save less. Reduced saving means that real interest rates end up higher, as some of the tax is shifted to borrowers. If bracket creep, or higher marginal tax rates on interest earnings, drives lenders into higher marginal tax brackets, these effects will be even more pronounced.

How far must rates rise to compensate lenders for the combined effects of inflation and higher taxes? Rates must increase enough both to pay the increased tax bill and to maintain the real value of the after-tax return.

For example, assuming no bracket creep, it turns out that market interest rates must rise to 21.67 percent in order for the lender to retain the three percent after-tax return he would have under stable prices and a five percent market rate. In other words, a ten percent inflation must be accompanied by a nominal interest rate of 21.67 percent and a real interest rate of 11.67 percent (not the former five percent) to preserve the saving incentives of the individual in the forty percent marginal income tax bracket.

These mechanisms help to explain why the savings rate is so low, and falling, and why, after a lag, interest rates have increased more than inflation, why real interest costs to borrowers are so high at the same time that after-tax returns to lenders are so low.

This analysis shows how reducing marginal tax rates is a direct way to increase after-tax returns on saving, and thereby to increase the saving rate. The damping effect of higher saving on interest rates will be more pronounced as tax cuts are accompanied by expenditure cuts.

At the present time, the post-tax return on saving for many, if not most, of us is negative. Little wonder we save and invest so little and why most families have abandoned financial markets for rug dealers and diamond merchants to provide for their futures or to protest capital. Lower nominal interest rates and higher post-tax real rates would not only involve more saving, but more saving would be channeled into financial markets and thereby to private capital formation. This is also the prescription for battered financial markets, and for so many of our endangered financial institutions. This is also why I support tax reduction on personal as well as business income and assets.

I may add that the combined effects of inflation and the Federal tax system also increases the demand for borrowing, thereby strengthening rather than moderating or offsetting the impact on interest rates of reduced saving. Interest costs are generally fully deductible. If borrowed funds are used to acquire assets whose value keep pace with inflation, fictitious capital gains are taxed at generally lower capital gains rates. Interest costs are expensed and deducted as incurred, but inflation-caused "gain" can be deferred until the sale of the assets, effectively reducing the tax rate on the "gain". Thus, reducing marginal income tax rates would reduce the relative attractiveness of debt financing.

The invalid Keynesian theory predicts the exact opposite effects. Essentially ignoring the supply and output consequences of tax change or changes in the quantity of money, it links tax cuts to increased aggregate demand, and theregby higher, not lower, prices. Despite the seeming plausibility of these Keynesian assertions, and widespread belief in their validity, there is essentially no evidence to support these assertions, especially when the effects of money and output are taken into account.

In addition, the invalid Keynesian theory also forecasts higher interest rates as the consequence of any economic expansion. Ignoring the central role of inflation anticipations or after-tax rates of return, Keynesians associate expansion of output and employment with increased demands for cash or for borrowing, and thereby with higher interest rates. As Keynesians see it, to keep interest rates from rising in the face of improved real economic conditions, the Fed must increase the supply

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[2] Wage rates that are indexed also have the same problem. The real value of wages that rise with the inflation rate may remain constant before tax, but the indexed portion of the wage may not fully adjust for inflation both because it is taxed and because of bracket creep. Again, government imposes a wedge between the labor cost of employers and labor income of employees.

of money to "accommodate" the expansion. Otherwise, rising interest rates will choke off the expansion. Keynesians, and many central bankers, slow, or loathe, to learn that increasing money causes rates to end up higher rather than lower, are still puzzled at what they perceive to be the apparent irrationality of bond markets in responding negatively to high rates of money growth intended to lower, not raise, rates, accommodate, not constrain expansion.

According to the Keynesian view, the only way for interest rates to fall without resort to the Fed printing press is to have a depressed economy, which, in turn, is seen as reducing demands for money and credit. Keynesians see high tax rates as a dependable and effective way to curb demand and slow the economy. This is one reason Keynesians who wish to fight inflation or to achieve lower interest rates support high tax rates In turn, with a depressed economy caused by tight fiscal policy, they believe the Fed can pursue an easy monetary policy, resulting in still lower rates. Belief in this invalid theory is one of the reasons why some Wall Street analysts fear tax cuts, why they devoutly wish for yet another recession and why they are so suspicious of any program that promises real economic growth.

I have recently conducted a series of statistical tests to see if, after making allowances for money and output, there was any discernable or dependable relationship between changes in tax rates and inflation. As I reported to the Joint Economic Committee in my testimony of February 23, 1981,[3] I found little. To the best of my knowledge, many other researchers have come to similar consclusions. This should not be surprising. Given the close relationship of money per unit of output and the price level, there is little left for other factors to explain. The only association I did find, and a weak one at that, was that higher tax rates are associated with higher, not lower, prices.

Along the same lines, I also examined whether the size of the deficit affected inflation. It turns out that, again, money and output explain almost all of the price level exerience since at least 1960. When debt in the hands of the public is introduced as a separate variable it does show a small and statistically significant impact on the price level. However, the effects are so small that it is clear that the deficit is a minor factor in the inflation drama. For given money and output, the main determinants of inflation, it takes about a ten percent change in the national debt in the hands of the public to change the price level by one percent. Thus, with about 700 billion dollars of the national debt held by the public outside government trust accounts and the Federal Reserve, a 70 billion dollar deficit in one year, none of which ends up in government accounts, would contribute about one month's inflation at current rates! Clearly, although the effects of the deficit are not trivial, the size of the deficit is not the major factor in the inflation scenario.

Even though the deficit per se may not be the crucial factor in inflation, the way the deficit is financed is central to any understanding of the inflation process. If a deficit is financed by selling government bonds to the Federal Reserve, the resulting increase in the supply of money leads to inflation. Alternatively, if the deficit is financed by selling bonds to the public, no such inflationary increase in money takes place. To be sure, real interest rates may rise in order to induce the public to buy the additional bonds, but unless there is an increase in inflation this rise in interest rates is bound to be small. The major factor in high and rising interest rates is the large inflation premium augmented by the tax wedge described above which is built into all interest rates at the present time. Thus, any attempt to lower interest rates by simply printing new money to buy additions to the national debt ends up by causing interest rates to rise, not fall.

It is widely believed that deficits somehow cause the Federal Reserve to increase the money supply. Deficits are seen as placing some great "burden" on the Federal Reserve. To lighten this "burden", the Federal Reserve creates some money and buys bonds.

The Federal Reserve is not required by law to monetize the deficit. Indeed, the spirit of the law explicitly prohibits the Federal Reserve from doing so; witness the restrictions on direct sales of debt by the Treasury to the Federal Reserve. Of course, the loophole is that the Federal Reserve can buy outsanding debt rather than new debt. Because there is essentially no difference between new bonds and old bonds, the results of buying old debt are the same as monetizing new debt. Bank reserves and the monetary base increase. Money expands. Inflation results. Although the intent of Fed intervention may be to "help" the Treasury by lowering interest rates, when the Fed monetizes deficits, interest rates end up higher. In addition, the inflation tax edge increases and saving declines.

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[3] "Tax Cuts, Inflation and Interest Rates," Statement by David I. Meiselman, Hearings Before the Joint Economic Committee, U.S. Congress, Feb. 23, 1981.

Although this hypothetical mechanism potentially connecting deficits and inflation is well known, the existence of a possible link between deficits and the money supply does not settle the empirical question, whether, in fact, the Federal Reserve and the monetary mechanism do systematically respond this way to budget deficits.

I have examined the evidence and it turns out that there is little if any connection between budget deficits, or changes in the Federal debt, and changes in the money supply! Still another Emperor with no clothes.

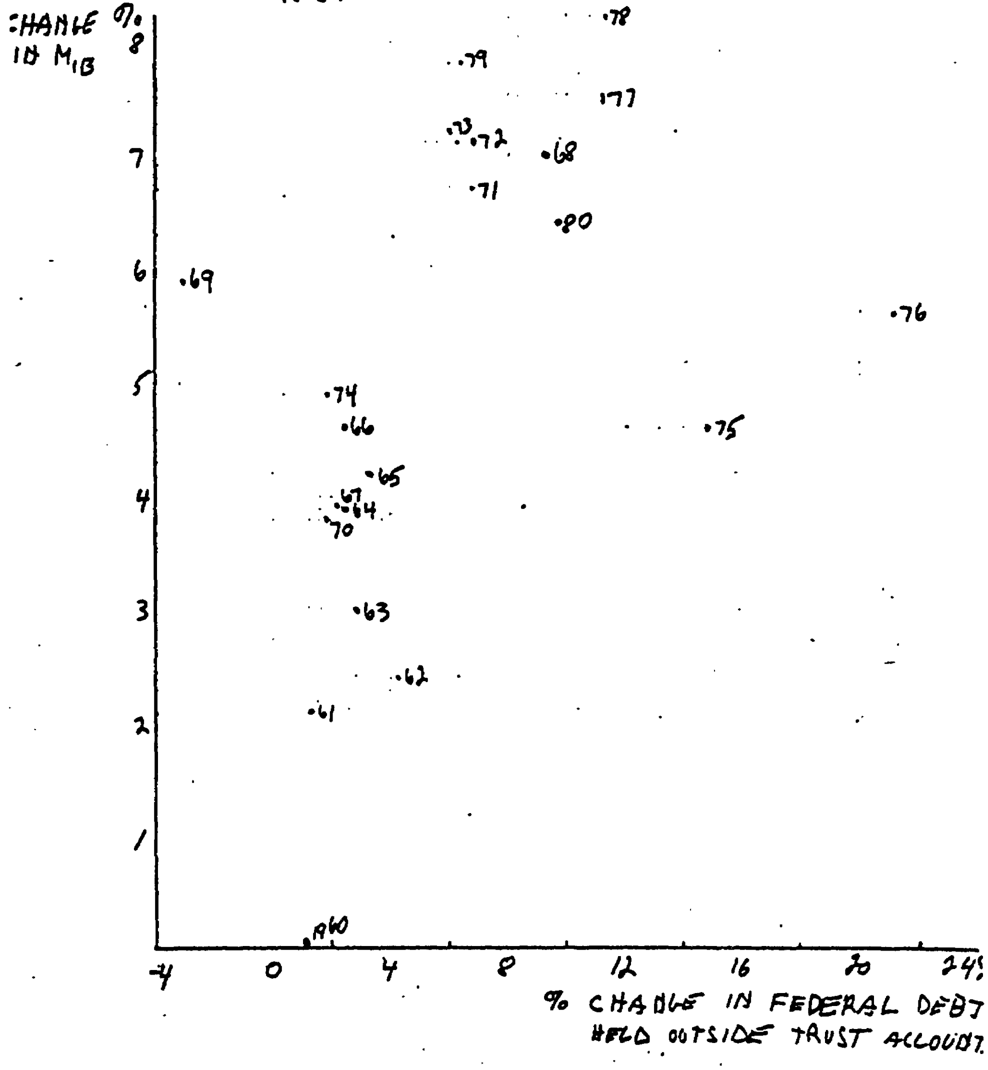
Chart 2 is a scatter diagram showing percent changes in the M_{1B} measure of money from 1960 to 1980 and corresponding annual changes in the Federal debt outside Federal trust accounts. The results are essentially the same if the gross Federal debt is used or if the data are adjusted to exclude holdings of the Federal Reserve itself. (It also makes little difference if the old M_2 measure of money is used.) If the Federal Reserve has created too much money, as it certainly has for at least the past 15 years, the Federal Reserve cannot legitimately blame poor fiscal policy for the shortcomings of monetary policy. Not only is there no legal or practical need to monetize public debt the Federal Reserve has not systematically done so. Apparently the Fed monetizes private as well as public debt.

Even if Federal deficits have not been primarily responsible for our inflation or for poor monetary policies, many people, including many financial experts, believe that deficits are a major factor causing high interest rates. Their reasoning is that deficits drive up interest rates because the Treasury adds to the supply of debt instruments, thereby decreasing prices of bonds, and driving up interest rates.

What is the evidence? Again, it turns out that there is no connection between changes in interest rates and changes in the national debt.

CHART 2

CHANGES IN MONEY AND DEFICITS



This many seem to fly in the face of fundamental economic laws of supply and demand. How can it be that an increased supply of bonds doesn't lead to a fall in bond prices, higher interest rates, tight credit and so forth?

The answer to this apparent paradox is found in two places. The first is the distinction between nominal and real interest rates. To be sure, if everything else is held constant, increased Treasury borrowing would cause interest rates to rise. This would be an increase in real, or inflation-adjusted, interest rates.[4] However, everything else is not held constant. The major factor shaping interest rates, especially in recent years, is the inflation premium, not real interest rates. Thus, rapid, unpredictable and erratic changes in money are the chief factors driving up market rates, not increases in the public debt.

The second factor is that the U.S. Treasury is only one among many factors in the supply and demand for funds. Although the U.S. Treasury is often the largest single borrower, Treasury operations alone cannot explain the entire supply and demand picture. This is why interest rates fell in 1975 and 1976 at the very time that the Federal government ran record budget deficits and the U.S. Treasury sold even more bonds than at the height of World War II.

My analysis also explains why countries such as Japan and Germany, where deficits are a significantly higher fraction of G.N.P. than the United States, have slower inflation, more growth, more saving, lower nominal interest rates and higher real interest rates than in the United States. Money has increased more slowly and smoothly in those two countries than in the U.S., and neither country penalizes saving and investment as severely as we do.

It should be noted that the effects of taxes and expenditures are not symmetrical. Increased governmental expenditures usually use up resources and typically leave fewer resources for the private sector. If resources are used less efficiently in the public sector than in the private sector, overall efficiency falls. Even if the same number of people are at work, total output is less useful, less valuable. This is the equivalent of a fall in output. I believe that we are well past this point at the present time in most areas of government expenditures. This is the major reason for shrinking the public sector in order to make possible a larger pie for U.S. citizens.

Regarding taxes, there is certainly an important and legitimate role for taxes in the financing of needed government services. If more resources are to be channeled into the public sector, higher taxes depress private sector activity, thereby freeing resources and making them available for the public sector. However, it would seem that tax rates have already become so high—largely because effective rates have been driven up by money-induced inflation rather than being explicitly legislated by Congress—that the private sector is already too depressed for our own good. Moreover, the depressive effects of high and rising marginal tax rates have differentially depressed saving, capital formation and risk taking more than consumption, and reduced work effort more than leisure.

High taxes have worked all too well in curtailing private sector activity. Instead, we need a reduction in marginal tax rates, especially those taxes that discourage investment saving, risk taking and work. We also need a reduction in marginal tax rates to undo some or all of the bracket creep of recent years. To achieve these results, we need large, permanent and predictable cuts in marginal tax rates. This is why I support the Administration's three year tax reduction package. If anything, the cuts are too modest and the horizon too short. We also need to index the tax system to prevent future bracket creep and other problems. Raising personal exemptions, widening tax brackets and similar tinkering will have little or no impact on marginal tax rates, and so will be ineffective in achieving the desired results of lessening disincentives. The 10-5-3 proposal will undo some of the bias against capital formation, growth and jobs, and I favor that part of the tax package, too.

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[4] It is useful to consider that nominal interest rates are composed of (1) the real interest rate, (2) the inflation premium, (3) the tax premium discussed above, and (4) the uncertainty premium. Real interest rates depend on underlying real economic factors of thrift and the productivity of capital. The inflation premium is largely the result of excessive money creation by the Federal Reserve. The tax premium, the wedge between interest paid by borrowers and interest earned after taxes by lenders was discussed above. (See pp. 8-12.) The Tax premium stems from taxing the inflation premium as ordinary income rather than as a return of capital, which results in reduced saving and in the uses of assets to make loans. The tax premium also results from provisions of the tax code which permit deductibility of interest expense, the deferral of capital gain taxes until realization, and capital gains tax rates which are lower than rates on ordinary income. The uncertainty premium reflects uncertainty about interest rates and interest rate-related phenomena. In relatively stable times, the uncertainty premium is small. In recent years, increasingly erratic and unpredictable changes in money have increased the variability and instability of interest rates and thereby uncertainty about interest rates and interest rate-related phenomena. Greater and greater numbers of investors have been driven out of the bond market, resulting in systematically higher and higher long-term interests rates.

High taxes do not reduce prices and do not fight inflation. High taxes do reduce output, employment and economic growth. It is time to stop punishing ourselves in the erroneous belief that slow economic growth and recessions are the needed remedy for high interest rates or in the hope that pain itself will cure our problems. Masochism is not the remedy. Budget cuts, tax cuts that lessen disincentives, regulatory reform, and above all, a slow, stable and predictable rate of growth of money are the necessary components and the solution for our serious inflation and high interest rate ills.

Finally, the desirable effects of well designed tax cuts and budget restraint, however beneficial in themselves, can easily be nullified by monetary growth that is fast, rather than slow, and erratic rather than stable. The best possible monetary policy cannot undo the waste and unemployment caused by excessively burdensome taxes, bloated Federal budgets, and regulations gone wild. In this sense, monetary policy, or the Federal Reserve alone, cannot do the whole job by itself. But unless the Federal Reserve pursues a non-inflationary monetary policy of slow, stable and predictable growth of money, inflation will follow. Inflation-caused waste and distortions will remain with us. Legislated tax rate and budget reductions will be undone again. Interest rates will remain high or go higher. Promised growth will falter. The program will fail

I would also urge the Congress to do a closer and more effective job of monitoring the Federal Reserve. Under the Constitution, Congress has the authority and the responsibility to regulate the value of money. The Federal Reserve, which is an agent of the Congress, may be independent of the Executive Branch, which is what the independence of the Fed means, but it surely is accountable to Congress. The Federal Reserve has great powers granted to it by Congress, but there are neither clearly mandated goals nor effective accountability procedures. These are most serious shortcomings, perhaps unique in our system of goverment. These failings may also be at the very heart of the whole inflation problem.

I trust that the Congress will meet its responsibilities to help get the country moving ahead once more.

TESTIMONY OF F. GERARD ADAMS, UNIVERSITY OF PENNSYLVANIA AND WHARTON EFA, INC.

Widespread consensus about the inadequate performance of the United States economy during the 1970's has turned attention away from issues of business cycle stabilization toward longer run concerns about endemic inflation and low productivity growth. But the policy maker must take into account the short term implications of new policy strategies lest they impose inflationary or deflationary pressures on the economy which would thwart achievement of the long run objectives. Even though the aims of the new tax policies may be long run, their short term implication in terms of inflation, unemployment and budget deficits must be considered. Moreover, tax policies must be seen in the context of the total policy scenario. The tax policy analysis must recognize the adjustments on the expenditure side and the posture of tight management of monetary aggregates being carried out by the Federal Reserve with support of the Administration. report today in some simulations of alternative tax policy scenarios in the context of the Wharton Quarterly Model of the United States economy. Econometric models, the Wharton Model among them, have been under considerable attack in recent months. Forecasting quarter-to-quarter movements of the economy during the past year has posed difficulties for econometric and non-econometric forecasters alike. But, as Stephen McNees of the Boston Federal Reserve has documented, the forecasting record of the models over a more meaningful time span of a year or so has been quite good. There have also been charges that the models lack a "supply side" that they do not recognize the impact of money on the economy, and that they do not allow for expectations. There is little factual basis for such accusations. Over the years, the models have been vastly expanded and improved over the overly simple theoretical prototypes on which such accusations are based. The Wharton model is completely open to public view. Any anyone who cares to examine the equation structure of the model will see that it contains a supply side, that it has an elaborate treatment of the monetary sector—money does matter—and that it does take into account informtion on anticipations. Since the real world undergoes change, the model is updated and adjusted to take into account the current institutional structure and behavior of the economy. Large scale econometric models, like the Wharton model, remain the principal instrument for studying the macroeconomic impact of tax policy in a consistent, scientifically-based, framework.

The base simulation forecast of the Wharton Econometric Forecasting Associates (Table 1) assumes the Reagan proposals being considered by the Congress for the fiscal year 1982. We have, however, assumed only a one-time 10 percent reduction in personal income taxes, effective in October 1981, and that the tax rates established at that time will prevail into the future. The 10-5-3 capital recovery program has been introduced into the system beginning in 1981 and it has significant impact on investment spending particularly in later periods of the forecast period. We have assumed that the Reagan Administration will be successful in limiting Federal spending to somewhere near the targets proposed for fiscal 1982 but not in subsequent years.

The base forecast obtained is one of moderate real growth, ranging 3 to 3½ percent in 1982 and 1983. Inflation eases to some 8 percent from its recent peak, but not as much as has been projected by some of the more optimistic recent forecasts. Very troublesome elements are the continued large deficits, some $60 billion, and the high level of interest rates projected. Indeed, the model indicates that with moderate constraint in the money supply, growth of M1B at 6 percent, interest rates will be approximately at the current peaks again in the early part of 1982 as the economy responds to the tax cuts and will decline moderately during the remainder of the period through 1983.

In comparison to this base forecast, we have prepared an alternative which fully implements the three year tax art and spending art features of President Reagan's program. You will note that the figures for 1981 and much of 1982 are about identical with our base solution. For 1983, the additional cut in taxes is almost matched by additional reductions in expenditures. Whether or not this is a realistic calculation depends on whether it will be possible twice again to make cuts in expenditures which are comparable in magnitude to those being done in 1981. If such a balanced tax cut and expenditure cut program can be carried out, then the results for overall economic activity and inflation are close to those obtained in the base forecast. There is little evidence of a supply side payout in terms of greater productivity or lower inflation. The deficit remains close to the base forecast and interest rates remain high. To be sure this solution implies somewhat smaller levels of government spending and somewhat higher levels of private expenditure.

The risk, however, is that it will not be possible in the future to match the three year tax cuts with corresponding reductions in expenditures. The "Administration without 1982-83 Spending Cut" calculation assumes the three year 10 percent tax cuts and a pattern of expenditures comparable to our base forecast. This is, of course, a considerably more stimulative scenario with a still larger budget deficit.

The economy is held in check by the assumption of monetary policy which continues to stick to the same aggregate monetary growth targets assumed in our base solution. The result is a slightly higher real growth rate for the economy, an average of 3.4 percent for 1983. This is a favorable development particularly since it accompanies about the same inflation rate. But it has serious consequences for the deficit and for financial markets. The projected deficits run to $115 billion in 1983. The impact on financial markets is a still higher interest rate, running at 20 percent for the Treasury Bill rate and at 17.2 percent for long term rates in 1983. It is important to note, moreover, that these represent substantial real interest rates after adjustment for the inflationary expectations element in the long term rate. The longer run implications of such high deficits and interest rates on investment and economic growth merit serious concern. The impact on investment spending offsets incentives which are intended by the tax cuts. From the longer term perspective of expanding and renewing the capital stock in order to improve productivity this is not a favorable development.

These calculations suggest that an advance commitment to a tax in 1982 and 1983 would be very risky unless there is substantial certaintly that further expenditure cuts will be possible. This is difficult to assure particularly since the cuts being made in 1982 are already proving very burdensome to the non defense portion of the government budget. Of course, the situation of the economy in late 1982, could be different than we have projected, and at that point the issue of whether a further cut in personal income taxes is possible should be reexamined. This is an important advantage of delaying a decision on tax cuts for 1982 and 1983.

Do these forecast simulations allow adequately for the supply side? We believe that they do. There is, as I have noted, a supply side in the model. It represents the result of exhaustive research into the responses of individuals to changes in tax rates. It embodies what is known about the impact of taxes on investment and of investment on the production potentials of the economy. This work has typically shown that direct tax reductions to business such as the 10-5-3- proposal, and investment tax credits have far more "bang for the buck" than do changes in personal income tax rates. The business tax cuts impact more directly on the supply side. Personal income tax cuts are not without merit, particularly if one considers the so-called "bracket creep" effect of inflation on the typical consumer's marginal tax rate. But, at a time when growth and productivity are of primary concern, the emphasis clearly should be on a reduction of business taxes which have more clear and focused an impact on capital investment.

Do these simulations take sufficient account of the changes in inflationary expectations? Unfortunately, very little is known of how inflation expectations are formed and how they operate within the economy. There is much evidence to suggest that the inflation process is as much retrospective—wage and price increases occur because of past price increases—as it is anticipatory. In any case, the evidence from the calculations does not go far to support the thesis that inflationary expectations will quickly be brought down and that this will greatly ease inflationary pressures and lower interest rates. On the contrary. The persistence of high deficits particularly if the second and third phases of the tax reduction program are enacted without assurance of corresponding spending cuts might suggest to consumers and investors that inflation will be higher rather than lower as we go further into the 1980's. I have too much confidence in the rationality of the American citizen to count heavily on the proposition that consumers can easily be persuaded into the expectation of significantly lower inflation rates.

In a nutshell, what does this calculation suggest for tax policy? As we have noted taxes must be seen in the complete context of government spending, monetary policies, incomes policies, international payments situation etc. Without being explicit about these considerations here, I would propose the following priorities for tax reduction:

1. Significant reductions in business taxes. These could take the form of accelerated capital recovery (though perhaps not all features of the 10-5-3 proposal), and additional investment tax credits. The latter might be targeted on industries which have been impacted by energy problems and environmental controls. They might be refundable or carry liberal carry-forward or carry-back provisions. Such measures are clearly more beneficial to business investment than would be general reduction in business profits tax rates or a cut in personal income tax rates.

2. To provide additional saving, and to ease the plight of the savings and loans, it might be useful to expand the program of tax sheltered retirement or savings as such as IRA and Keogh.

3. If the budget permits, cuts in the remaining excise taxes—since such cuts would reduce the inflation measures which enter into adjustment of wages.

4. If the budget permits, adjustments for the high level of social security taxes—which would benefit both employees and employers.

5. Finally if the budget permits, adjustments in personal income taxes to wipe out inequities such as the marriage tax and to lower high marginal rates. The latter adjustment might be combined with efforts to wipe out some of the more glaring tax loopholes which have made the effective tax rate on very high incomes considerably lower than the rates on the tax schedule.

TABLE I.—ALTERNATIVE WHARTON MODEL SIMULATIONS

[Dollars in billions]

	Control			Administration			Administration without 1982-83 spending cuts		
	1981	1982	1983	1981	1982	1983	1981	1982	1983
GNP current dollars (percent change)	12.2	12.2	11.7	12.2	12.3	11.6	12.2	12.3	12.1
GNP, 1972 dollars (percent change)	2.7	3.1	3.5	2.7	3.0	3.2	2.7	3.1	3.4
GNP deflator (percent change)	9.2	8.9	8.0	9.2	9.0	8.2	9.2	8.9	8.3
CPI (percent change)	10.4	9.7	8.6	10.4	9.8	8.9	10.4	9.8	9.4
Unemployment rate (percent)	7.4	7.3	7.2	7.4	7.3	7.2	7.4	7.3	7.1
Current account balance	$15.9	$12.3	$4.7	$16.0	$12.3	$3.7	$16.0	$12.1	$4.4
Money supply (MIB) (percent change)	8.0	6.4	5.9	8.0	5.8	5.1	8.0	5.8	5.1
Treasury bill rate (percent)	13.6	14.6	12.9	13.6	14.8	13.3	13.6	17.5	20.0
Prime loan rate (percent)	17.4	18.3	16.0	17.4	18.5	16.4	17.4	20.5	23.4
Long term bond rate (percent)	14.0	14.7	14.5	14.0	14.8	14.6	14.0	15.3	17.2
Federal deficit	$49.8	$63.6	$61.7	$41.8	$55.1	$63.0	$42.5	$63.3	$115.4

PREPARED STATEMENT OF GARY L. CIMINERO, VICE PRESIDENT, MERRILL LYNCH ECONOMICS, INC.

Mr. Chairman and Members of the Committee: As you know, the Reagan Administration proposals envision a coordinated four-pronged policy of economic initiatives in the areas of federal spending, monetary policy, taxation, and regulatory relief. On the tax policy side, the program would reduce both individual and business taxes in the largest tax cut recommendation ever proposed in the U.S. Aren't large tax cuts inherently over-stimulative? Don't they imply equally massive increases in the federal deficit? Won't this deficit lead to further inflation via debt monetization?

Assuming that the multi-faceted Administration program is implemented, there is a very good chance, according to our analysis, that the questions posed above can each be answered in the negative.

First of all, this tax cut would be different in form from earlier ones. For individuals, the proposal would eventually reduce the marginal tax rates in all brackets by identical 30 percent proportions. Unlike prior tax cuts which often redistributed tax burdens from lower to upper income brackets, the Reagan proposal would seek to leave the distribution of tax burden essentially unchanged. It would thereby result in a larger absolute amount of cut per taxpayer in the upper-income higher-savings brackets, thus giving this tax cut a higher savings component than that typical of tax cuts in the past.

Also, the after-tax rates of return on taxable savings, capital gains and other investment components would increase sharply while the tax benefits of borrowing would decrease. These incentives would tend to elicit more productive labor efforts while replenishing the engine of investment-led productivity gains: savings. The business tax cuts would also encourage capacity and productivity gains via increased investment spending. The only way a corporation can enjoy the proposed faster writeoffs is by making investments in new plant and equipment, thus expanding capacity and improving productivity which will aid in lowering inflation and improving the standard of living.

The implied stimulus of the tax reductions would be largely offset by the "fiscal drag" implied in the proposed spending curtailments. Real GNP growth over the 1981–84 period would average an estimated 4.1 percent under the Reagan policy—not sluggish, yet certainly not overly robust either.

How would the federal deficit fare in the face of Reagan's tax and spending curtailments? We estimate that it would be cut in half under this program to an estimated $30 billion by 1984; very low, by then, in relation to the economy's size. Even large deficits do not, ipso facto, create inflation. Other elements—such as an easy monetary policy or the lack of private sources of funds to purchase the implied debt—must be added to the deficit equation to yield inflation. The Reagan deficits would be consistent with diminishing inflation for two key reasons. First, the large savings attributes of the proportional tax cut would provide significant private funds sources to offset (or purchase) the resultant funds use implied by the deficit. Secondly, the assumed tight monetary policy would result in minimal debt monetization. In contrast with past tax cut episodes, the Reagan policy outlook, in co-opting help from the Fed, would significantly reduce monetary growth over time.

We estimate that as much as 56 percent of the individual tax cuts would be saved. Over the four-year period, the marginal savings rates would range from 50 to 56 percent, averaging 53 percent which is in line with earlier tax cut episodes we have analysed.

The general magnitudes of past savings-consumption propensities lend credence to the savings rates that we are projecting for the Reagan tax cut proposals. Specifically, the "Kennedy-Johnson" tax cuts ("The Revenue Act of 1964") and the rebate and tax cut initiated in 1975 disclose a 45 to 70 percent saving propensity. The Revenue Act of 1964 lowered personal and corporate taxes approximately $14 billion at an annual rate (static revenue loss basis). The personal tax cut was substantial, amounting to about $11 billion by 1965, representing a cut of 18 percent. Results of our analysis disclose that about 45 percent of the tax cut was saved in 1964 and 58 percent was saved in 1965. Accordingly, the average savings rate grew from 5.4 percent in 1963 (the year before tax cut) to 6.7 percent in 1964 and 7.1 percent in 1965.

A similar analysis of the one-quarter rebate and on-going tax cut of 1975 discloses that upwards of 58 to 70 percent of the cut was saved in the first quarter of implementation. Of course, a rate as high as 70 percent approximates the upper limit of what one would expect since the rebate was known to be a temporary, one-shot increment to spendable income.

There is also ample evidence that saving propensities increase significantly from lower to higher income brackets which supports the higher savings characteristics of the strictly proportional Reagan tax cut. A 1971 study estimated short- and long-run marginal savings propensities by income bracket, based on the 1960–61 BLS Survey of Consumer Expenditures. Results confirm the increasing marginal propensity to save across income brackets. Short-run marginal savings rates range from 67 percent in the lowest income bracket, gradually increasing to 82 percent in the highest bracket. Long-run marginal savings rates likewise range from 16 percent to 55 percent. In the Reagan program, the recurrence of proportional tax cuts annually for three years (10-20-30 percent) would tilt savings behavior more toward the short-run response curve, since the tax rates shift anew in July of 1981, '82 and '83.

It is this tendency to save which, in the Reagan tax cut, would fund much of the federal deficit while curtailing the possibility of run-away consumption spending. As measured by the average personal savings rate, the Reagan policy would sharply improve savings over the 1981-84 time frame. As the policy progresses, the high marginal savings rate out of the tax cut restores the average savings rate from an expected 5.1 percent level this year to 6.8 percent by 1984, thus approaching prior highs for this statistic.

In our sources-and-uses of funds assessment of the federal budget deficit, we estimate that the burden of the federal deficit would shrink significantly, relative to "total uses", as business investment uses rise in response to the Reagan program. On the sources side of the equation, we estimate that personal savings would grow quite rapidly, nearly doubling from 1980 to 1984. Corporate saving would also grow rapidly, according to our projections, as profits recover and the cash flow benefits of the tax cuts are, initially, largely retained. On balance, sources would be deficient by about $18 billion in 1981 but would be in surplus by 1983, and strongly so by 1984. Thus the very high savings characteristics of the Reagan tax cut policy would more than offset the uses-of-funds demands of the federal deficit while accommodating the larger, more rapidly-growing business uses-of-funds.

In short, our analysis generally supports Reagan Administration projections for both lower inflation and more rapid growth. And it supports the contention that the sharp cuts in individual income tax rates would revive savings, help fund the deficit, and spur investment growth rather than generate more inflation.

EXHIBIT I.—REAGAN TAX CUTS: ESTIMATED STATIC REVENUE LOSSES, FISCAL 1981-84

[In billions of dollars]

Type of tax cut	Year			
	1981	1982	1983	1984
Individual tax cuts	6.4	44.2	81.4	118.1
Business tax cuts:				
Corporate	2.2	7.6	15.0	24.4
Noncorporate (accrues to personal income)	0.3	2.1	3.6	5.6
Total tax cuts	8.8	53.9	100.0	148.1

Source: Office of Management and Budget, Executive Office of the President.

EXHIBIT II.—REAGAN PLAN: ESTIMATED DYNAMIC PATH OF FEDERAL RECEIPTS,[1] 1980-1984

[Dollars in billions]

	1980	1981	1982	1983	1984
Total tax receipts	$540.8	$614.4	$656.5	$713.8	$781.3
Annual increase	$46.4	$73.6	$42.1	$57.3	$67.5
Percent of GNP	20.6	21.1	20.4	19.9	19.6

[1] National Income Accounts (NIA) basis.

Source: Office of Management & Budget, Executive Office of the President; Merrill Lynch Economics, Inc.

EXHIBIT III.—FEDERAL SPENDING, REAL GROWTH, AND BUDGET DEFICITS: REAGAN POLICY VERSUS "NO POLICY" BASELINE

[Dollars in billions, NIA basis]

	Calendar year				
	1980A	1981	1982	1983	1984
Federal spending:					
Baseline		$680.0	$768.7	$863.2	$971.9
Reagan policy	$602.0	$677.0	$716.4	$761.8	$812.5

EXHIBIT III.—FEDERAL SPENDING, REAL GROWTH, AND BUDGET DEFICITS: REAGAN POLICY VERSUS "NO POLICY" BASELINE—Continued

[Dollars in billions, NIA basis]

	Calendar year				
	1980A	1981	1982	1983	1984
Difference		$3.0	$52.3	$101.4	$159.4
Federal spending share (percent of GNP):					
Baseline		23.4	23.4	23.6	23.6
Reagan policy	22.9	23.2	22.2	21.2	20.4
Real GNP growth (percent):					
Baseline		1.5	2.7	1.7	1.9
Reagan policy	−0.2	2.0	4.0	5.6	4.7
Federal deficit:					
Baseline		$46.6	$30.7	$33.0	$29.0
Reagan Policy	$61.3	$62.6	$59.9	$48.0	$31.2

Source: Office of Management and Budget, Executive Office of the President; Merrill Lynch Economics, Inc.

EXHIBIT IV.—PERSONAL SAVINGS BEHAVIOR: REAGAN PROGRAM VERSUS A "NO POLICY" BASELINE 1980-1984

	Marginal and average savings rates				
	1980	1981	1982	1983	1984
Percent of tax cut saved, Reagan policy		50.4	50.7	54.2	56.4
Personal savings rate (percent of disposable income):					
Baseline		4.8	4.9	5.2	4.9
Reagan policy	5.6	5.1	5.6	6.3	6.8

Source: Merrill Lynch Economics, Inc.

EXHIBIT V.—PERSONAL SAVINGS RATE ANALYSTS: THE REVENUE ACT OF 1964

[Dollars in billions]

	1963	1964	1965
1. Disposable personal income:			
a. Reported		$440.6	$475.8
b. Less: estimated tax cut		$8.0	$11.0
c. Equals: adjusted		$432.6	$464.8
2. Personal consumption expenditures:			
a. Reported		$400.5	$430.4
(Percent of 1a)		(90.9)	(90.5)
b. Adjusted		$396.1	$425.8
(percent of 1c) [1]		(91.5)	(91.5)
c. Induced consumption (2a-2b)		$4.4	$4.6
3. Personal savings:			
a. Reported		$29.6	$33.7
b. Less: incrementally induced (1b-2c)		$3.6	$46.4
c. Equals: adjusted		$26.0	$27.3
4. Personal savings rates (percent):			
a. Averaged reported (3a/1a)	5.3	6.7	7.1
b. Average adjusted (3c/1c) [1]		6.0	5.9
c. Marginal rate (3b/1b)		45.0	58.2

[1] Average propensity to consumer adjusted higher to reflect recent experience before tax cut. This calculation estimates what consumption might have been had there been no tax cut and had the savings propensity remained at the lower level observed in recent years prior to 1964.

Source: U.S. Department of Commerce; Merrill Lynch Economics, Inc.

EXHIBIT VI.—SHORT- AND LONG-RUN MARGINAL SAVING PROPENSITIES (1960-61 SURVEY DATA)

Income bracket [1]	Marginal saving propensity (percent)	
	Short run	Long run
$0-$2,800	67	16
$2,800-$5,500	68	17
$5,500-$8,300	68	19
$8,300-$11,100	69	21
$11,100-$13,800	70	23
$13,800-$16,600	71	25
$16,600-$19,400	71	27
$19,400-$27,700	73	30
$27,700-$41,500	75	36
$41,500+	82	55

[1] Restated from 1960-61 real basis to 1980 dollars.

Source: Ralph D. Husby, "A Non-Linear Consumption Function Estimated from Time-Series and Cross-Section Data." Review of Economics and Statistics, vol. 53(1) (February 1971), pp. 76-79.

EXHIBIT VII.—USES AND SOURCES OF FUNDS: REAGAN PROGRAM, 1980-84

[In billions of dollars]

	Year				
	1980	1981	1982	1983	1984
Uses of funds:					
Federal deficit	61.3	62.6	59.9	48.0	31.2
Fixed business investment	401.2	438.9	492.2	571.1	649.7
Inventory business investment	−5.9	−4.8	14.7	38.7	53.2
Total uses	456.6	496.7	566.8	657.8	734.1
Sources of funds:					
Personal savings	101.4	102.8	125.6	159.3	192.5
Corporate savings [1]	265.4	278.8	323.0	368.2	411.5
State and local government surplus	29.1	33.0	36.8	46.4	58.1
Net other sources [2]	60.7	63.6	74.4	88.0	101.5
Total sources	456.6	478.2	559.8	661.9	763.6
Net (sources less uses)		−18.5	−7.0	4.1	29.5

[1] Retained net cash flow.
[2] Calculated to balance net in 1980. Projected over 1981-84 as a constant (1980) proportion of total sources.

Source; Merrill Lynch Economics, Inc.

EXHIBIT VIII.—MAY BUSINESS OUTLOOK—SCENARIO I—REAGAN POLICY FORECAST

[Billions of dollars[1]]

Selected indicators of economic activity	1980	1981	1982	1983	1984
Gross national product	2,626.1	2,915.0	3,221.0	3,591.8	3,982.0
GNP (1972 dollars)	1,480.7	1,509.8	1,570.1	1,658.5	1,737.1
Annual rate percentage change	−0.2	2.0	4.0	5.6	4.7
Final sales (1972 dollars)	1,483.6	1,512.7	1,564.5	1,644.3	1,718.6
Annual rate percentage change	0.7	2.0	3.4	5.1	4.5
GNP deflator (1972=100)	177.4	193.1	205.1	216.5	229.2
Annual rate percentage change	9.0	8.8	6.2	5.6	5.9
Personal income	2,160.3	2,397.2	2,630.2	2,927.5	3,261.2
Annual rate percentage change	11.1	11.0	9.7	11.3	11.4
Disposable personal income	1,821.7	2,025.8	2,248.9	2,519.7	2,812.6
Annual rate percentage change	11.0	11.2	11.0	12.0	11.6
Capital expenditures	295.5	312.5	354.5	419.6	480.5
Annual rate percentage change	9.6	5.8	13.4	18.4	14.5

EXHIBIT VIII.—MAY BUSINESS OUTLOOK—SCENARIO I—REAGAN POLICY FORECAST—Continued

[Billions of dollars[1]]

Selected indicators of economic activity	1980	1981	1982	1983	1984
Corporate pretax profit	245.5	231.8	254.0	275.4	275.4
Annual rate percentage change	−3.8	−5.6	9.6	8.4	−0.0
Corporate aftertax profit	163.2	153.8	167.8	181.6	183.0
Annual rate percentage change	−2.7	−5.8	9.1	8.2	0.8
FRB index of production	147.1	151.0	158.0	170.1	182.3
Annual rate percentage change	−3.6	2.7	4.6	7.7	7.2
Consumer Price Index—All urban	247.0	271.8	289.9	308.4	328.7
Annual rate percentage change	13.5	10.1	6.6	6.4	6.6
Producer Price Index	268.8	297.0	316.3	334.5	354.2
Annual rate percentage change	14.2	10.5	6.5	5.8	5.9
Housing starts (units, thousands)	1,303.5	1,471.4	1,765.0	2,011.2	2,095.4
Annual rate percentage change	−24.0	12.9	20.0	13.9	4.2
Retail auto sales (units, millions)	9.1	9.7	11.0	11.7	12.1
Annual rate percentage change	−15.0	7.2	13.6	5.8	3.7
Unemployment rate (percent)	7.2	7.7	7.5	6.3	5.4

[1] Unless otherwise noted.

AFTERNOON SESSION

The hearing came to order at 2 p.m., Senator Durenberger (acting chairman) presiding.

Present: Senators Dole, Durenberger, Packwood, Long, Danforth, Roth, Matsunaga, and Bradley.

Senator **Durenberger**. We have three panelists today, Dr. Oswald Brownlee, professor of economics and chairman of the department, University of Minnesota, Minneapolis, who has taught there since 1950, done a variety of consulting, visiting posts, and has a long list of publications including contributions to the Encyclopedia Britanica.

Dr. Joseph Pechman, director of economic studies, Brookings Institution since 1960, well-known for his work in taxation.

Dr. Martin Feldstein, president of the National Bureau of Economic Research and professor of economics, Harvard University, Cambridge, Mass. He is especially well-known for his work on savings rates and capital formation.

We are praying for a larger attendance. We want you to know you are going to impress a much larger audience than you see behind the table today. On behalf of that audience, I thank you for being willing to come and present your views on a part of the national economic recovery package.

I believe that unless you have a preference for an order of proceeding, the way I introduced you might be an appropriate way. Dr. Brownlee are you still getting organized?

STATEMENT OF DR. OSWALD BROWNLEE, PROFESSOR OF ECONOMICS, UNIVERSITY OF MINNESOTA; DR. JOSEPH PECHMAN, DIRECTOR OF ECONOMIC STUDIES, THE BROOKINGS INSTITUTION; DR. MARTIN FELDSTEIN, PRESIDENT, NATIONAL BUREAU OF ECONOMIC RESEARCH, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Dr. **BROWNLEE.** Mr. Chairman, members of the committee, ladies and gentlemen.

I thank you for the opportunity to present to you my views. I have a mimeographed statement which I have left with the staff and I'll take just a few minutes to talk about some of the general aspects of tax reduction and leave my views on details to the questions you ask.

Senator **DURENBERGER.** Your mimeographed statement will be made a part of the record.

Dr. **BROWNLEE.** Thank you.

It seems to me the basic question is whether tax reduction is going to bring the things which the administration tells us is good. In general, my answer is yes, providing that the reduction is in all taxes—not only those that are collected by the Internal Revenue Service, but the inflation tax as well.

The big question is whether the taxes which are paid to the Internal Revenue Service can be cut and not be offset by increases in the inflation tax.

Although I haven't seen the Treasury's program in detail, I infer that it proposes something like a 30-percent cut in the personal income tax and the corporation income tax which amounts to about a 15-percent reduction in the overall tax rate.

As a result of this, it is expected by the Treasury that there will be an expansion in income on account of an increase in work effort and eventually, although not necessarily immediately, an expansion in income on account of the larger capital stock that will result from the increased saving which is brought about by this tax reduction.

Now, I don't think that anybody knows how large these income increases are going to be. The response of production on the part of labor to the tax decrease depends upon a number for which nobody has a real good estimate—namely, the elasticity of the supply of labor—and this number could easily be such that we would get as much as a 3- or 4-percent increase in income or as little as less than 1 percent.

Similarly, the expansion in saving depends upon a number that we don't know very much about. It could be that we would get as much as the Treasury expects which is about a 15-percent increase in the rate. But it could be something quite a bit smaller, perhaps on the order of a 6-percent increase in rate. But, nobody really knows what these numbers are.

The question then becomes whether if we do get substantial responses in income but are not able to cut spending more or less commensurate with the tax decreases, the inflation tax will offset the reductions in taxes that are collected by the Internal Revenue Service.

The administration seems to be relying upon the Federal Reserve to hold the rate of expansion in the money supply to an amount such that there will be no expansion in the rate of inflation.

Its general picture seems to be that there has never been an inflation without an expansion in the money supply, nor has there ever been a large expansion in the money supply without an inflation. Also there is no correlation between short-run budget deficits and short-run changes in the price level.

That seems to be true, but the correlation between longrun budget deficits and longrun increases in the price level seems to me to be very substantial and if one looks at the histories of Latin American countries, their inflations have all been the result of budget deficits. This seems to me what the financial markets and some of the economists, who are not in accord with the conclusions being reached by the administration, are afraid of.

Now, it doesn't make much difference whether taxes are reduced now and expenditures are reduced later so that the overall longrun growth in the debt is not large or whether expenditures are reduced now and taxes are reduced later. The present value of the tax payments will be approximately the same providing that the overall amounts of tax collections spread over time are not too different.

The administration is counting on reductions in expenditures beyond the ones which are being promoted for 1981–82. Cuts in social security expenditures are among them.

For sure it is easier to get the first $45 billion of expenditure reduction than it will be to get the next $45 billion and that is what I think the financial markets are telling us. They do not have faith in the ability of the administration to obtain expenditure reductions commensurate with the tax reductions and do not have faith in the Federal Reserve's willingness and/or ability to maintain a low rate of growth in the money supply.

It seems to me, under these circumstances, that the administration and the Congress have to give stronger signs now that they are willing to make expenditure cuts in the future if they want to get the benefits of the tax program as these are being described by the administration.

I'll be willing to answer questions or make suggestions about details of the tax program subsequently.

Thank you.

Senator DURENBERGER. Thank you very much, Dr. Brownlee. Dr. Pechman.

Dr. PECHMAN. Thank you very much, Mr. Chairman.

I too, will summarize my statement and will be glad to answer any questions about the details.

My statement is a summary of a new book that I hope the members of the Senate Finance Committee will read that was just published by the Brookings Institution, called "How Taxes Affect Economic Behavior." This is an attempt to obtain the best econometric estimates available in the profession on supply responses to changes in taxation.

We have papers on supply responses to changes in taxes on labor supply, on investment, on saving, on corporate finance and so on.

I regret to say that no individual chapter are technical, but I hope that members of the committee will read the introduction which I and my colleague Henry Aaron wrote. It is in English.

The basic conclusion of this study confirms what Professor Brownlee just said. Jerry Hausman of MIT wrote the basic paper on labor supply. He concluded that the response of the core labor force—white males between ages of 25 to 62—will have some response to an increase in net return to work through taxation or any other means.

But, that the response is nowhere near what would be required to justify the extreme claims of the supply-side economists.

In the case of investment, I think that economists are generally in agreement, although there are still some dissenters, that if you reduce the cost of capital or increase the rate of return on capital through special incentives to invest you will have an affect on investment.

There is also an important affect from the general health of the economy. If you increase investment incentives in a time when the economy is in bad shape, as for example in England, it is hardly likely that a tax cut for investment will have an immediate response.

There is, very definitely, a response to such things as liberalized depreciation allowances, investment credits, or even corporate rate cuts, though I think that most economists would agree that if you tie the corporate tax cut to investment you are likely to get a bigger bang for your buck in investment.

With respect to saving, the article in our book is inconclusive. This is an area where economists really have not been able to detect a firm response either way to the rate of return on saving and we ought to do much more work on it.

One other point I should mention about labor supply is that practically every econometric study that has ever been made has found, and our book finds it too, that the marginal tax rate on supplementary earners in the family, particularly working spouses, tends to be high because of the way we combine incomes on joint returns. The existing tax structure which places a relatively heavy tax on couples does reduce the supply of working spouses very substantially.

The conclusion that I draw from these studies is that you can be certain of a significant, modest effect on investment if you liberalize depreciation allowances or increase the investment credit.

It is difficult to increase private saving by tax cuts, though perhaps not impossible, and the response of labor supply will be modest.

In any case, the supply effect of a large tax reduction of the type that is envisioned by the administration, which would amount to $150 billion 3 years from now, will not be enough to recover the revenue loss as some extremists have argued.

Fortunately, the administration has been much more realistic about this and has not incorporated extreme supply responses in its projections.

Under the circumstances, what should be done? Well, I would say that the next tax bill ought to include some incentives to investment in the form of liberalized appreciation allowances or investment credits. It looks like there is pretty much substantial agreement inside and outside of Congress that this should be done.

I think that the administration's proposal that the incentive be made effective retroactively to the beginning of this year, should be followed simply because if you did not, I think you would have an unfortunate effect on investment decisions. Businesses would wait until the congressional process was finished before they actually did the investment.

I think that liberalized appreciation is of the highest priority. With respect to the income tax cut, my own view is that in light of the problems that Oswald Brownlee just mentioned, there is no urgency in making a very large tax cut and certainly no urgency in committing ourselves now to the kind of tax cut that the administration proposes.

I, like everybody else, would like to have tax cuts, but it would be unfortunate if we prejudged the elbow room that is available in the budget at this time.

It is true that the Congress seems to be going along in the first leg of expenditure cuts, but as Professor Brownlee correctly said, the next $45 billion is going to be tougher. As a matter of fact, just yesterday the House subcommittee, in conforming with the guidelines of the Senate budget resolution on social security, actually took $1.7 billion from the longrun social security benefit cuts proposed by President Reagan just the other day, and included it in the shortrun program.

At least on the House side, they are using some of the longrun resources to make up the $45 billion in the shortrun.

I believe it would be a good thing to reduce the rate of growth of Federal spending and it would be good, if it were possible, to do as much as the administration projects.

I have my doubts that we can get political consensus on reducing expenditures to the extent that the administration has proposed. I certainly would wait until the second round of expenditure cuts are given to the Congress in detail before the individual income tax cut is actually made.

I don't think this would be a terrible thing. I don't think the economy would suffer one bit if the individual income tax cut were delayed until October 1 of this year or even January 1, 1982.

What is important is that you reassure the public that you are going to cut income taxes on a permanent basis. Whether you do it July 1 of this year or January 1 of next year, will not be very significant for longrun economic policy.

With respect to the composition of the individual income tax cut, it seems to me that there are an awful lot of demands for particular types of cuts that have to be paid attention to and just cutting the rates would preempt practically all of the elbow room for many years. The administration has promised a second-round tax bill.

There will be no elbow room for a second-round tax bill if you adopted Kemp-Roth without spacing it out or reducing the total amount of cut. So, my advice is wait and see what your expenditures cuts will actually be and then measure what all of the demands for tax cutting are before you actually cut the rates.

I would like to have a rate cut, but there are other things that you will want to do that will cost revenue and I would not preempt those things to begin with.

Senator DURENBERGER. Thank you, Dr. Pechman. Your full statement will be made a part of the record.

Dr. Feldstein, now that my colleagues are here, I am going to add only one other thing to your credentials and that is that I know you to be a supporter, at least in theory, of competition and health care. I am grateful for that.

Dr. FELDSTEIN. Well, I, too, have a formal statement which I will leave for the record.

Senator DURENBERGER. Your statement will be made a part of the record.

Dr. FELDSTEIN. I will just try to summarize it briefly.

I think there really are two issues that we want to talk about this afternoon. One is the overall size of the tax cut over the next several years and the other is the structure of the tax cut.

As I have tried to analyze the figures, I have come to the conclusion that the administration's proposals for the next 2 years, for 1981 and 1982, cuts of about 15 percent, are indeed appropriate and that an additional 15 percent in 1983 and 1984 is probably a reasonable cut to make at this time. Ten percent rather than 15 percent in those 2 outyears would be very safe and would leave room almost certainly for an additional tax cut at a later time.

As I look at the budget proposals, the spending and tax side combined, I cannot but conclude that the budget that has been put forward is deflationary rather than inflationary and that the monetary policy that the Fed has promised us for this year and is likely to promise for next, simply reinforces that very deflationary package.

I cannot really understand much of the debate that I hear. When I listen to the administration's spokesman talk about the important incentives that will be produced for the supply of various kinds of effort and saving by reductoins in tax rates, I don't know how to square that with the fact 2 years from now tax rates will be no lower than they are in 1980.

When I listen to the critics charge that these tax cuts are going to be inflationary, I again don't know how to square it with the obvious fact that a 15-percent tax reduction over the next 2 years will simply be giving back the additional tax revenue over and above the inflation gains.

I think people in analyzing this situation are thinking more about the rhetoric of the campaign than they are about administration's actual proposal. The campaign was all full of supply side hyperbole about self-financing tax cuts. None of that is really there now.

What we have is a nontax cut over the next 2 years and a very small tax cut over the 2 years after that against any kind of realistic projections of income and very substantial spending cuts already put in.

If the House and Senate stick within the budget limits that they have voted, we will have a $25 billion real decrease in spending between 1981 and 1982 and no tax cut to offset it. So, one shouldn't think about these tax cuts as somehow balancing the spending cuts. The tax cuts are balancing the extra tax increases that would otherwise occur and the spending cuts and the off-budget cuts are unbalanced deflationary.

When I look ahead to 1983 and 1984, of course, it is more difficult to know what the economy is going to do. If we get anything like the nominal income growth that the administration and most commercial forecasters are looking for, then it is very easy to have the additional 15-percent tax cut in those 2 years and still come out with more revenue as a share of income than we have today.

That is why it would be cautious, indeed, to cut back that aggregate cut from 15 percent to 10 percent in 1983 and 1984 and would almost certainly provide room for additional cuts, especially if more spending cuts can be found.

What I would emphasize is that you can have a cumulative 25-percent cut over these 4 years simply to give back the extra revenue that is otherwise brought in by inflation without the spending cuts at all. The spending cuts would simply be used to shrink the size of the deficit.

Let me turn from that issue, which is the overall size of the tax cut, to the question of structure and start with the business side where I agree with Joe' Pechman that substantial incentives for investment are a good thing.

I think that the general flavor of the administration's proposal in this area, the modified 10–5–3, may not be the best bill that man could design, but it is a good bill and it may be the best bill that is politically possible.

It certainly is long overdue in terms of reversing the very substantial increase in effective tax rates that has occurred in the last 15 years because of the historic cost depreciation and because of the continued use of inventory accounting.

As I have testified to this committee before, the effective tax rate paid by companies and their shareholders and creditors was 55 percent in the mid-1960's and has risen to 75 percent today.

Beyond the business tax cuts, looking to the personal side, I think it is very important to have major reductions in marginal tax rates because otherwise we are simply going to have major increases in marginal tax rates.

The administration's bill, just to say it one more time, really doesn't reduce marginal tax rates significantly over the next 2 years and may not over the 2 years after that if the economy shows significant nominal growth.

It would be a pity to give away too much of that additional revenue to other special purposes. Some things, however, are relatively low cost and are potentially high benefit. I think bringing down the top tax rates, as a number of people have suggested, immediately to 50 percent. That is, going beyond the effects of the 70- to 60-percent reduction that would be implied in the first couple of years of the administration's bill is very low cost even if there are no favorable changes in taxable income.

The $2 billion cost of bringing it down from 60 to 50 percent maximum tax rate, I would think would almost certainly be offset by the changes in sheltering and the additional realization of taxable income rather than its transformation into capital gains and other forms.

The savings incentives that have been promised for the second bill I think deserve high priority. I think we can talk in the discussion about some of the pros and cons of different forms of that.

My own preference would be for a two-pronged attack. On one hand, providing a partial exclusion for interest and dividends rather than simply an increase in the ceiling. Second, providing an expanded system of IRA's.

I think that different kinds of individuals are likely to respond to different sets of those incentives and within the IRA's I think they could be made much more appealing by eliminating the wait-until-age-59 feature and allowing individuals the option of withdrawing funds at the end of say 3 or 4 years, paying tax or rolling them over.

I suspect there would be more long-term savings if it didn't have that illiquidity that is presently there.

Well, let me stop there, Mr. Chairman, and we can return to some of the details for discussion.

Senator DURENBERGER. You didn't want to get caught in the middle of a sentence like Joe did.

Thank you all very much for your testimony. Let me ask some general building a border around subject before we landscape it questions.

I understand the panel this morning generally agree that the size of the tax cut is appropriate. I have heard varying opinions on that here today and I am not sure Oswald the degree to which you hit directly at that.

Dr. BROWNLEE. I think that Joe, to some extent, has misinterpreted me. In general, I am in favor of the tax cut in spite of a substantial amount of uncertainty with respect to what it might do.

My remarks about what ought to be done with respect to expenditures is a suggestion for taking care of this uncertainty. In the event that things don't turn out to be as optimistic and Marty and the administration are suggesting, you ought to let it be known that you are willing to make adjustments in expenditures.

The administration's model, if you wish to call it that, is one in which only the taxes that are collected by the Internal Revenue Service seem to affect the output of the economy. The inflation tax is not in there.

But, that is because they are hoping and praying that money expenditure will not increase more rapidly than output and not everybody has the same faith which they seem to have. I am suggesting that you ought to strengthen the public's faith through statements about your willingness to modify expenditures.

Senator DURENBERGER. Thank you. Any additional comments on size? I think the two of you are fairly clear on that issue.

Yesterday, Secretary Regan said the purpose of the administration's package was to get people to work harder, save more and invest more. But, he also said he was open to be shown that other plans would accomplish these purposes. Either accomplish them better or at less cost.

I heard Dr. Feldstein talk about—I know in your paper you argue that there is going to savings which some people on this committee had found hard to believe on the theory that half the tax cut is going to people over $30,000 a year and they just have to save some of that.

You have also talked increasing IRA's, perhaps LIRA's and expanding the exclusion.

Would the three of you comment on the savings that come with this tax cut and whether or not some of the tax reform or the adjustment in the rates on unearned income is necessary to go along with the cut in order to make it effective.

Dr. PECHMAN. Let me say that I think that it is very, very difficult for you to design a tax incentive that will substantially increase savings.

The cuts in marginal rates even under Kemp-Roth, in my view, will have a modest effect on saving and will certainly not create the amount of new saving that is needed for the future.

The most certain way, and this is where I disagree with Martin, of increasing national saving is to reduce the dissaving of the Federal Government. We are running a deficit of over $60 billion this fiscal year and the deficit, if you enacted the administration's program, is likely to be in the neighborhood of $50 to $60 billion again in fiscal year 1982.

If you want to increase national saving, simply defer the tax cut—except for the investment incentives that we all agree ought to be adopted—and reduce or eliminate the deficit. That increases national savings promptly and dollar for dollar.

Whereas, Martin's proposals are chancy. You might be spending money without very much of a payoff right away.

Let me give you an example. I think you wasted $3 billion this year and next year when you increased the exclusion for dividends and included interest to $200 per person or $400 for a family.

The saving rate hasn't been changed. You could have known in advance that a device like that would not affect total saving because it was a flat tax cut for everybody who had over $400 of interest and dividends. The people who would be affected at the margin by that tax cut account for very little, if any, saving.

This holds true for most of the savings gimmicks, the IRA's and so on. Increasing the amount of money I can put into my Keogh Plan doesn't increase my saving; it simply gives me a nice healthy tax cut. We have had Keogh's and IRA's and neither of them have had very much of an effect on total savings.

Now, I do think that Martin is right in one respect. The best way to promote an increase in private saving is to increase the rate of return on all savings. That would require a tax rate cut on property income and there you get into an equity problem.

Suppose you excluded half the interest and dividends received by people from their tax return? That is a whopping tax cut for the wealthy and will be objected to on equity grounds.

I don't think we are yet at the point where we have to distort the tax system to that extent on equity grounds to achieve the national saving objectives.

If after you have balanced the Federal budget there is not enough national saving, I will be glad to meet with Martin and design a specific saving cut.

Senator **Durenberger**. Martin, this is your chance to eliminate——

Dr. **Feldstein**. I don't think you want to debate tax equity this afternoon although my own prospective is——

Senator **Durenberger**. I do.

Dr. **Feldstein** [continuing]. My own prospective is that the right base for a tax is consumption and that the right base for a tax is consumption rather than our current concept of income and that by eliminating the taxation on either savings when it goes in or the income on savings that is earned along the way, we move closer to that more equitable base.

Let me though, talk to numbers rather than philosophy. Joe is in many ways not typical. One of the ways Joe is not typical is in his savings behavior. I have some numbers. Unfortunately they are not very up-to-date numbers. The most recent numbers that the Consumer Expenditure Survey collected were for 1972.

In 1972, it turns out that 85 percent of households did not save at least 10-percent of the income. That is, they saved less than 10 percent of their income. So that, providing a 10-percent IRA option would, for 85 percent of households, if that distribution has not changed over the years, would provide a marginal incentive for them to save more. They wouldn't simply be moving money from one account to another.

Indeed, we also looked in this study, which I will leave for the record, at the amount of assets that individuals currently have and that they might simply transfer over from current accounts into IRA type accounts.

[The study follows:]

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ALTERNATIVE TAX RULES AND PERSONAL SAVINGS INCENTIVES: MICROECONOMIC DATA AND BEHAVIORAL SIMULATIONS

Martin Feldstein

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Alternative Tax Rules and Personal Savings Incentives: Microeconomic Data and Behavioral Simulations

SUMMARY

This study examines the potential effects on personal savings of alternative types of tax rules. The analysis makes use of two extensive samples of information on individual savings and financial income: the 1972 Consumer Expenditure Survey and a stratified random sample of 26,000 individual tax returns for that year.

The first type of tax rule that we consider would permit all taxpayers to make tax deductible contributions to individual savings accounts. The interest and dividends earned in these accounts would also accumulate untaxed. A potential problem with any such plan is that individuals could in principle obtain tax deductions without doing any additional saving merely by transferring pre-existing assets into the special accounts. The evidence that we have examined indicates that this is not likely to be important in practice since most taxpayers currently have little or no financial assets with which to make such transfers. For example, a plan permitting contributions of 10 percent of wages up to $2000 a year would exhaust all the pre-existing assets of 75 percent of households in just 2 years. Our evidence also shows that a ceiling on annual contributions of 10 percent of wages still leaves an increased saving incentive for more than 80 percent of households since fewer than 20 percent of households currently save as much as 10 percent a year. Specific simulations of a variety of such proposals show that even when income and substitution effects balance for a representative taxpayer (implying no change in his consumption) aggregate saving would rise considerably.

The second type of tax rule that we examine would increase the current $200 interest and dividend exclusion. In 1972, among families with incomes of $20,000 to $30,000, 55 percent had more than $200 of interest and dividends; for those with incomes of at least $30,000, 82 percent had more than $200 of interest and dividends. For such families, the $200 exclusion provides no incentive for additional saving. Our analysis considers four ways of strengthening the saving incentive while limiting the reduction in tax revenue: (1) a limit of $1000 on the interest and dividend exclusion; (2) a 50 percent exclusion of interest and dividends up to a $1000 limit; (3) exclusion of interest and dividends in excess of 5 percent of income over $10,000 with an exclusion limit of $1000; and (4) exclusion of 20 percent of interest and dividend income without any limit. The revenue effects of all of these options were found to be quite small. But even with quite modest elasticities of current consumer spending with respect to the relative prices of present and future consumption, these plans could increase saving by significantly more than the reduction in tax revenue.

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Alternative Tax Rules and Personal Savings Incentives: Microeconomic Data and Behavioral Simulations

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Personal saving has traditionally accounted for more than half of all real net private saving in the United States. Incentives that increase the personal saving rate therefore have a potentially significant effect on the total rate of capital formation.[1] The purpose of the current paper is to present some new microeconomic evidence that is relevant to evaluating alternative changes in the personal tax treatment of savings and of interest and dividends.

There are, of course, many factors in addition to the personal tax rules that contribute to the low rate of saving in the United States, including consumer credit rules, the Social Security system, the taxation of business income, and the tax treatment of personal interest expenses. Our focus on the personal tax treatment of savings and the income from savings should not be misinterpreted as an indication that we believe that personal tax rules alone are responsible for the low U.S. saving rates. We do believe, however, that changes in these tax rules are a potentially useful way of increasing savings.

There has nevertheless long been resistance among both economists and government officials to changing the tax rules to encourage saving.[2] The opposition to encouraging saving has in part been a vestige of the Keynesian fear that a higher rate of saving might only increase unemployment. Whatever the relevance of this concern in earlier decades, oversaving is no longer regarded as a potential problem. A further source of opposition to modifying the tax rules to encourage saving has been a concern that any such change would thwart the egalitarian thrust of tax policy. This in turn reflected a belief that the incentive effects of tax changes would be negligible, implying that tax policy could only encourage saving by redistributing disposable income from lower income taxpayers with low marginal propensities to save to higher income taxpayers with high marginal propensities to save.

In contrast, there is now strong professional and political interest in tax changes that could encourage personal saving.[3] This reflects in part a reassessment of the earlier studies that had concluded that saving is not sensitive to the rate of return and therefore also not sensitive to the tax treatment of that return. Because those studies used nominal rather than real interest rates, the interest rate coefficient was biased in a way that made it appear to be insignificant or even to have the reverse sign (Feldstein, 1970). New studies that relate saving to an estimate of the real net rate of return have suggested that savings do respond positively to this more appropriate measure of the return (Boskin, 1978; Feldstein, 1981). Unfortunately, the problems of measuring the relevant real expected return are such that the econometric evidence is never likely to be compelling. It is important, therefore, that the general theory of consumer behavior implies directly that a compensated increase in the real net rate of return necessarily induces individuals to postpone consumption. The effect on savings of a change in the taxation of capital income therefore depends on the timing of tax payments and on the response of government spending.[4] If government spending in each year remains unchanged, national saving must rise. If the compensating changes in the tax keep tax liabilities in each year unchanged, private saving must also increase.[5]

Tax changes that reduce the difference between the pretax and posttax returns on capital may be worthwhile even if the saving rate does not respond positively to the net rate of return. A gap between the pretax and post-tax rates of return implies a loss of welfare no matter what the uncompensated savings response. Of course, since the revenue lost by reducing the tax on savings could alternatively be used to reduce some other distorting tax, the desirability of reducing the tax on saving is not unambiguous. Nevertheless, recent investigations in the theory of optimal taxation do suggest that the tax rate on the income from saving should probably be lower, and perhaps very much lower, than the tax rate on labor income. If the marginal rate of substitution between current consumption and future consumption is independent of the quantities of leisure consumed, the optimal tax rate on the income from savings is zero (Mirrlees, 1976). Substantial departures from this separability assumption still leave it optimal to tax capital income less than labor income. Indeed, if subsidizing retirement consumption reduces the distorting effect of the labor income tax on preretirement work effort, it may be optimal to "tax" the income from saving at a negative rate, i.e., to subsidize it. Explicit calculations of a simple model using empirically plausible but conservative parameter values (i.e., assuming that the compensated supply responses of both labor and saving are zero) imply that there may be a substantial potential welfare gain associated with reducing the tax on capital income and making up the lost revenue by an increase in the tax on labor income (Feldstein, 1978; see also Green and Sheshinski, 1979 and Summers, 1980). More generally, the potential gain from reducing the tax on capital income depends on the extent of the existing wedge between the pretax and net-of-tax rates of return. It is significant therefore that in recent years personal, business and property taxes have taken more than two-thirds of the real pretax return on capital used by nonfinancial corporations (Feldstein and Poterba, 1980).

Although economists have generally been concerned with reducing this source of welfare loss, the public and Congressional discussion has focused on increasing aggregate savings. Moreover, the recent proposals to encourage saving emphasize the incentive effects of a higher net rate of return and not a redistribution of disposable income from lower income to higher income groups. Indeed, a principal reason for using personal tax changes in addition to changes in business tax rules is to permit a targeting of the tax reduction benefits on middle income taxpayers rather than on all taxpayers in proportion to their existing wealth.

A further reason for directly encouraging an increase in personal saving is to reduce the inflationary pressures that might otherwise accompany a tax-induced increase in the demand for investment. Although the total rate of capital accumulation is constrained by the rate of saving, capital accumulation can be increased without altering the personal tax rules if the corporate tax rules are changed to increase the rate of return after the corporate income tax. This in turn raises the net return to savers and encourages increased saving. If the savings response were rapid enough, the economy would shift to a higher rate of investment with no increase in the rate of inflation. In practice, however, the corporate tax changes would probably raise investment demand more rapidly than the supply of savings. The result would be an increase in inflationary pressure.[7] Direct tax incentives to save can prevent these inflationary pressures by causing the increase in saving to occur at the same time as the increase in investment demand.

Two dynamic aspects of saving are particularly important. First, because saving represents an adjustment of the stock of wealth, a relatively small change in the desired level of wealth can induce a relatively large increase in the rate of saving. Second, because the desired level of wealth depends on the expected future net rates of return, an anticipated reduction in the future rate of tax on investment income can induce a rise in current saving. Thus there can be an increase in saving without any concurrent government deficit.[8]

There is surprisingly little econometric evidence about individual saving behavior and the likely magnitude of response to alternative tax rules. In particular, there is no evidence that deals explicitly with such things as the anticipated rate of return, the effect of the tax rate per se, or the impact of nonlinear rules like the maximum levels of deductible savings for the current Individual Retirement Accounts. Although we cannot fill these gaps in the current paper, we believe that we can provide some useful information on the current distribution of saving, wealth and investment income in relation to tax rates and total income. This evidence can be used to evaluate the potential impact and revenue cost of alternate tax rules in a way that is just not possible without detailed microeconomic evidence. In particular, we focus attention on the conflict between the desire to limit the individual deductions or exclusions (in order to reduce the total revenue loss and to focus the benefits on middle income taxpayers) and the possibility that such limits would eliminate any marginal incentive for most taxpayers.

Our analysis uses two bodies of microeconomic data. The principal data source is the Treasury's public use sample of individual tax returns. We use a stratified random sample of 26,643 individual tax returns for 1972 (a one-in-four random sample of the full public use sample) in conjunction with the

NBER TAXSIM model[9] which computes tax liabilities and tax rates based on the tax law as of 1972 and the alternative modifications. This data set provides detailed information on current interest and dividends, labor income and total taxable income for each individual. A special advantage of the 1972 data is that the exact age of each taxpayer is included (based on I.R.S. examination of Social Security Administration records for each individual). Our second body of data is the 1972 Consumer Expenditure Survey of the Bureau of Labor Statistics. Although the sample of 7,795 observations is inferior to the TAXSIM data in a number of ways,[10] it has the unique advantage of containing information on individual financial saving. Since the TAXSIM sample used in this paper is also for 1972, results obtained with the two data sets are generally comparable.

Although a great many specific proposals to encourage saving have been made, all of them have in common the purpose of increasing the net rate of return on saving or, equivalently, of increasing the amount of future consumption that can be obtained per dollar of current consumption that is foregone. The proposals that are particularly concerned with saving and that form the focus of our analysis can usefully be divided into two types: (1) those that allow the taxpayers to exclude some amount of saving from taxable income and (2) those that allow the taxpayer to exclude some amount of interest and dividend income from taxable income.[11] Before examining the specific saving proposals, we comment briefly on some more general tax proposals that also might encourage saving.

The most general of these proposals is to replace the income tax with a tax on consumer spending.[12] In comparison to the income tax, a consumption tax in effect allows a deduction for all saving. A more modest partial move in the direction of a consumption tax would be to adopt a value added tax to replace part of the current tax structure. This again would be like the deduction method because income that is saved would avoid the value added tax.

Several general proposals that would reduce the effective tax rate on interest and dividends have also been actively discussed. Some form of integration of the corporate and personal taxes (presumably by giving individuals a credit for corporate taxes in proportion to dividends received) would raise the net rate of return on equity investment and therefore encourage equity finance as well as increased saving. The same would be true of a proposal to permit individuals to exclude a limited amount of dividends that are reinvested in new issue corporate stock. Adjusting the measurement of interest income to exclude some or all of the effect of inflation on interest rates would encourage the use of debt as well as increased saving. The proposals to reduce the maximum marginal tax rate to 50 percent or to tax "personal services income" and "investment income" on two separate schedules would raise the net return on all forms of capital.

Although these general proposals might be useful in encouraging saving, we shall not explore them further in the paper in order to concentrate on the simpler and more direct deduction and exclusion proposals. Section 2 examines the deduction approach and considers the consequences of such a change in both the short-run transition and the longer run. The next section then analyzes the short-and long-run consequences of interest and dividend exclusion proposals. There is a brief concluding section.

2. Deductions for Saving

Under existing law, an individual who is not a participant in an employer-sponsored pension plan[13] can establish an Individual Retirement Account (IRA) and contribute up to 10 per cent of his wage and salary, with a limit of $1500 per year. These contributions are deductible from total income in calculating taxable income and the earnings on the assets in the IRA are not subject to tax. A penalty is imposed if the funds are withdrawn from the IRA before the individual reaches age 59. Withdrawals after that age are taxable as ordinary employment income. The IRA is thus similar to a consumption tax with respect to the eligible amount of saving.[14]

The saving incentive provided by the IRA could be increased in three ways: (1) by raising the percentage and/or dollar ceilings on contributions, (2) by extending the IRA option to everyone with wage and salary income and not just to those who are not already participating in a pension plan; and (3) by increasing the liquidity of the IRA accounts by permitting withdrawals after as little as (say) four years. To the extent that IRA participants are effectively constrained by either the 10 percent or $1500 limits, the IRA does not provide any marginal incentive to save more. In the present paper we compare some of the implications of 10 percent and 15 percent limits with ceilings of $2000 and $3000. Because higher limits increase the revenue cost of these plans, we also consider a combination of a higher ceiling and partial deductibility, e.g., allowing an individual to contribute 15 percent of earnings up to $3000 but deduct only half of this amount. Such partial deduction plans increase the range of marginal effectiveness although, for previously intramarginal contributions, they reduce the incentive as well as the cost. (Because the 1972 tax return data do not separate the earnings of husbands and wives, all of the proposals are defined in terms of the taxpaying unit rather than the individual.)

The current rule that limits eligibility for an IRA to those who do not participate in employer pension plans eliminates approximately 50 percent of all employees.[15] Moreover, those employees without pension coverage tend to be those who are least likely to save and least likely to be affected by tax considerations; they have low incomes and are frequently quite young.[16] The current eligibility limit thus eliminates substantially more than 50 percent of those who would be encouraged by saving deductibility if it were generally available. The current paper examines a savings deduction plan in which all individuals with wage and salary income may participate.[17]

Finally, the restriction that funds must remain in the IRA until the individual reaches age 59 (or be subject to a special withdrawal tax and other penalties) substantially reduces the liquidity of the IRA savings. For many individuals, this reduction in liquidity may outweigh the higher net-of-tax return that the IRA offers. An individual at age 40 may be unwilling to commit funds for 19 years even in exchange for a higher rate of return. This illiquidity could be eliminated by allowing individuals to choose at the end of a short period like four years between withdrawing the funds in the account (and paying tax on the amount) or "rolling over" the funds for another four year period. In practice, individuals who are reluctant to commit funds for a very long period may decide sequentially to leave the funds in the IRA account rather than pay the tax on the withdrawal. Although we have no way to examine this issue with the existing data, this possibility for making IRA accounts more attractive should be borne in mind when considering the likely responses to extending the IRA option to all individuals.

If the savings deduction is judged as an incentive to a higher rate of saving,[18] there are three potential problems. First, during a transition period after the tax law is changed, individuals can reduce their tax liability without any increase in saving by transferring previously accumulated assets into the special account. Under an IRA-type plan with a ten percent limit, an individual with assets equal to one year's earnings could obtain the maximum saving deduction for a decade without doing any additional saving. Indeed, for such an individual, the tax change would provide no marginal incentive to save while the tax reduction for previous saving would increase disposable income and therefore presumably cause an increase in consumer spending.[19] The extent to which this is a problem depends on the amount of financial assets (relative to earnings) that individuals have available and on their willingness to sacrifice the liquidity of those assets by committing them to an IRA.[20] We shall examine in detail the amount of financial assets that individuals have and the potential revenue effect if these assets were transferred to a special savings account during a transition period after the introduction of a savings deduction rule.

The second potential problem with a savings deduction plan is that, even after the transition period in which individuals merely transfer pre-existing assets into a special savings account, there would be some individuals for whom a saving deduction with dollar and percentage limits would provide either no marginal incentive or a marginal incentive that is small relative to the intramarginal tax reduction. Thus an individual earning $10,000 and saving $900 might increase his saving by $100 to the $1000 maximum allowed by a 10 percent ceiling but would receive a tax reduction on the entire $1000 amount. With even a 20 percent marginal tax rate, the tax cost would be double the induced saving. We shall investigate the potential importance of the problem by examining the current distribution of saving relative to wage and salary income and the potential savings and revenue effects if individuals respond in different ways to the change in tax rules.

The third problem is that individuals may not be very responsive to the change in the net rate of return implied by the saving deduction. Because we are uncertain about the likely response, we shall present results for several different behavioral assumptions. At one extreme, we assume no behavioral response. At the other, we assume that all individuals take maximum advantage of the potential deduction. We also investigate a response described in terms of the elasticity of current consumption with respect to the marginal rate of transformation between current and future consumption.

Before looking at the specific results, four notes of caution are appropriate. First, our analysis is only a partial equilibrium one. We assume that interest rates and other factor incomes remain unchanged. Second, the only behavioral response that we consider is saving. Since a higher net rate of return improves the trade-off between current work and future consumption, some individuals may respond by working more. Their saving would increase even if their saving rate remained unchanged. Of course, for some individuals the income effect would dominate and work effort would be decreased.[21] We ignore any such change in work effort and labor income. Third, we do not adopt an explicit life cycle framework for our analysis. This implies that we do not take age explicitly into account in calculating the response to tax rules[22] and that we do not deal separately with the increased saving of the saving cohorts and their subsequent increased dissaving. Analyzing the complex dynamics of explicit intertemporal optimization would require much better data than currently exist. Moreover, there is no agreement on the extent to which individual saving does correspond to such rational life-cycle optimization. Finally, we consider only limited tax consequences; in particular, we ignore the effects of increased accumulation on corporate tax revenue.

2.1 Asset Transfers during Transition

We begin our analysis by examining the extent to which individuals could respond to an expanded IRA program by transferring preexisting assets into the special saving accounts. The data that we present show that this is a relatively unimportant problem except perhaps for those with relatively high incomes.

Table 1 presents the cumulative distribution of gross financial assets in each income class based on the 1972 Tax Model. Although the tax returns do not report financial assets as such, the gross financial assets can be estimated from the reported interest and dividends. For this purpose, we have used a uniform dividend yield of three percent for all taxpayers and a uniform interest rate of 4.5 percent.[23] It may be useful to bear in mind that in 1972 per capita disposable personal income was $3837 and by 1980 it had somewhat more than doubled (in current prices) to $8010. The population to which this tabulation refers includes all families and unrelated individuals, except those headed by someone aged 65 or older. Note that among those with incomes under $10,000 (approximately $20,000 at 1980 level), 79 percent had less than or equal

Table 1

Cumulative Distribution of Gross Financial Assets

Gross Financial Assets	Income Class (Thousands of Dollars) 0-10	10-20	20-30	30+	All
$0	69	38	16	6	55
$1000	79	54	27	10	66
$2000	83	63	34	13	72
$5000	89	75	47	20	80
$10,000	93	84	62	28	87
$20,000	96	91	74	39	92
$40,000	98	96	85	54	95

Source: 1972 Tax Model. Dividend and interest are capitalized at 0.03 and 0.045 respectively. Individuals over age 65 are excluded.

Table 2

Cumulative Distribution of the Number of Years of Transferable Assets

	Income Class (Thousands of Dollars)				
Years of Transferable Assets	0-10	10-20	20-30	30+	All
1	79	60	39	27	69
2	82	69	47	31	75
3	84	73	54	34	78
4	85	77	60	36	80
5	86	80	64	38	82
6	87	82	68	40	83
7	88	84	70	41	85
8	89	85	73	44	86
9	90	87	74	46	87
10	90	88	76	47	88
11	91	89	79	49	88
12	91	89	79	50	89
13	91	90	81	52	89
14	91	91	82	53	90
15	91	91	82	54	90
16	91	92	82	55	90
17	92	92	83	55	91
18	93	93	84	57	92
19	93	93	85	58	92

Source: 1972 Tax Model.
Cumulative percentage of taxpayers without the indicated number of years worth of financial assets to finance an IRA equal to 10% of wages, with a ceiling of $2000, solely from those assets. Individuals over age 65 are excluded. Dividends and interest are capitalized at .03 and .045 respectively.

to $1000 of gross financial assets. Only 11 percent had as much as $5000.

Since our concern is with the extent to which individuals could use existing financial assets to contribute to an IRA-type plan without doing any new saving, we have also restated these estimates of gross financial assets in terms of the number of years that they could be used to fund the maximum IRA-type contribution for which the individual is eligible. For example, with an allowable IRA-type contribution equal to 10 percent of income with a maximum of $2000, an individual earning $15,000 with $7000 of gross financial assets would have enough to finance somewhat more than 4 years of maximum IRA contributions. Table 2 shows the cumulative distribution of "potential years" for taxpayers grouped by income class based on IRA's equal to the lesser of $2000 and 10 percent of wage and salary income. These data exclude taxpayers over age 65 and apply the IRA rule to taxpaying units rather than separately to each individual. Note that in the class with adjusted gross incomes of less than $10,000, 79 percent did not have enough financial assets to finance even a single year's maximum IRA contribution. Since this under $10,000 group contained 60 percent of all taxpayers below age 65, it is clear that for the great majority of taxpayers there is little problem of a substantial revenue loss while these individuals finance IRA-type contributions out of previously accumulated assets. Even in the higher income group with 1972 adjusted gross incomes of $10,000 to $20,000, 60 percent lacked even one year's worth of IRA contributions at the maximum allowable rate. Only about 15 percent of taxpayers with AGI's below $10,000 and 20 percent with AGI's between $10,000 and $20,000 had enough financial assets to finance as much as five years' of contributions.

Table 3 presents the aggregate implications of this potential asset transfer for a saving deduction plan that allows contributions of 10 percent of income with a $2000 annual maximum. The table shows that the maximum contribution that individuals could legally deduct totalled $56.1 billion or slightly more than $800 per taxpayer. By contrast, the maximum amount that could be financed by transfers from existing assets in the first year was only $26.9 billion. It should be emphasized that this maximum transfer would occur only if all taxpayers were prepared to lose the liquidity of these assets in order to obtain the higher net-of-tax return. (Note that because of the $2000 ceiling approximately four-fifths of this deduction accrues to those with incomes below $20,000 and nearly all of it to those with increases below $30,000.)

The distribution of assets in Tables 1 and 2 implies that this first year transfer would exhaust much of the available assets of most taxpayers. The final column of Table 3 confirms the importance of this by tabulating the amount of preexisting assets that could be transferred in the third year of such a new tax rule. The total amount of transferable assets is reduced from $32 billion to only $17 billion, or less than one-third of the maximum potential contribution in that year.

In interpreting the revenue losses associated with asset transfers, it is important to bear in mind that they represent a one-time fixed cost of transition to a new system. The true economic cost of this revenue loss is not the revenue loss itself but the much smaller excess burden that would be incurred in making up this lost revenue or that otherwise could have been avoided if the lost revenue had instead been used to reduce some other distorting tax. The

Table 3

Aggregate Effects of Alternative Savings Deduction Plans

AGI Class ($1000)	Millions of Returns	Maximum Contribution ($ billion)	Contributions from Assets Year 1 ($ billion)	Year 3 ($ billion)
0-10	42.2	17.9	5.1	3.1
10-20	22.2	28.6	14.4	8.1
20-30	4.1	7.2	5.2	3.6
30+	1.6	2.4	2.1	1.9
All	70.0	56.1	26.9	16.8

Source: 1972 Tax Model

Potential reductions in taxable income with the introduction of a universal IRA. The maximum deduction is 10 percent of wages with a ceiling of $2000. Individuals over age age 65 are excluded.

corresponding gain is the present value of the perpetual reduction in the excess burden caused by the incorrect mix of taxes on capital and labor incomes. Because this is a comparison of a one-time cost with a perpetual gain in a growing economy, the one-time transition cost is likely to be relatively small.

2.2 Marginal and Intramarginal Saving After the Transition

After the transition period, an individual can have a tax deduction only for net saving that actually adds to individual wealth and the national capital stock.[24] Of course, some of this saving would have been done anyway. Moreover, for those individuals who would in any case have saved more than the maximum deductible amount, the deductible saving would be intramarginal and the tax rule would influence saving only by an income effect. For such individuals, since some of the tax reduction would be spent, the net effect would be an increase in consumption. But for those individuals who would otherwise have saved less than the deductible amount, the new rule would provide a marginal incentive to save. If however, the saving would have been close to the limit, the increased saving may be constrained to be less than the tax reduction.

To shed some light on this issue, we have examined the distribution of existing saving rates relative to wage and salary income. For this purpose, we use the 1972 Consumer Expenditure Survey and define saving as the 'change in nominal net financial assets, excluding the appreciation of portfolio assets.' We use this definition of saving (rather than say the change in net worth) because this defines the kind of saving for which the tax deduction would be allowed. We then use this information to calculate the amount of intramarginal saving and other preexisting saving for which taxpayers would receive deductions and compare this to the potential increases in saving that might be induced under different assumptions about the behavioral response of taxpayers. The effects on tax revenue are also calculated.

Table 4 presents the cumulative distributions of the ratio of net financial saving to wage and salary income for four income classes as well as for households as a whole. It is clear that a 10 percent limit on deductible saving would be a binding constraint for only a small fraction of all households. Among those with income below $10,000, only 14 percent saved 10 percent of their income in the form of financial asset accumulation. The fraction is essentially the same for those with incomes between $10,000 and $20,000. Among those with incomes over $20,000, the $2000 limit on saving deductibility becomes the constraint instead of the 10 percent limit. This implies that deductibility would be intramarginal for a larger fraction of these taxpayers. But the figures for the $20,000 to $30,000 class imply that only about one in five would otherwise be at or above the deductibility limit.

Another striking feature of Table 4 is the very high fraction of households who report no change in their gross financial assets. Some 24 percent of all households indicate some reduction in financial assets during the year and an additional 37 percent indicate neither saving nor dissaving. Only 39 percent report positive saving. A tax rule allowing deductibility of saving would provide an unambiguous incentive to save more to the 60 percent with zero or negative saving since there would be no offsetting income effect associated with preexisting saving (Feldstein and Tsiang, 1968).

We have prepared simulations to compare the effects on saving and tax revenue of four alternative saving deductions and several different possible

Table 4

Cumulative Distribution of the Ratio of Changes in Net Financial Assets to Wage and Salary Income

Ratio of Change in Financial Assets to Wage and Salary Income	Income Class (Thousands of Dollars)				
	0-10	10-20	20-30	30+	All
-0.04	15	16	14	12	15
-0.02	19	20	18	15	19
< 0	23	26	24	20	24
0	69	57	49	41	61
0.02	76	69	59	54	70
0.04	80	77	68	63	77
0.06	83	81	74	67	80
0.08	85	84	77	69	83
0.10	86	87	79	72	85
0.12	88	88	86	73	87
0.15	89	90	86	77	89
0.18	90	91	87	78	90
0.36	94	96	94	88	95

Source: 1972 Consumer Expenditure Survey

Tabulations exclude households with no wage or salary income behavioral responses. The two basic savings deductions are 10 percent of earnings with a $2000 limit and 15 percent of earnings with a $3000 limit. A more restricted alternative that reduces the revenue loss without changing the set of taxpayers for whom the deduction provides a marginal incentive would limit the tax deduction to only half of the contribution to the saving plan; i.e., a taxpayer with earnings of $15,000 could contribute up to $1500 but would receive a tax deduction for only $750. The earnings on all the assets in the fund would, however, be untaxed. The final option presented in this table is designed to offset the fact that higher income taxpayers already save a larger fraction of their income than low income taxpayers. For taxpayers with incomes over $10,000, it restricts the deduction to the excess over a "floor" equal to 5 percent of the earnings over $10,000. For example, a taxpayer with earnings of $20,000 could only deduct savings contributions in excess of $500. Such a taxpayer could contribute an additional $2000 but would receive a deduction only of $2000 for the $2500 contribution. This would have no adverse incentive effect on anyone who would save at least five percent under existing tax rules. Moreover, even the initial five percent has some incentive effect associated with it since the income on all the assets in the fund is untaxed. Indeed, for some high income taxpayers for whom the $2000 ceiling is a binding limit, the ability to contribute an additional five percent of nondeductible earnings may be an incentive to save.[25]

For each of the four alternative plans, we have calculated the increase in savings and decrease in tax revenue implied by several alternative behavioral response assumptions. The first assumption, that there is no change in saving, provides a reference standard for comparing the tax revenue implications of alternative behavioral responses. At the opposite extreme would be the assumption that taxpayers increase their saving to the maximum amount of the allowed deduction. It seems very unlikely, however, that individuals who currently do no saving would suddenly switch to this maximum amount. We have therefore examined two alternatives that are much more conservative. The first assumption is that only those who currently have positive saving would switch to the maximum, with no change in the behavior of nonsavers. The alternative assumption is that taxpayers with positive assets would take the maximum deduction while those with no assets would not respond at all. A fourth assumption is an arbitrary intermediate response: each taxpayer who has positive saving increases his saving halfway from his actual 1972 level to the maximum amount. For example, a taxpayer with \$15,000 of earnings and \$500 of preexisting annual savings would, with the 10 percent plan, increase his saving to \$1000.

The other three behavioral response calculations reflect the assumption that consumer spending responds to the income and substitution effects of a deduction rule with constant partial price and income elasticities. The basic concept in this calculation is the relative "price" of current consumption in terms of foregone future consumption. Consider an individual who decides between spending a dollar now or saving it and spending the principal and accumulated interest at the end of T years.[26] Let the nominal interest rate be i, the inflation rate be π, and the individual's marginal tax rate be θ. Under current law, the individual chooses between spending \$1 now and spending $(1+(1-\theta)i)^T$ dollars in year T. The real value of that T-th year spending is $(1+(1-\theta)i)^T/(1+\pi)^T$, or, ignoring terms that are of second order, $(1+(1-\theta)i-\pi)^T$. We shall call this rate of transformation R_0. If the individual could instead deduct the dollar of saving, by foregoing one dollar of current consumption he could add $1/(1-\theta)$ dollars to his current savings. If the saving accumulates untaxed, this grows to $(1+i)^T/(1-\theta)$ dollars at the end of T years. The individual pays tax on this nominal value, although presumably at a lower tax rate ($\theta' < \theta$) because he is then retired. The net of tax accumulation is thus $(1-\theta')(1+i)^T/(1-\theta)$. In real terms this is (again ignoring second order terms) $R_1 = (1-\theta')(1+i-\pi)^T/(1-\theta)$.[27]

Note that if $\theta' = \theta$, the combination of deductibility and the nontaxation of the interest on the saving acccount is equivalent to having no deduction and then allowing the saving to accumulate completely untaxed (i.e., with no tax when funds are disbursed from the account). This is equivalent to consumption tax treatment and removes the distortion in the individual's choice between early and late consumption. However, the distortion between leisure and consumption (both present and future) remains and presumably biases the individual's decision in favor of leisure. At the alternative extreme in which withdrawals from the fund at retirement are untaxed ($\theta' = 0$), the individual chooses between one dollar of current consumption and $(1+i-\pi)^T/(1-\theta)$ dollars of consumption in year T. This represents a more favorable tradeoff between current and future consumption than a consumption tax and thus distorts consumption in favor of the retirement years. But because it permits the individual to transform a dollar of pretax earnings into retirement consumption at the real rate of interest, such treatment offsets the bias against working that is inherent in the consumption tax. Indeed, with $\theta = 0$ this method is equivalent to no tax at all as far as the trade-off between current leisure and future consumption is concerned.

For the purpose of the simulations, we approximate the change in consumption as the sum of a price effect and an income effect:

$$dC = \frac{\partial C}{\partial R} dR + \frac{\partial C}{\partial Y} dY \tag{2.1}$$

where C is consumption, R is the price of current consumption (in terms of foregone future consumption) and Y is disposable income. From 2.1 it directly follows that

$$\frac{dC}{C} = \frac{R}{C} \frac{\partial C}{\partial R} \cdot \frac{dR}{R} + \frac{Y}{C} \frac{\partial C}{\partial Y} \cdot \frac{dY}{Y} \tag{2.2}$$

$$= \alpha_R \frac{dR}{R} + \alpha_Y \cdot \frac{dY}{Y}$$

where α_R and α_Y are the price and income elasticities. We shall assume that these partial price and income elasticities are locally constant.

We use this approximation to calculate the level of consumption under the deduction rule (C_1) as a function of the initial consumption level (C_0), the two related price values (R_1 and R_0) and the income effect of the tax change (dY). For simplicity, we shall describe this in the case where the individual initially has a positive level of saving ($S_0 > 0$) but in which the deduction limit is never binding (i.e., both S_0 and the level of saving under the deduction rule, S_1, are less than the limit, L). In this case, the relative price increase caused by the deduction rule is $dR/R = (R_1 - R_0)/R_0$. The income effect depends on the change in income caused by the deduction rule at the initial level of saving. Recall that under current tax law the individual who saves S_0 "buys" future consumption of S_0R_0. With the deduction rule, this same level of future consumption can be bought at the lower current cost, R_0S_0/R_1. The difference between these two is the increase in income at the initial consumption pattern. Thus $dY = S_0 - S_0R_0/R_1 = S_0(R_1 - R_0)/R_1$. Substituting these expressions into equation 2.2 we obtain:

$$(2.3) \qquad \frac{C_1-C_0}{C_0} = \alpha_R \frac{R_1-R_0}{R_0} + \alpha_Y \frac{S_0(R_1-R_0)}{Y_0R_1} .$$

It is clear that equation 2.3 is only an approximate measure of the change in consumption. We use the linear approximation of equation 2.1 and evaluate it at the initial values of R_0 and S_0. We define consumption to include all uses of income other than financial saving and taxes; in particular, we include mortgage repayments in consumption. Moreover, we look only at a single year in isolation. In a full life cycle model, the price effects would be more complex, the income change would reflect the discounted value of the price changes in future years as well, and the initial level of income (Y_0) would be replaced by a discounted value of future incomes. (Note however that if the individual's saving rate remained relatively constant over a number of years, the use of S_0/Y_0 instead of a ratio of two discounted values would not change the result appreciably.)

The magnitudes of the income and substitution effects determine whether the switch to a deduction rule raises or lowers consumption. The effect on saving can then be calculated from the change in consumption and the change in tax revenue:

$$(2.4) \qquad (S_1-S_0) + (C_1-C_0) + (T_1-T_0) = 0$$

where T_0 is the individual's tax liability under current tax law and T_1 is the tax liability under the deduction rule. For an individual whose final level of savings is below the deduction limit, $T_1 - T_0 = -\theta S_1$, i.e., the individual's tax liability is reduced by the product of his marginal tax rate (θ) and his savings deduction (S_1). Note that equation 2.4 implies that even if the income and substitution effects on consumption balance so that consumption remains unchanged ($C_1 - C_0 = 0$), saving will increase if the tax liability falls ($S_1 - S_0 > 0$ if $T_1 - T_0 < 0$). Of course, the income effect could dominate the price incentive and cause consumption to rise by enough to leave savings lower. To evaluate this in the current case, we need values of α_R and α_Y and the microeconomic distributions of tax rates, savings, and incomes.

Before discussing the values of α_R and α_Y, we may comment briefly on three special cases where saving is negative, zero or above the limit. If initial saving is negative ($S_0 < 0$), there is neither an income effect nor a price effect. Both consumption and saving remain unchanged. With zero initial saving, there is a price effect but no income effect; consumption falls and saving rises. For an individual whose initial saving exceeds the deduction limit ($S_0 > L$), there is no price effect (since $R_1 = R_0$) and an income effect given by $L(R_1 - R_0)/R_1$; consumption rises and savings may rise or fall. Finally, for an individual whose initial level of savings is below the ceiling ($S_0 < L$) but for whom equation 2.3 and 2.4 imply that S_1 exceeds the ceiling, we take savings to be either the limit or, if it is greater, the value of savings implied by the income effect alone.

In all of our simulations, we assume a unit elasticity of consumption with respect to disposable income: $\alpha_Y = 1$. Since we lack reliable econometric evidence on α_R, we perform simulations for a range of values. At one extreme is the case of $\alpha_R = 0$, i.e., no substitution effect. In this implausible limiting case, the only response to the tax change is the income effect and therefore an increase in consumption. More generally, $\alpha_R < 0$ and the response of consumption depends on the relative strength of substitution and income effects. Since intuition about consumer behavior is in terms of the uncompensated price elasticity rather than the pure price effect, we derive simulation values of α_R from assumptions about the uncompensated response of consumption for a "representative" taxpayer with disposable income of Y_0 = \$10,000, savings of S_0 = \$200 and a marginal tax rate of $\theta = 0.25$. To calculate the values of R_0 and R_1, let $i = 0.10$ be the nominal interest rate and $\pi = 0.08$ be the rate of inflation. Assume that the time to retirement consumption is $T = 15$ years and that in retirement the individual's marginal tax rate will be half what it is now: $\theta' = 0.50\theta$. Then $R_0 = (1 + (1-\theta)i - \pi)^T = (1 + .075 - .08)^{15} = 0.93$ and $R_1 = (1-\theta')(1+i-\pi)^T/ (1-\theta) = 0.875\ (1.02)^{15}/0.75 = 1.57$. Thus $R_1/R_0 = 1.69$.

Consider first the case in which a change in the net rate of return has no effect on consumption: $C_1 = C_0$. Equation 2.3 then implies that

$$(2.5) \qquad 0 = \alpha_R \frac{R_1-R_0}{R_0} + \alpha_Y \frac{S_0(R_1-R_0)}{Y_0R_1}$$

or, with $\alpha_Y = 1$,

$$(2.6) \qquad \alpha_R = - \frac{S_0}{Y_0} \frac{R_0}{R_1}$$

These specific assumptions for our representative taxpayer then imply α_R = -0.0118. Note that although this value of α_R implies that the income and substitution effects balance and leave consumption unchanged for the "representative" taxpayer, someone with a lower initial saving rate will have a smaller income effect and will, therefore, be induced by the deduction rule to reduce consumption while someone with a higher initial savings rate will be induced to increase consumption.

We also present simulations based on the assumption that an increase in the net rate of return would cause our representative taxpayer's consumption to decrease, i.e., that the substitution effect outweighs the income effect. More specifically, we approximate the consumption response of this type of "representative" taxpayer to deductibility as a two percent decrease in consumption. Equation 2.3 then implies

$$(2.7) \qquad -0.02 = \alpha_R \frac{1.57 - 0.93}{0.93} + \frac{0.02(1.57 - 0.93)}{1.57}$$

or $\alpha_R = -0.041$.

The relation between these responses of a "representative" individual and the aggregate responses that we obtain in the simulations reflects the distribution of initial saving rates and price changes and the effects of the deductibility ceilings. We should again emphasize that these calculations are not precise estimates but are approximations for a broad range of parameter values. A more complete analysis would instead derive each individual's consumption response with the help of an explicit utility function in a life cycle context. Realistic life cycle calculations would have to take into account bequests and inheritances as well as family structure, private pension benefits, Social Security, etc. Liquidity considerations and the possible favorable misunderstanding of the deductibility should also be considered. At this time, there is just not enough information to perform such a calculation.

In the simulations we calculate two different measures of the effect of the deduction on tax revenue. The first of these is the short-run effect that results from the immediate deduction of the savings deposited in the special account. This is approximately equal to the product of the individual's marginal tax rate and the lesser of savings (S_1) and the ceiling on the savings deduction. In fact, we use the Tax Model to calculate more precisely the effect of the savings deduction in a way that takes into account the nonlinearity of the tax schedule and other features of the tax law. Of course, for taxpayers with negative savings, there is no change in tax revenue.

Because withdrawal of funds from the savings account requires paying tax, the initial deduction is in part only a postponement of the tax liability. Indeed, if the tax rate in retirement is equal to the tax rate when working ($\theta' = \theta$), the initial deduction is fully offset by the subsequent withdrawal tax. The advantage of the deduction account is then only that the income on the assets accrues without tax. More generally, the long-run reduction in tax revenue reflects both the lower tax rate when funds are withdrawn ($\theta' < \theta$) and the exclusion from taxable income of the interest and dividend income on the amount of savings that would have been done under the old law (since the income on the induced saving would not otherwise exist).

We calculate the long-run revenue loss by noting first that the initial level of saving S_0 grows under current law to R_0S_0 before it is consumed while, with the deductions, it grows to R_1S_0. The entire difference, $(R_1-R_0)S_0$, is the accumulated value of the lower taxes that the government collects on S_0 and on the resulting interest and dividend income. The present value of that difference as of the initial date, discounting at the real pretax rate of returns, is $(R_1-R_0)S_0/(1+i-\pi)^T$. This is the present value of the revenue loss associated with the initial level of savings. The additional saving causes an additional revenue loss to the extent that the tax rate in retirement (θ') is less than the tax rate at the time that the deduction is taken. If S_1 is less than the deduction limit, the initial revenue loss on the induced saving is $\theta(S_1-S_0)$. The induced saving grows over time to $(S_1-S_0)\ (1+i-\pi)^T$ and yields a tax revenue of $\theta'(S_1-S_0)(1+i-\pi)^T/(1+i-\pi)^T = \theta'(S_1-S_0)$. The net revenue loss on the induced saving is thus $(\theta-\theta')(S_1-S_0)$. The full long-run reduction in revenue (associated with the single year's saving) thus has a present value of $(R_1-R_0)S_0/(1+i-\pi)^T + (\theta-\theta')(S_1-S_0)$. The simulations modify this formula in the appropriate way in the cases where initial saving is negative or where the limit on deductibility is binding [29] and use the full tax simulation calculations instead of just the marginal tax rate.

Table 5 summarizes the results of these simulations. Consider first the effects of the alternative plans on tax revenue if taxpayers do not adjust their saving at all. A savings deduction limited by 10 percent of wages and $2000 would have an immediate revenue cost of $49. The present value of the full long-run tax effect is slightly larger, $60, implying the exclusion of the interest and dividends outweighs the recouping of part of the initial deduction. Increasing the limits by 50 percent (to 15 percent of wages and $3000) increases the initial cost by proportionally less but increases the long-run deduction by almost 50 percent. This indicates that the primary value to taxpayers of the higher limits is in the implied interest and dividend exclusion. Finally, note that while cutting the deduction in half obviously halves the short-run revenue loss, the long-run revenue effect is much less.

Consider now the effects of the alternative saving responses to the 10 percent deduction limit. If taxpayers who already do some saving increase their saving to take full advantage of the deductions, average saving would rise by $158. The deduction of this saving would increase the revenue loss by $36, from

Table 5.

Simulations of Different Behavioral Responses to Alternative Saving Deduction Rules: Mean Changes in Saving and Taxes

	10 Percent Deduction, $2000 Limit			15 Percent Deduction $3000 Limit			Partial Deduction: One-half of 15 Percent Deduction, $3000 Limit			Deduction with floor: 10 Percent Deduction, $2000 Limit, Floor of 5 Percent of Income over $10,000		
	Change in			Change in			Change in			Change in		
	Saving	Tax Revenue		Saving	Tax Revenue		Saving	Tax Revenue		Saving	Tax Revenue	
		Short Run	Long Run		Short Run	Long Run		Short Run	Long Run		Short Run	Long Run
Savings Unchanged	0	49	60	0	61	86	0	31	67	0	37	24
Savings Increase to Maximum If Saving > 0	158	85	78	298	125	118	289	64	83	97	57	34
Savings Increase to Maximum If Assets > 0	129	79	75	240	116	114	240	61	82	79	53	32
Savings Increase Half Way to Maximum If Saving > 0	79	67	69	144	94	102	144	94	99	48	47	29
Representative Consumption Unchanged (α_R=-0.0118)	58	47	57	57	54	82	28	29	66	26	32	22
Representative Consumption Increased (α_R = 0)	10	37	51	5	43	77	-8	25	64	10	30	21
Representative Consumption Decreased (α_R=-0.041)	157	69	68	168	79	94	111	39	71	68	40	26

Source: Simulations based on 1972 Consumer Expenditure Survey.

$49 to $85. The present value of the long-run revenue loss would also rise, but by proportionately less since the increase reflects the differences between the initial deduction and the present value of the extra revenue obtained when the funds are withdrawn. The corresponding figures when the response is limited to those who initially had positive assets or when the size of the response is halved are similar although obviously somewhat smaller.

The partial price elasticity associated with unchanged consumption for the representative taxpayer (α_R = -0.0118) causes saving to rise by an average of $58 per taxpayer. The immediate revenue loss associated with this is $47 and the long-run revenue loss is $57. Thus in this case, the increased personal saving exceeds the immediate reduction in personal tax revenue and is approximately equal to the long-run tax reduction. If the incentive to postpone consumption does cause a fall in consumption, the increase in saving exceeds the short-run and long-run loss of tax revenue.

Since all of these figures are means per taxpayer and there were 70 million taxpayers in 1972, these estimates imply that the immediate revenue cost of a 10 percent deduction plan is a minimum of $3.5 billion (at 1972 levels) with no saving response. Beyond that, each dollar of induced saving reduces revenue by only about 20 cents. With consumption unchanged, the revenue loss is $3.5 billion and the increased saving is $4 billion. With consumption reduced by two percent, the revenue loss is somewhat less than $5 billion and the saving increase is about $10 billion.

Tables 6 and 7 analyze the effects of a savings deduction by income class. Table 6 accepts the conservative assumption of unchanged consumer

Table 6

Distributional Implications of Alternative Savings Deduction with No Change in Consumption

Mean Changes in Saving and Taxes

Income Class	10 Percent Deduction, $2000 Limit Change in			15 Percent Deduction $3000 Limit Change in			Partial Deduction: One-half of 15 Percent Deduction, $3000 Limit Change in			Deduction with floor: 10 Percent Deduction, $2000 Limit, Floor of 5 Percent of Income over $10,000 Change in		
	Saving	Tax Revenue		Saving	Tax Revenue		Saving	Tax Revenue		Saving	Tax Revenue	
		Short Run	Long Run		Short Run	Long Run		Short Run	Long Run		Short Run	Long Run
Less than $10,000	13	9	9	11	10	15	6	5	12	12	9	9
$10,000	60	53	70	58	61	96	28	33	79	26	38	35
$20,000	166	143	168	146	160	273	67	88	221	69	88	38
$30,000+	444	310	329	521	387	427	282	193	291	172	175	16
All	58	47	57	57	54	82	28	29	66	26	32	22

Source: Simulations based on 1972 Consumer Expenditure Survey.
All figures are means and are expressed in 1972 dollars.

Table 7

Distributional Aspects of Alternative Behavioral Responses to a 10 Percent Savings Deduction:

Mean Changes in Saving and Taxes

	Change in Saving Income Class				Short Term Change in Taxes Income Class				Long Run Changes in Taxes Income Class			
	Less than $10,000	$10,000–	$20,000–	$30,000+	Less than $10,000	$10,000–	$20,000–	$30,000	Less than $10,000	$10,000–	$20,000–	$30,000
Savings Unchanged	0	0	0	0	9	58	155	260	9	73	174	307
Savings Increase to Maximum If Saving > 0	44	251	353	267	16	110	252	371	12	99	223	362
Savings Increase to Maximum If Assets > 0	26	207	320	253	14	101	243	366	11	95	218	360
Savings Increase Half Way to Maximum If Saving > 0	22	126	177	134	13	84	204	319	11	86	199	336
Representative Consumption Unchanged (α_R = −0.0118)	13	61	166	444	9	53	143	310	9	70	168	329
Representative Consumption Increased (α_R = 0)	2	6	41	112	7	43	115	194	8	65	154	272
Representative Consumption Decreased (α_R = −0.041)	39	194	462	691	13	77	210	452	11	82	202	400

Source: Simulations based on 1972 Consumer Expenditure Survey.

spending and examines the impact on saving and taxes of alternative deduction plans. It is clear that the basic deduction of 10 percent of wages with a $2000 limit induces proportionally more response at each higher level of income. Note that switching from a 10 percent, $2000 limit to a 15 percent, $3000 limit has virtually no effect except in the highest income group. Table 7 focuses just on the 10 percent, $2000 deduction limit but examines the responses in each income class associated with different types of behavior. One point worth noting is that the effect of different price elasticities on the amount of saving is proportionately greater for low income taxpayers than for high income taxpayers. Note also that, regardless of the price elasticity, there is little tax reduction below $10,000 and that above $10,000 the tax reduction rises at least in proportion to income.

3. Exclusion of Interest and Dividends

Until 1980, an individual taxpayer could exclude the first one hundred dollars of dividend income from adjusted gross income and therefore from taxable income. A couple could exclude twice that amount. The law was modified in 1980 to double these exclusions and to extend them from dividends to both dividends and interest. For anyone with interest and dividend income below the limit, the exclusion effectively eliminates the tax on such income at the margin and therefore has the full neutrality of a consumption tax.

The principal problem with the current exclusion is that the limit may be too low. For a couple with more than $400 of interest and dividends, the exclusion is intramarginal and has no effect on the taxation of additions to wealth. With today's interest rates, a couple with as little as $4000 of wealth could easily find that the income that results from any additional saving would be fully taxed. This section considers alternative proposals to raise the limit on the exclusion. To reduce the cost of such an increase, we also consider two partial exclusion plans (the first plan excludes 20 percent of all interest and dividend income while the second plan excludes one half of the first $1000 of interest and dividend income)[30] and a plan with a floor (individuals with incomes in excess of $10,000 can only exclude interest and dividend income to the extent that it exceeds five percent of the income over $10,000 and then only up to a limit of $1000).

From the taxpayers' point of view, the interest and dividend exclusion has two advantages over a savings deduction that implies the same real net rate of return. First, because the interest and dividend exclusion is not restricted to a separate account, there is no loss of liquidity to counterbalance the increase in yield. Second, there are no additional accounting or record keeping requirements. Both of these features suggest that, all other things equal, individuals are likely to be more responsive to an exclusion than to a savings deduction. Against this might be balanced the "psychological" effect of the savings deductions in focusing attention on an immediate tax reward for saving. We know of no evidence on the basis of which this can be evaluated.

The dividend and interest exclusion also has the advantage that there is no transition problem comparable to the transfer of existing assets that occurs with a savings deduction. Of course, the interest and dividend exclusion has an analogous problem since taxes are reduced immediately on the interest and dividends earned on preexisting wealth. But this problem does not just apply during the transition. Rather, with the interest and dividend exclusion, there is no real distinction between the initial "transition" tax reductions and the subsequent "steady state" reduction in taxes that result from assets that would have existed even without the exclusion.

The principal issue in judging the potential usefulness of the interest and dividend exclusion is the amount of additional saving that is generated per dollar of foregone tax revenue. Of course, there is no revenue loss directly caused by the increased accumulation of wealth induced by the new tax rule. The interest and dividends that go untaxed would not have existed otherwise and therefore obviously would not have been taxed. All of the revenue loss is due to the exclusion of interest and dividends or wealth that would have existed in any case.[31] This revenue loss therefore depends on the distribution of existing interest and dividends, the limit on the exclusion, and the fraction that is excluded if less than a full exclusion. Section 3.1 presents evidence on this distribution.

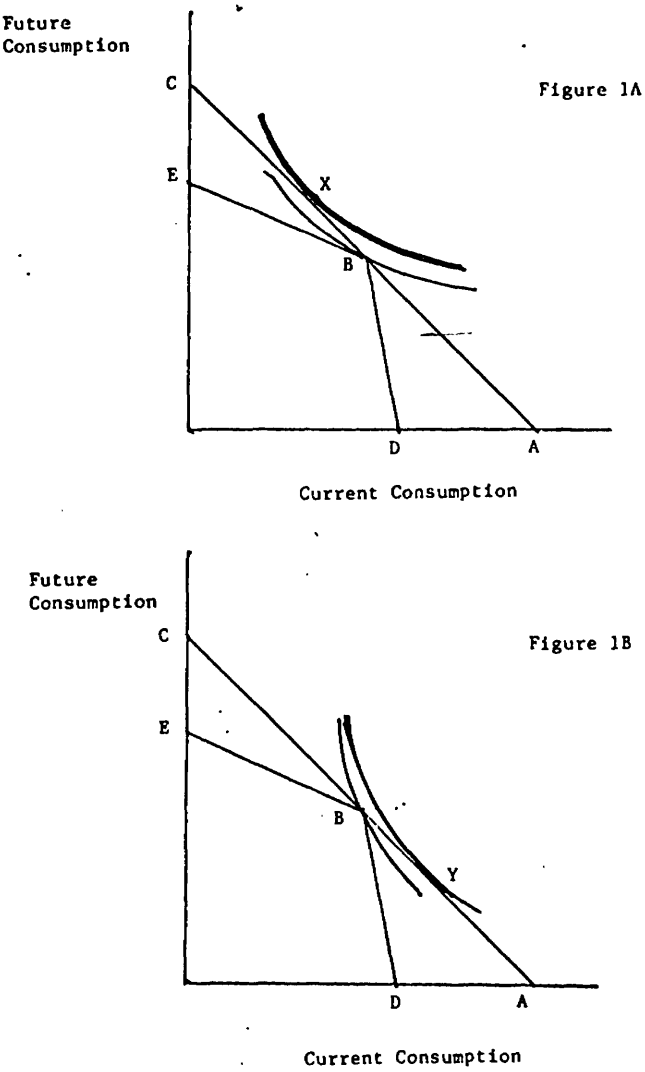
In evaluating the likely response to an interest and dividend exclusion, we give particular attention to those who currently have zero interest and dividends. As the data in section 2 on the distribution of gross financial assets implied, this is a very sizeable group. Among taxpayers as a whole, 46 percent had no interest and dividends. The concentration of individuals at zero reflects a kink in the intertemporal budget constraint. Even in the absence of taxes, the budget constraint would be kinked at the point of zero saving, reflecting the fact that the borrowing rate exceeds the rate that individuals receive on deposits. Since most taxpayers do not itemize their deductions, the tax rules leave the borrowing rate unchanged but reduce the net lending rate even more.[32]

Because of the kink, individuals with different preferences will have the same behavior. Because the reason that a particular individual has zero interest and dividends in equilibrium cannot be determined from the available data, the likely effect of a tax change is ambiguous as well. Figure 1 illustrates this ambiguity in a two-period model of income and consumption. In both parts of this figure, line ABC represents a constant interest rate budget line between current and future consumption. At point B, the individual neither borrows nor lends. The tax on interest income shifts the lending segment of the budget constraint from BC to BE. The higher interest rate on borrowing than on lending shifts the borrowing segment from AB to DB.

In figure 1A, the individual faced with the constant interest rate budget line ABC would choose to save and therefore to consume at point X. But with the kinked budget line DBE, the individual chooses point B with no borrowing and lending. In figure 1B, the individual faced with line ABC would choose to borrow and therefore to consume at point Y. But with the kinked budget line DBE, this individual also chooses point B. The exclusion of interest and dividend income would raise the savings segment of the budget line from BE to BC. In figure 1A, this induces the individual to save and shifts the equilibrium from B to X; in contrast, in figure 1B this has no effect on the individual's behavior. Because we only observe that the individual is now at point B and cannot distinguish between the 1A and 1B situations, the effect of the tax change is ambiguous.

Figure 1

The Kinked Intertemporal Budget Constraint



We might in principle reduce the uncertainty by distinguishing between those individuals with zero interest and dividends who also borrow and those who do not. The borrowers are in equilibrium on segment BD and would not be influenced by a shift in the lending line from BE to BC. The ambiguity would therefore pertain only to those who were truly at point B with no borrowing as well as no lending. There are two difficulties with this line of reasoning. The first is a practical one: information on borrowing is only available for itemizers and is therefore not available for the majority of taxpayers and for an even larger share of the group without interest and dividends since itemizing of deductions is relatively uncommon in this group. But even if information on borrowing were available, there would be a problem since many individuals both borrow and lend. Since the borrowing is generally at a higher interest rate than the lending (typically consumer credit and savings accounts), the observed behavior reflects considerations of liquidity and convenience and therefore cannot be reconciled with the simpler analysis of figure 1.

Since the prospective behavior of those who currently have no interest or dividends is inherently ambiguous, we present simulations based on two alternative assumptions about this group. The first type of simulation makes the very conservative assumption that all individuals would prefer to be borrowing and therefore do not change their saving in response to an interest and dividend exclusion rule. The alternative sets of simulations assume that all individuals respond by increasing their wealth to take at least some advantage of the exclusion; no distinction is made between those who initially have interest and dividend income and those who do not. This behavior is consistent with figure

1A (although with the individual switching from B to a point that may induce less saving than at X if the exclusion limit is binding). Further information about the simulation method as well as the simulation results will be presented in section 3.2

3.1 The Distribution of Interest and Dividend Income

The current distribution of interest and dividend income determines the tax revenue effects of various exclusion limits and the extent to which changes in the limits can have marginal incentive effects. In considering the data presented in this section, it is important to bear in mind that the 1980 level of per capita income was approximately double the 1972 level and therefore that the typical taxpayer in 1980 had approximately twice the amount of financial assets. Moreover, the level of interest rates and the dividend-price ratio also doubled between 1972 and 1980. Thus, a taxpayer who had $200 of interest and dividends in 1972 probably had about $800 in 1980.

Table 8 presents the cumulative frequency distribution of interest and dividend income by AGI class. Note that 46 percent of all taxpayers had no interest and dividend income and that an additional 25 percent had between $1 and $200 of such income. Introducing a $200 exclusion would thus provide an increase in the <u>marginal</u> real net interest rate for 71 percent of taxpayers while giving a tax reduction with no marginal incentive effect to the remaining 29 percent. Extending the exclusion from $200 to $400 would add an additional 7 percent to the number of taxpayers with a higher real net return and would double the intramarginal tax saving for the 22 percent of taxpayers with more than $400 of interest and dividends.

Table 8

Cumulative Distributions of Interest and Dividend Income by Adjusted Gross Income Classes

Interest and Dividend Income	Adjusted Gross Income Class (Thousands of Dollars)				
	0-10	10-20	20-30	30+	All
$ 0	58	37	16	5	46
$ 200	77	70	45	18	73
$ 400	82	80	59	26	78
$ 800	87	87	73	40	85
$1600	91	93	82	54	90

Data: 1972 Tax Model Data

Numbers indicate cumulative percentages of taxpayers with less than the indicated amount of interest and dividend income.

Since the vast majority of 1972 taxpayers had AGI's below $10,000, the overall pattern also describes the distribution of interest and dividend income in that income class. The pattern is also similar among those with AGI's between $10,000 and $20,000. Only in the very small class of taxpayers with higher incomes (less than 10 percent of 1972 taxpayers had AGI's over $20,000) did the interest and dividend distribution differ substantially from this pattern. For example, among those with AGI's between $20,000 and $30,000 of income, only 45 percent had less than $200 of interest and dividend income. For that income class, a $200 exclusion would be intramarginal for 55 percent of taxpayers.

Table 9 shows that the distribution of interest and dividend income also differs substantially by age. While 71 percent of all taxpayers had less than or equal to $200 of interest and dividends, more than 90 percent of those less than 29 years old and 80 percent of those aged 30 to 49 fell into this category. By contrast, only 32 percent of those over age 64 had as little as $200. These figures indicate that a $200 exclusion in 1972 would have had a marginal incentive effect for a relatively large fraction of preretirement taxpayers and that, for those older than 65, the exclusion would be largely an intramarginal reward for earlier saving.

3.2 Simulations of Alternative Exclusion Rules

We now present the results of simulations of alternative exclusion rules. These simulations use the Taxsim model for 1972; the baseline simulation therefore includes a $200 dividend exclusion. For cost reasons, we have reduced the sample by a one-in-three random selection, yielding a simulation sample of 8881 taxpayers.

Table 9

Cumulative Distributions of Interest and Dividend Income by Age Class

Interest and Dividend Income	Age Class				
	22-29	30-49	50-64	64+	all
0	65	51	34	18	46
$ 200	91	80	59	32	71
$ 400	95	87	69	39	78
$ 800	97	93	78	50	85
$1600	98	94	89	63	90

Data: 1972 Tax Model.

Numbers indicate cumulative percentage of taxpayers with less than the specified amount of interest and dividend income, by age category.

The effect of an exclusion rule on tax revenue depends only on the parameters of the exclusion rule and not on the taxpayers' behavioral response. This reflects the fact that no revenue is lost on the induced increase in saving and the resulting increase in interest and dividend income.

Because the exclusion rules refer to the income earned on the stock of financial assets and not to annual savings, we simulate the behavioral response in terms of the stock of financial assets (or "assets" for short). We estimate each taxpayer's initial level of assets by assuming that the interest income reflects an interest rate of 4.5 percent and that the dividend income reflects a dividend-price ratio of 3.0 percent. On this basis we estimate an initial average level of gross financial assets of $ 8,230 for each of the 77.5 million tax returns.

Table 10 presents the simulated effects on tax revenue and on assets of the six exclusion plans: (1) exclusion of the first $200 of interest and dividend income; (2) exclusion of the first $400; (3) exclusion of the first $1000; (4) exclusion of half of the first $1000; (5) exclusion of interest and dividend income in excess of a floor equal to 5 percent of income over $10,000 subject to a limit of $1000; and (6) exclusion of 20 percent of interest and dividend income without limit. These simulations are based on all taxpayers, including those over age 65. The first row shows the effect of each exclusion rule on the mean annual tax liability per taxpayer. Under the existing law, the mean 1972 tax liability was $1,247. Exclusion of the first $200 of interest as well as dividends would reduce this by $13 to $1234. This very small change in tax revenue reflects the fact that most taxpayers have much less than $200 of interest and dividends. With 77.5 million tax returns, the

Table 10

Simulated Effects of Alternative Dividend and Interest Exclusions with Different Behavioral Responses: Mean Changes in Tax Revenues and Assets

	$200 Limit	$400 Limit	$1000 Limit	$1000 Limit; 50% Exclusion	$1000 Limit with floor*	No Limit 20% Exclusion
1. Decrease in Tax Revenue	$13	$21	$37	$19	$30	$34
Increase in Assets						
2. Maximum Response	$3284	$7122	$19646	$19646	$14390	-
3. Half-way Response	$1642	$3561	$9823	$9823	$7195	-
4. Maximum Response for those with Positive Initial Financial Assets Only	$727	$2008	$6861	$6861	$4639	-
5. Constant elasticity, $\eta = 1$	$98	$219	$546	$270	$369	$1539
6. Constant elasticity, $\eta = 2$	$191	$429	$1089	$543	$733	$3283

Source: Simulations based on 1972 TaxSim Data.

*The floor restricts the interest and dividend exclusion to the excess of interest and dividends over five percent of their income over $10,000.

reduction of $13 per return implies a total revenue loss of $1.0 billion.

Increasing the exclusion from $200 to $400 reduces mean tax revenue by $8 per return, i.e., a doubling of the exclusion raises the revenue loss by about 60 percent. Similarly, raising the exclusion by 150 percent from $400 to $1000 only raises the revenue loss by about 75 percent or $16 per return. Limiting the exclusion to 50 percent of the first $1000 cuts the revenue loss in half; i.e., the total revenue loss with this rule is $19 per return or about the same as for a full exclusion of the first $400 of interest and dividends. Limiting the exclusion to the excess over a floor of 5 percent of income over $10,000 cuts the revenue loss from $37 to $30. Finally, the 20 percent exclusion without limit reduces tax revenue by $34 per return.

Four types of behavioral responses are simulated. The first assumes that each taxpayer increases his assets enough to take full advantage of the exclusion. Thus for the $200 exclusion each taxpayer accumulates a total of $4445 of assets since we asume an interest rate of 4.5 percent. Although the average initial value of assets is $8,230 the distribution of these assets is such that most taxpayers have substantially less than $4000; as Table 8 indicated, 71 percent of taxpayers had less than $200 of interest and dividends. The first number in the second row of Table 10 indicates that the average increase in assets if each taxpayer accumulated enough to take advantage of the full $200 exclusion would be $3,284.

The second simulation reduces the full response in an arbitrary way by assuming that everyone moves half way from his existing assets to the full $4445. Thus someone who currently has $3000 of assets increases them by $772.

This response is of course equivalent to assuming that half of the taxpayers do not respond at all while half respond fully, or to any other distribution of individual responses that averages a half-way response.

The third simulation makes the very conservative assumption that all those taxpayers with no dividend and interest income in 1972 would not respond at all to the exclusion. All other taxpayers increase their assets to take full advantage of the exclusion. The result, shown in the third row of Table 10, is an increase in mean assets of \$727.[33]

The final simulation also begins with the conservative assumption that those taxpayers who initially have no assets would continue to have no assets. Moreover, those with a relatively small initial amount of assets are assumed to show a correspondingly small increase in wealth. In particular, we assume that their behavior is governed by a constant elasticity response of assets to the relative "costs" of present and future consumption.

$$(3.1) \qquad \frac{A_1}{A_0} = \left(\frac{R_2}{R_0}\right)^n$$

where A_0 is the actual assets with the existing law, A1 is the assets with the exclusion, and R_0 and R_2 are the rates of transformation with the current and alternative tax rules. With an exclusion but no deduction, $R_2 = (1+i-\pi)^T$ and, as before, $R_0 = (1+(1-\theta)i-\pi)^T$; for any individual whose interest and dividend income already exceeds the exclusion, $R_2=R_0$ and there is no change in assets. We are fully aware that this is a very rough model of behavior that does not capture the life cycle character of the induced change in consumption and that quite arbitrarily assumes that all those who currently have no assets are either myopic or would prefer to be net borrowers even if there were no tax on interest income. We nevertheless illustrate this constant elasticity asset response by simulating with two alternative values: $\eta = 1$ and $\eta = 2$.[31] A unit elasticity implies, for example, that an individual with a marginal tax rate of 20 percent and initial assets of $2000 would increase his assets by $692; an elasticity of 2 would imply an increase of $1623. The result of these simulations are shown in rows 5 and 6. With a $200 limit and a unit elasticity of response, the average increase in assets would be $98; an elasticity of 2 implies a mean asset increase of $191.

Although the results for the other exclusion limits in Table 10 are self-explanatory, three comments are worth making. Note first that increasing the exclusion limit raises the potential asset accumulation by more than a proportionate amount even though the revenue effect rises less than proportionately. Second, the floor reduces the revenue cost of a $1000 limit exclusion by $7 or somewhat less than 20 percent. In contrast, the increase in assets in every behavioral simulation fell by a greater percentage. Third, the 20 percent exclusion has by far the largest behavioral effect both absolutely and per dollar of revenue loss.

It is clear from the wide range of possible responses that we have tabulated in Table 10 that our uncertainty about the effect of a dividend and interest exclusion is very substantial. The 1980 legislation, introducing a $400 interest and dividend exclusion, will provide a natural experiment from which we can hope to learn more about the nature of the individual savings response. Of course, the evidence on even the first year's experience will not be available in usable form until about 1984 and the political process many want to make decisions about savings incentives before then. It is perhaps reassuring therefore that the simulations reported in Table 10 indicate that the alternative exclusion plans involve quite little revenue loss. Moreover, even these revenue loss figures overstate the net impact of an interest and dividend exclusion to the extent that the additional capital is invested in the corporate sector and results in increased corporate tax revenue.

4. Conclusion

The public's increased awareness of the low rate of personal saving in the United States and of the high effective tax rate on the income from personal saving has generated a growing interest in changing the individual income tax rules to stimulate saving. Although there are many specific plans, there are two principal options: (1) deductions from taxable income for savings deposited in special accounts where interest then accrues untaxed until the funds are withdrawn and (2) the exclusion of interest and dividends from taxable income. The revenue loss that would result from such deductions or exclusions can be limited by restrictions on the maximum amount of the deduction or exclusion or by allowing only a partial deduction as exclusion. The problem with any such ceiling or floor, however, is that it may eliminate marginal incentives (for those with savings or investment income above the ceiling or well below the floor) or severely restrict the size of the incentive effect (for those who are near the ceiling). The desirability of any saving plan depends critically on its ability to limit the revenue loss without destroying the marginal incentives.

Analyzing the effects of limits and floors requires microeconomic data on saving, financial assets, and interest and dividend income. The present paper uses such data from individual tax returns and from the Consumer Expenditure Survey to estimate the potential effects of alternative tax rules. Because the likely response of households to new tax rules is not known, we present simulations for a variety of different behavioral assumptions.

Although the savings deduction and the interest exclusion are fundamentally very similar, they are likely to have quite different effects during a rather long period of transition because they treat active savers very differently from those who previously saved and are currently dissaving. Moreover, potential savers may be influenced by the liquidity differences between the two methods or by the appearance that the immediate deduction confers a greater benefit. Because individuals differ in their situations and perceptions, a combination of both plans might be more effective in raising saving than an equal-cost reliance on either plan alone. The paper therefore presents separate analysis for both types of plans.

The evidence that we present is not adequate for choosing the best combination of these options or even for deciding whether either option should be chosen. We do not have sufficient information about savings behavior to predict the response of capital accumulation to these plans. Moreover, the design of an appropriate tax policy involves not only the savings response but more general aspects of excess burden and the fair distribution of the tax burden.

But the analyses in this paper are sufficient to demonstrate that some of the potential problems that have been raised as objections to the savings proposals are not very serious. First, although some of any savings deduction would merely reward saving that would have occurred in any case, even with a deduction limited to 10 percent of wages and salaries (with a ceiling of $2000) there would be very few savers for whom the incentive was intramarginal. Similarly, at 1972 levels of wealth and interest rates, a $400 exclusion of interest and dividends would provide a marginal incentive for more than 75 percent of taxpayers.

The second basic fact that emerges in our study is that the reduction in tax revenue caused by an exclusion or deduction plan would be relatively modest. With the exclusion plans, the revenue loss does not depend on the taxpayers' response to the changed incentive. In 1972, a $400 interest and dividend exclusion would have entailed a revenue loss of only $21 per taxpayer or an aggregate of less than $2 billion. Increases in the $400 limit involve substantially less than proportionate increases in the revenue loss. The revenue effect of a savings deduction plan does depend on the reaction of savers to the new incentive. Although some preexisting assets would be transferred into the special accounts in the years immediately after a savings deduction plan was introduced, the potential transfer amounts and associated revenue loss are relatively small for the vast majority of taxpayers. After the transition period, if there were no increase in saving, a deduction limited to 10 percent of wage income (with a ceiling of $2000) would entail a revenue loss at 1972 levels of only $4 billion.[33] Any actual increase in saving that is induced by the deduction would then substantially exceed the associated loss of tax revenue.[34]

-Footnotes-

[*] Martin Feldstein is Professor of Economics, Harvard University and President of the National Bureau of Economic Research. Daniel Feenberg is a Postdoctoral Research Economist at the NBER. This paper was presented at the NBER Conference on <u>Behavioral Simulation Methods in Tax Policy Analysis</u> on January 26-27, 1981. The views expressed here are the authors' and should not be attributed to any organization.

[1] Total capital formation depends also on government saving and international capital flows. Government saving has always been small and, in the majority of years since 1950, has been negative. Feldstein and Horioka (1980) show that U.S. net international capital flows have averaged less than one percent of saving and, for the OECD as a whole, are not responsive to domestic differences in saving rates.

[2] Some would say to "reduce the features that discourage saving." The difference depends on whether one takes "income" or "expenditure" as the appropriate object of taxation. We need not comment on this issue in the current paper.

[3] See, for example, Auerbach and Kotlikoff (1981), Becker and Fullerton (1980), Boskin (1978), Bradford (1980), Feldstein (1977, 1978a), Fullerton et. al. (1979), King (1980), McLure (1980), Summers (1978) and Von Furstenburg (1980).

[4] This sentence and the following two sentences are explained in Feldstein (1978b).

[5] The proposed changes in the tax treatment of saving are compensated changes if not reducing the tax on saving would imply that some other tax would be reduced.

[6] We use the expressions "tax on saving" and "tax on the income from saving" interchangeably.

[7] The inflationary pressure could of course be checked by a tighter monetary policy, allowing the money rate of interest to rise relative to the Wicksellian natural rate of interest during the transition. But such exclusive reliance on monetary policy in the transition is not without substantial real costs in our economy with many long-term fixed interest contracts.

[8] These ideas about the timing of tax changes are discussed briefly in Feldstein (1980) and developed more fully in Auerbach and Kotlikoff (1981).

[9] The economists who have participated in the development of TAXSIM are Daniel Feenberg, Martin Feldstein, Daniel Frisch, Larry Lindsey, and Harvey Rosen.

[10] The Consumer Expenditure Survey contains fewer observations on high income families, is aggregated into family units rather than taxpayer units and does not contain a precise measure of taxable income.

[11] These two methods can be equivalent in the sense that they define the same lifetime budget constraint for an individual and therefore induce the same consumption choices. This equivalence is violated to the extent that these are bequests or that the individual's marginal tax rate varies over time. Moreover, in practice these proposals would differ for a very long transition period

because different cohorts of taxpayers are affected differently, e.g., the benefits of deducting saving have little effect on those who are already retired while an interest and dividend exclusion does; more generally, on the nonequivalence in the transition generation of consumption taxes (that allow a savings deduction) and labor income taxes (that exclude capital income) see Feldstein (1978b).

[12] This proposal has a long and venerable pedigree that is discussed in Kaldor (1955) and Musgrave (1959). See also Bradford (1980), Feldstein (1976), Fisher (1937), Kay and King (1978), The Meade Commission (1978) and the U.S. Treasury (1977).

[13] Individuals with self-employment income are eligible for a similar program. Anyone can contribute up to 15 percent of self-employment income to a Keogh Plan, with a maximum of $7500. The contribution is deductible and the income of the plan is untaxed. Withdrawals are taxed as ordinary employment income.

[14] A "participant" in such a pension plan need not have or be accruing any vested benefits.

[15] On the extent of private pension coverage, see President's Commission of Private Pensions (1980).

[16] The number of IRA plans indicates that only about 5 percent of those who are eligible have actually established an IRA; see Lubick (1980) p.14.

[17] The Canadian government introduced such a plan in 1972.

[18] As opposed to judging it in terms of removing the tax wedge between the pre-tax and post-tax rates of returns or of switching the tax base to avoid what some regard as an unjust double taxation of income that is saved.

[19] This would, of course, be offset by a reduction in other consumer spending caused by the increase (or lack of decrease) in some other tax.

[20] Individuals might in priciple borrow and use the borrowed funds to finance their IRA contributions, thus earning tax free interest in the IRA and paying tax deductible interest on the borrowed funds. We ignore the possibility of borrowing on the assumption that most individuals have little opportunity to borrow without collateral and that the expanded IRA (like the existing IRA and Keogh) could not legally be accepted as collateral for a loan. Individuals might borrow by enlarging their house mortgage but this would be discouraged by the need to hold most of the proceeds of such borrowing for several years before it could be contributed to the IRA.

[21] If the change in the saving rule is a compensated change, the income effect could be ignored. Of course, the alternative tax change might also affect current work and thus current saving.

[22] In some calculations, however, we assume that taxpayers over the age of 65 are not eligible to participate.

[23] The 1972 mean dividend price ratio for the Standard and Poor's corporate index of 500 stocks was 2.84 percent. The maximum interest rate that could be paid on time deposits was 4.5 percent.

[24] Unless the individual borrows to finance these contributions. See footnote 20 for the reasons why this is not likely to be a significant problem.

[25] Individuals might, of course, seek to circumvent the floor by bunching their saving into alternate years but this would be worth doing only if the ceiling is not binding.

[26] In reality, there would not be single year but a probabilistic interval with probabilities that reflect survival probabilities.

[27] If only a fraction λ of the contribution is deductible but the subsequent tax is limited to the same fraction of withdrawals, the rate of tranformation becomes $R_1 = (1-\lambda\theta') (1+i-\pi)^t/(1-\lambda\theta)$; with a binding level of deductibility, the plan has no effect on marginal saving and therefore $R_1=R_0$.

[28] Recall that for the representative taxpayer the real net rate of return rises from -0.005 to 0.020; including the deductibility effect implies that the current opportunity cost of consumption rises from 0.93 to 1.57.

[29] This measure of revenue loss does not reflect the extra corporate tax revenue that would be collected on the additional capital.

[30] Different combinations of the "exclusion limit" and the "exclusion fraction" correspond to the same loss of tax revenue but have different incentive effects. The incentive effect depends on the distribution of existing wealth and on the sensitivity of saving to the net return. It would be interesting to use the information on the distribution of assets and alternative assumptions about the savings response to examine the implication of alternative combinations of the limit and the exclusion fraction.

[31] At first, this seems to be in sharp contrast to the savings deduction plan where a deduction is given for induced saving as well as for the saving that would have occurred in any case. But the deduction itself is relevant only to the extent that the marginal tax rate of the saver exceeds his marginal tax rate when funds are withdrawn. Even when this is true, it is not a reason for preferring one plan over the other without knowing more about the response of individuals to this aspect since schemes with equal reveue loss could obviously be designed.

[32] In 1972, all interest income was taxable. Although a $200 exclusion applied to dividend income, most taxpayers did not have any dividend income.

[33] This short run revenue loss is based on the existing saving distribution and excludes asset transfers; see section 2.1 for evidence on the modest one-time revenue cost of allowing deductions for asset transfers. The corresponding long run revenue loss, which reflects also both the loss of the subsequent tax revenues that would have been collected on the interest and dividends on these savings and the gain in tax revenue that would eventually be collected when the funds are withdrawn, would be about $5 billion.

[35] Recall that if the revenue loss on this additional saving is measured by the immediate consequence of the deduction, an extra dollar of saving reduces tax revenue by only about 20 cents. This tax reduction is partially recovered (in a present value sense) to the extent that the individual's tax rate is as high when the funds are withdrawn. Although no tax is collected on the interest and dividends earned on the extra capital, this is not a revenue loss since it would not otherwise have existed. Indeed, the corporate income tax on this additional capital could more than offset the loss in personal tax revenue.

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Dr. **Feldstein**. The vast majority of people, I think, 75 percent of households would have exhausted their available assets in just 2 years. After that, in order to take advantage of an IRA they would have to do new net savings.

While I think I agree that the move from $200 to $400 was not a very effective one, moving from $400 to $1,000 or $400 to $2,000 would be an effective one, in the sense that again unlike Joe, very few people have anything like that kind of income.

In 1972, 90 percent of taxpayers had less than $1,600 of interest and dividends. I suppose now that would be more like 70 percent who would face a real incentive to save more if the ceilings were raised to those limits.

Dr. **Pechman**. Just one point. The fact that 85 percent of the people or the families would have an incentive at the margin on any one of these proposals doesn't mean they are going to use it and as a matter of fact, I know the paper that Martin is talking about and he makes an assumption in his paper that in fact, they are going to use all of the tax cut for saving rather than consumption.

Dr. **Feldstein**. Joe, just for the record now, is there any assumption in facts that I just quoted?

Dr. **Pechman**. No; but the paper that he referred to concludes that you can have, you do get a substantial saving effect by these devices and what I am saying is that the results of that paper are entirely assumed and not based upon any empirical data.

I just disagree wholeheartedly with Martin's conclusions on that point.

Senator **Durenberger**. Dr. Brownlee, do you have a comment?

Dr. **Brownlee**. I agree with Martin that the appropriate base for taxation is consumption rather than income and that steps such as expanding the IRA convert what is now an income tax into something which more nearly approximates a consumption tax.

Also, let me talk a bit about numbers. While we don't know the exact volume of what we call the elasticity of saving with respect to its rate of return, we know that it is higher, the higher the rate of taxation. It is higher for young people than it is for old people.

Joe is atypical on both counts, although his traits tend to, in a certain sense, offset each other. He is in the high tax bracket and ought to respond more to reductions in the tax rates than people who aren't subject to a high rate of tax, but he is near retirement. He is not going on this account to shuffle his asset accounts very much.

Senator **Durenberger**. Let me ask you a last first round question. This is one that relates to debt as a form of consumption. Shouldn't we be talking in all of this about discouraging going into debt by limiting the interest deduction and do the same principals apply to mortgage interests as apply to consumer interest? What would your advice be to us as to what we ought to be doing on that subject?

Dr. **Feldstein**. We could create the Tax Code all over again. There would be a strong reason for not making nonbusiness interest payments deductible or offsetting interest deductions against interest income and then not allowing deductions for the excess.

I think the real problem is in dealing with home mortgages. People have bought houses, the prices of which very much reflect the deductibility of mortgage interest. If you eliminated that deductibility over night or over 2 or 3 years, a lot of people would find that they had no equity in their homes at all and indeed were a lot worse off than that.

Senator DURENBERGER. Any other comments?

Dr. PECHMAN. I agree with Martin that there should be a limitation on deductions for consumer interest, both home mortgage interest and consumer installment interest. If you are trying to increase saving that would be a very effective device.

Dr. FELDSTEIN. You can't say you agree with me in saying that though because I didn't say that.

Dr. PECHMAN. You said if they were starting all over again.

Dr. FELDSTEIN. You said if——

Dr. PECHMAN. I think that a good principal ought to be adopted even after you had 60 years of income taxation.

The proposal that Marty talked about is a reasonable proposal. You should in effect expand the investment interest restrictions now in the law which excludes consumer interest, to include all interest. That is, a taxpayer should be entitled to deduct the interest he pays against his total property income because that in effect is an expense of getting property income in many cases, and then you tax the net.

In order to protect homeowners, you can give a deduction for property income plus $5,000 of interest or $10,000 of interest and achieve the objectives you want without hurting the large mass of taxpayers.

I really do think that this ought to be considered along with many other proposals you are now considering.

Senator DURENBERGER. Thank you. I better pass this on to Senator Packwood.

Senator PACKWOOD. Is it a fair statement to say that most European countries, at least our major trading competitors, have higher consumption taxes and lower capital and income taxes than we do?

Dr. FELDSTEIN. Yes.

Dr. PECHMAN. Yes.

Dr. BROWNLEE. Yes; but they have the value added tax.

Senator PACKWOOD. That is their principal consumption tax.

Dr. BROWNLEE. Yes; that tax is 11 percent and is higher than our State, local, and every other consumption tax that we have.

Senator PACKWOOD. I have just had the Library of Congress finish a study for me and it very definitely concludes that. When you add their equivalent of social security and wage income tax to their consumption tax, they have significantly skewed their incidence of taxation away from capital and higher income and skewed it toward consumption.

Should the United States be moving in that direction as a tax system?

Dr. BROWNLEE. I don't think it is appropriate to add the social security tax and the consumption taxes together.

Senator PACKWOOD. Only as the social security tax is here is a regressive and it pushes it toward a middle or lower income bracket.

If you add the total incidence of taxation and the way the Library of Congress did the report, it was 10,000, 20,000, 50,000, and 100,000. The total incidence of taxation when you combine their social security and their consumption taxes is even greater yet than just their consumption taxes alone.

Dr. PECHMAN. There is another sense in which those payroll taxes are like consumption taxes, while the consumption tax exempts savings, the social security payroll-type taxes exempt the income from savings. That way they are both fundamentally different from a general income tax which taxes the income from savings and labor income at equal rates.

Senator PACKWOOD. Now, let's assume this, we agree——

Dr. PECHMAN. Senator Packwood, I just want to say that those international comparisons are very, very hazardous to draw conclusions from.

Senator PACKWOOD. I know they are hazardous and the Library of Congress report is very careful to indicate that but on the other hand, I have three reports now. One from the New York Stock Exchange, one from the Organization of Corporation and Development, and one from the Library of Congress and they all seem to generally conclude the same thing.

Our major trading competitors have pushed their tax incidence toward consumption and away from investment. Not totally, but more than we have.

The three of you seem to agree that is a direction we should be moving in. I am not sure if you said that or not.

Dr. PECHMAN. No; I do not agree we should be moving in the direction of taxing consumption.

Senator PACKWOOD. OK.

Dr. PECHMAN. The fact that they do have it doesn't mean that we should move in that direction. I think we have a better tax sytem then they have. I would like to improve the income tax and reduce the marginal rates. I think all of us would. I agree that we ought to reduce the top bracket rate. I certainly don't think we ought to go to the consumption tax.

Senator PACKWOOD. I will drop you out of further answers.

On the assumption that we should be moving in that direction or at least, and again assuming people respond to incentives at all. If they don't, all this talk about savings incentives and capital gains incentives are all irrelevant. Most people seem to presume, most economists seem to presume, there is some cause and effect between incentives and reaction.

I don't know what kind of a tax bill we are going to get from the House, but if we are willing to assume the revenue loss that Kemp-Roth assumes—here I want to talk about only the individual side, not the business side, not the corporate side. Is there a better way to structure that 10-10-10 so that it tilts more toward investment and savings than does the 10-10-10 within the same revenue loss and if so, what is that way.

Let's start with Marty.

Dr. FELDSTEIN. Well, there are probably a variety of them. Anything that really targets on personal savings and investment income would do better than the simple 10-10-10.

Now, bringing the top rate down from 70 to 50 does a good deal for the people who are affected by that, but that is a small part of the population. Let's take that for granted, either as a result of a 3 year program or something that gets put in sooner as part of a first tax bill.

Beyond that, I think that we ought to pursue or you ought to pursue a mix of extending IRA's to everyone probably with a movement toward higher ceilings than we have now and also an exclusion of a part of interest and dividend income.

Senator PACKWOOD. Would you exclude it on a first dollar basis or a certain percent of interest and dividend?

Dr. FELDSTEIN. I would do a percent of interest and dividend. If you took 20 percent——

Senator PACKWOOD. Twenty percent, 30 percent rather than saying the first $2,000?

Dr. FELDSTEIN. Right. That avoids the problem that at least for some people it is a wasted deduction.

Senator PACKWOOD. I think that is a very valid point. Probably we did not get the so-called bang for the buck with the hope for encouragement, but if you were to say one-third or one-quarter of the first savings interest that is a significant incentive.

Dr. FELDSTEIN. In the variety of trade-offs, if you said 50 percent of the first $5,000 worth of interest and dividends rather than 30 percent of all of it, I don't know how that is going to work.

Senator PACKWOOD. Yes.

Dr. FELDSTEIN. We don't know as economists enough about the different behavioral responses of people at different points of the income distribution to really answer that.

Senator PACKWOOD. If you were king, you would tilt that 10-10-10 in that direction rather than the straight across the board 10-10-10?

Dr. FELDSTEIN. Yes, although I would worry about doing too much of that. I think these things are relatively low cost in comparison to the 10-10-10 program and therefore, you wouldn't have to not do much of that 10-10-10 because I am frankly worried about the fact that marginal tax rates for people in the 30- to 40-percent tax bracket are going to get pushed up 15 percent over the next couple of years.

Senator PACKWOOD. I am thinking if we took Joe's idea of putting off this tax cut, and making it prospective so it doesn't start until next January and maybe going 5-5-5 instead of 10-10-10. It gives you some margin to play with.

Dr. FELDSTEIN. The other thing that I have testified before to this committee about is the idea of phasing in that kind of saving exclusion. If people are rational in their thinking you get most of the advantages of 25-percent exclusion even if you just put 5 percent in the first year, if they know that they are going to get the rest over a few years.

Senator PACKWOOD. Joe?

Dr. PECHMAN. Just to show you that I am not unsympathetic completely, I also think that you should cut that top marginal rate from 70 to 50 percent. The only thing I find wrong with Martin's way of putting it is that you should offset the revenue loss. This can be done very easily by eliminating some inefficient tax subsidies, like industrial development bonds.

The distributional effect would be sort of neutral. You would get quite a bit out of that kind of an exchange, without distorting the distribution of tax burdens.

With respect to how you promote saving by increasing the rate of return, I agree with Martin. I don't like it, but I certainly think the lowest priority is to give a flat amount of exclusion. His idea of a percentage cut in the marginal tax rate on propery income is better.

There is one other idea that is kicking around and I hope you will not entertain it. That is to simply start the progressive rate schedule over again for property income. I think that is a silly proposal.

Senator PACKWOOD. I haven't heard that idea. What does it do? It starts the progressive rate over?

Dr. PECHMAN. That's right. You file two tax returns. One for your property income and one for earned income. The reason it is silly is that it would provide a different marginal rate cut on property income depending on what your earned income is.

I just don't see why you want to differentiate tax liabilities in that way. I think the way to do it is to cut marginal rates as Marty has proposed.

I hope you stay away from the split tax system. Aside from the fact that it would horribly complicate the tax return and make life miserable for the Internal Revenue Service, it is also bad tax policy.

Senator PACKWOOD. You shouldn't put those ideas in our heads. Until you mentioned it, I hadn't heard of it.

Dr. PECHMAN. Well, I just want to be sure that you now know about it and stay away from it.

Senator PACKWOOD. Chairman Dole.

The CHAIRMAN. I just have a couple of questions. I think most of the discussion has been on the 10-10-10 and we have 20 members on this committee so let me inject two other tens. I think there are about 10 for and 10 against that 10-10-10. There are five tens.

If that is an accurate assessment—it may be off 10 either way—we need to review other options, though there has been no signal yet from the White House that there is any flexibility, I think yesterday Don Regan said we are standing firm. Bill Roth made the same remark. Bill from Roth-Kemp fame just entered the room.

We are at least exploring the possibilities for changes in what the President suggested to leave a little room for other things that we think might be done.

I guess you are all in agreement on cutting marginal rates. Is that correct? I missed Dr. Brownlee's statement.

Dr. PECHMAN. Yes.

Dr. BROWNLEE. Yes.

The CHAIRMAN. Do you have any advice you would pass on if you were sitting up here. You would probably have it all worked out if you were up here, but you are not.

How would you advise those of us who are searching for some, maybe not middle ground, but some common ground where we can sort of get together on a proposal.

Dr. BROWNLEE. What are the things that you want to trade for the cut in marginal rates?

Senator PACKWOOD. I assume that on the business side there is not too much difference. Maybe some modifications in the 10-5-3 and maybe some would like to more in that area and less on the individual side.

Let's just say we took the President's business recommendations, that leaves us with a pretty good pile on the individual side.

Dr. BROWNLEE. Well, we have already talked about a percentage exclusion on investment income or capital income in place of a flat exclusion. That is, if you have a flat exclusion of $500 then there is no tax incentive for anything over $500.

The CHAIRMAN. But, do you just lower it to some other arbitrary 8-8-8 or——

Dr. BROWNLEE. Sure, 8-8-8 or 7-7-7 or some such numbers and put in these other gimmicks, if you wish to call them that.

The CHAIRMAN. No one here has any gimmicks. There may be other members who will have.

Dr. BROWNLEE. Well, you're substituting special treatment or preferred treatment of capital income taxation for some of the general tax reduction. I think what I would be willing to agree to that.

Dr. FELDSTEIN. I think I would emphasize is that if you vote against 10-10-10 or more accurately a 27-percent reduction spread over 4 years, it shouldn't be because you think it is too inflationary. It shouldn't be because you are worried that there won't be additional spending cuts in the outyears.

That 27-percent reduction spread over 4 years is very close to just an offset for the extra revenue that comes in because of inflation. No economist knows enough about how the economy is going to behave in the next few years to say whether it ought to be 25 or 29 percent over those 4 years.

If you don't have that large a cut in across-the-board rates, it should be simply because you are going to substitute other kinds of structural cuts, savings incentives, capital gains reductions for the across-the-board rate reductions.

Those savings reductions are, especially if phased in the way we were talking about a minute ago, relatively low cost so that you wouldn't have to depart very much from the President's package in order to add those things to your agenda.

The CHAIRMAN. So, you are not worried about the $54 billion number. That is the size I think that somebody mentioned in a $3 trillion economy, $10 billion in either way is not that significant.

Dr. FELDSTEIN. That was my language.

The CHAIRMAN. That was your statement.

Dr. FELDSTEIN. Probably several other people's language as well.

The CHAIRMAN. But, there has been some concern expressed, I think, by some on this committee that thought it was $10 billion too much or $12 billion or $14 billion.

Dr. **Feldstein**. They have bigger magnifying glasses than any know now to buy. They just can't see the economy in that kind of detail to really know.

The **Chairman**. Joe.

Dr. **Pechman**. Well, actually it is not a detail. Ten billion dollars additional borrowing by the Federal Government has an effect on the capital markets. The fact that we are running a $60 to $65 billion deficit rather than the original estimate of $40 to $50 billion explains the high interest rates that we now have.

I would not say that $10 billion difference doesn't matter. It does matter.

With respect to your question about other tax changes—you called them gimmicks, I would say devices other than rate cuts—the Senate Finance Committee bill had a large number of devices other than rate cuts in it. I think you should consider revisions other than rate cuts.

We have already mentioned the reduction in the top bracket rates. I would like to offset that by some revenue gains, but that should have high priority.

I think that, when you are cutting income taxes over a period of years, you ought to also, as you did in your bill last year, modify the personal exemptions and the standard deduction.

There has been a 25-percent increase in prices since you last adjusted the personal exemptions and standard deduction. I think it would be unwise as well as inequitable to cut taxes without adjusting the exemptions and deductions.

I think you should do something about the marital penalty and again I don't think you ought to waste your scarce resources for 1981. If you did it for 1982 and later years, that would be quite satisfactory,

Beyond that, I don't think it is essential immediately to reduce the tax rate on saving. I would use the rest for rate cuts. As I indicated earlier, I have my doubts that you can reduce expenditures enough over the next 3 years to warrant as much as a total cut of 30 percent.

Now, Martin says that he wants to get that tax rate down by 30 percent. I would like to do that, too. Otherwise, the real tax rate will increase. There is no question about it. However, you should not pursue a fiscal policy that maintains a large deficit over the period of years.

Dr. **Feldstein**. If we do have the kind of slack that seems to be inherent in the current budget and in the current monetary policy, then a few years from now interest rates will be down. If interest rates come down, the deficit goes away. It is an interest rate deficit.

The **Chairman**. Just one other question. We had some discussion yesterday about the role of the Federal Reserve in stock and the bond market, whether it was a judgment on Federal Reserve policies or on the administration's economic policies. Maybe it is neither. Do you have any comment on that?

Dr. **Brownlee**. Well, it could be both. There are some people in the financial markets who don't trust the Federal Reserve, but I think there are others who don't distinguish between non-interest-bearing debt and interest-bearing debt.

For those people who don't distinguish between the two types of debt, it is the size of the deficit and not the way in which it is financed which counts. For those who do distinguish, they may not trust the Federal Reserve. It is Federal Reserve policy for them that counts and I think it is both of these things that are being reflected in the financial markets now.

Dr. FELDSTEIN. People have been saying for months the market will "correct." The market bounces up and down 4 or 5 percent of its value all the time. That is what it is doing. I don't think one should read a lot into the fact that the Dow Jones has dropped 45 or 50 points.

Dr. PECHMAN. You ought to read a lot, however, but in the fact that no business enterprise can, under present conditions, borrow money on a long-term basis at less than a 15 or 16 percent interest rate and that Government bonds are now selling at interest rates which are the absolute peak in U.S. history, including the Civil War interest rates.

I want to agree partially with what Professor Brownlee said about what the capital markets are telling us. They are not criticizing the Fed. I think they are taking the Fed very seriously and what they are doing is saying they don't like our fiscal policy.

Wall Street is very, very sharp with its pencils. They know that the current deficit, the deficit in fiscal year 1981, is above $60 billion and they know that the Federal Government has to come to the market to finance that and that competes with other funds and raises interest rates.

They also know that the Fed does not intend to cooperate in creating more money to let that happen. So, what they are saying is that, until the Congress and the administration get hold of the Federal budget, they are skeptical about the ability of the Reagan administration to keep the economy going at the rate they project.

Dr. FELDSTEIN. I think in part they are misreading the nature of the budget. They are hearing the critics who say it is very inflationary and they are beginning to believe it.

I think if they understood, more correctly, that the cut that is being promised, that is being touted by the administration as the great miracle worker on the supply side, that that tax cut was not a tax at all and that the only thing that is really being cut on a net basis is Government spending over the next couple of years, the bond markets would be behaving differently.

But, in fact, they are hearing about a tax cut and being told that is going to do supply side wonders. They don't believe the supply side story. They haven't caught on that there isn't a tax cut and the combination is to engender these kinds of inflationary expectations.

The CHAIRMAN. Thank you. Senator Long.

Senator LONG. I believe that you gave the answer to Senator Dole's question. As I understand it, Senator Dole wanted to know if you had the power to amend the bill with reasonable prospect that your suggestion would become a part of the law, would you make any change? If so, what would it be? Now, that is what I would like to know, Dr. Feldstein. What would your reaction be?

Dr. FELDSTEIN. Let me try another way of putting it. One thing would be to recognize that what has already happened is this 3 year, 30-percent cut has become a 4 year, 30-percent cut. So, let's make it a 5 year, 30-percent cut. Let's pass it as a 5 year, 30-percent cut and that opens up a modest amount of revenue that can be used for other things.

I would use that additional revenue for savings incentive and for further action on the capital gains front. That way, there wouldn't be the issue of whether the President received his 30-percent cut. There wouldn't be the philosophical question about whether it was a multiyear cut or not. It would be both of those. The magic 30 percent could still remain there, 6 percent a year for 5 years, but that would then give you significant room for phasing in——

Senator LONG. Would you be a little more specific as to what you would have?

Dr. FELDSTEIN. I would have a savings and deduction, extension of IRA's to people who are covered by employer plans and I would have an exclusion of part of the interest and dividend income, say 25 percent phased in over a number of years. Five percent in 1982, 10-percent exclusion in 1983 and so on.

Senator LONG. Other witnesses have indicated they thought we ought to stop the discrimination against investment income which means a 50-percent top rate and some have suggested that we ought to do something about capital gains. Would you do something about those two, also?

Dr. FELDSTEIN. Yes, well, I said to Senator Dole before I took it for granted in answering his question and therefore yours that the top rate was going to come down from 70 to 50. It was only a question of when and I said in my prepared remarks, it costs so little, probably nothing, to bring it down immediately from 70 to 50 because of the unsheltering in the wide sense that would occur, that that ought to be done right away.

Senator LONG. Now, another point has been——

Dr. FELDSTEIN. On the capital gains if I can come back to that and that is a subject that we have discussed before, I think the current capital gains tax has become an economic nonsense.

Last year accrued nominal capital gains in the American economy were about $1,000 billion. Taxable capital gains were probably about $50 billion, 5 percent of it, so it is silly.

Some people just happen to have realized capital gains. When they do, they get taxed, but 95 percent of capital gains don't get taxed. It seems to me we ought to remove the other 5 percent.

Senator LONG. In other words, it is like a businessman told me. I am not sure I made reference to it here. We are talking about getting the top capital gains rate down to 15 percent. This man has hundreds of millions of dollars worth of assets and he said here is one investment I have. I was just planning to trade it for something. I can do that without paying a tax.

If you would get the rate down to 15 percent, I might decide to sell it and let you fellows have some tax money, but otherwise I will trade it and eventually put the assets I received in the trade into a foundation at some point when I died, if not sooner.

We would not make any money out of any of that, but if you had it at a rate that was, from his point more reasonable, you would make some money from that taxpayer.

I have been thinking about this. I want your reaction to it. If we were still on the gold standard, we wouldn't be paying such high interest rates because you had a commitment to pay in gold—available currency.

Of course, the same would be true if you were going to pay off in 1980 dollars. That is what would be called indexing the national debt.

Now, if one were thinking in those terms, that we were going to pay off in the same value that we borrowed, the interest rates would be much lower. It looks to me as if that were the case we wouldn't be running a deficit. We would be running a surplus issue. Is that correct?

Dr. FELDSTEIN. That is correct.

Senator LONG. In other words, basically——

Dr. FELDSTEIN. It is, as I said before, an interest payment deficit. If you were paying real interest rates, there would be no deficit.

Senator LONG. The reason we are showing this big deficit is because of our single entry bookkeeping system. The value of the national debt goes down, by the same amount as inflation moves the dollars up and if one were on the gold standard or if you were thinking in terms of paying off in constant dollars, right now this would be a surplus budget.

I am not saying that is a dangerous thing. I was a little boy when we went off the gold standard. All I am saying is that thinking in terms of constant dollars, we are not running at deficit right now. Is that right, Mr. Pechman?

Dr. BROWNLEE. The thing I think we are forgetting is that this bond that would mature at a $1,000 is going to mature at $2,000. You are going to be paying back more in principal and less in interest. But, some of the payments, if we have correctly anticipated the inflation, would be the same whether you indexed or not.

It seems to me the function of indexing is to take some of the uncertainty out of the picture. We are not able to predict accurately what the rate of inflation is and therefore, do quite a few things to hedge against the varying rates.

Although it is because interest payments are a separate account in the budget, that Martin is able to call this an interest rate deficit.

Senator LONG. What is your reaction, Dr. Pechman?

Dr. PECHMAN. I agree with Os. It is true that if you recast the budget in real terms that you would get a different balance between receipts and expenditures.

Even if it turned out to be a surplus, fiscal policy should be judged on the basis of the aggregate of what is happening to the economy. We are suffering right now from too little investment and savings and too much consumption

If the present balance between receipts and expenditures permits that, we ought to cut down on consumption. That is what we have been talking about and that is why I suggested that you ought to take it easy before you start on a tax cutting spree.

Let's get the budget deficit down or reach the surplus and then see whether there is enough savings in the economy to provide the investment that is needed.

Senator LONG. Well, Dr. Feldstein has another statement to make, but I just want to get to thinking on this problem.

Dr. FELDSTEIN. I think there is no question that we do want to have more savings, but I think you are absolutely right about the fact that we keep our accounts in an old fashioned way and it is only because of that that it looks like we are running a deficit.

As you probably know, the Federal Accounting Standards Board has now required all large private firms to report what they call a gain on monetary liabilities. That is to say, that they in part of the annual report to their shareholders have to report the reduction in the real value of their debt as an add on.

Well, if we did that for the U.S. Government, we would have about $1,000 billion worth of debt. We had 9½-percent inflation last year. We would add $95 billion on as a correction term if we followed the FASB rules for the Federal Government and low and behold, our deficit would be a surplus.

Senator LONG. I am not here proposing some crazy idea. All I talking about is this. If you go down and talk to your banker and you say that you want to borrow some money, $1 million. He would say how much money did you make last year?

I don't know about other businesses, but I know if you are in the oil and gas business I know a little about that. If you are in that business, you would say, well, according to my tax return I made this. But, let me show you what I would have made. I drilled some wells last year and some of them were good and while I am deducting my intangible drilling cost I am allowed front end write-off on the intangible costs.

While I am deducting all that, I am not putting down here what the well is going to make next year or what it is worth right now. So, it is somewhat like that story about the father who came home and said son, let's see how much you have learned about business. How much is 2 plus 2 and the son said it all depends. Are we buying or are we selling.

I just think we ought to look at both sides, that is all.

Senator DURENBERGER. Senator Danforth.

Senator DANFORTH. This is a politically impossible notion, but I would like your judgment as to the economic consequences of what we are doing.

Let's suppose we take exactly the same amount of money the first year of this bill and instead of passing it what the administration wants, we do the following. We abolish the capital gains tax. We abolish all taxes on interest and all taxes on dividends.

Last year, 1981, the revenues from capital gains taxes and taxes on interest and dividends was about $51 billion. So the static revenue loss would be about that. What would be the economic consequences of having no capital gains taxes and no taxes on interest and dividends? What would it do to the economy?

Dr. BROWNLEE. In comparison with what?

Senator DANFORTH. If you decide we are not going to have this bill, It is a wonderful idea, but instead of that, there is another idea. We are going to repeal taxes on capital gains and on interest and dividends so interest income and dividend income would be totally untaxed.

Dr. PECHMAN. Well, as you pointed out, it is politically impossible and I would oppose it strongly for many reasons. I think you would have more saving and investment than you would have under Kemp-Roth.

Senator DANFORTH. The savings and loans would be back in business. The housing industry would be moving. The automobile sales would be booming. Isn't that right? Interest rates would be down.

Dr. FELDSTEIN. I am not sure about those things. I mean the savings and loans wouldn't benefit nearly that much from this. The housing would look less attractive relative to other kinds of investments that pay off in currently taxable dollars that would benefit from your alternative proposal, so housing might down go. The stock market and real investment and real savings would undoubtedly go up.

Senator DANFORTH. Would it be, in your opinion, an improvement over the President's proposal or not?

Dr. FELDSTEIN. Putting distributional considerations aside, I still would worry about the higher marginal tax rates on unearned income that would result if one put all of that into interest and dividend reduction.

I really haven't thought about it enough to give a good answer.

Senator DANFORTH. I would imagine that you could have—on the income tax itself—instead of having an across-the-board rate cut you could have a basic income tax for earned income. The cut would be skewed very much toward people who are in the lower middle range.

It would be much less of a cut for the people in the higher range. You could even do it by increasing, say, the exemptions and also cut the rates. Then a very low tax on dividends and interest.

Dr. PECHMAN. Well, I can't put distributional considerations aside. I think that it would be undesirable to move that way. I don't think it would increase the confidence of the American people in the tax system to have such an inequitable tax cut. I would much prefer—even though I would not get as much of a bang on saving and investment—I would much prefer to move in the direction of modifying the rates and increasing the personal exemption standard deduction.

Dr. FELDSTEIN. Of course, as your number brings out that $50 billion revenue loss, most capital income doesn't get taxed in this country now.

People do their savings through pensions. They do their savings through accruing capital gains and a variety of other ways. So, what we have is a system that doesn't tax most capital income, but at the margin puts very high tax rates on it and that is the great pity with the system now.

The amount of "injustice" that Joe worries about of eliminating the marginal taxes when we have already eliminated the intramarginal taxes to such a great extent, is much smaller than would appear.

We don't tax most capital income. We don't tax most, as I indicated before, most capital gains so the inequities associated with reducing at the margin what we have already eliminated intramarginally are not nearly so great.

I would emphasize that you can get a lot of advantages by phasing in that kind of an exclusion rather than doing it all at once. If I know that my interest and dividend income is going to be taxed at much lower rates 10 years from now, that is incentive for me to save today.

Senator DANFORTH. What would happen if we did it disproportionately in favor of interest as opposed to dividends?

One of the points that has been made about the Japanese is that much of their finance is debt rather than equity financing and therefore, they are able to take a longer view. They don't have to show the vast appreciation of their assets.

Would that be desirable?

Dr. BROWNLEE. We already have the corporation income tax which gives an incentive for this variety of financing and I don't think that we should go further in this direction. A corporation income tax is a tax on equity and capital income in corporations and induces more debt financing than would otherwise take place.

If I understand you correctly, you are proposing to reduce interest taxes, not at the corporate level but at the personal level. Reducing interest income taxes further relative to taxes on dividend income would seem to me to skew even further our preference for debt financing.

Senator DANFORTH. That would be the purpose of it.

Dr. BROWNLEE. I think that more equity financing and less debt financing would be desirable.

Dr. PECHMAN. I agree with Professor Brownlee that to skew it in the direction of more debt financing would go counter to it. I think that most corporate finance experts would say there is too little equity in the system and too much debt.

Senator DANFORTH. Let me say just parenthetically, I am not proposing this.

I think the point I want to make is simply that if the interest—if the consideration we have is for encouraging savings and encouraging investments, there may be other things that we could do other than the 10-10-10. Some very dramatic things for practically the same amount of revenue.

Dr. BROWNLEE. If that were the only thing that you were interested in, yes. We have already said the most dramatic thing that could be done would be switch to consumption taxation.

Senator DANFORTH. That is what this would be. It would be a consumption tax.

Dr. BROWNLEE. Not quite. It is not quite a consumption tax because under a consumption tax you would be taxing consumption out of withdrawals of assets, cashing in of assets. Whereas, under this kind of tax you would be simply taxing earned income and you would not be taxing consumption unearned income.

There is the difference between the two, but they are quite similar.

Dr. FELDSTEIN. There is essentially only a difference because of the progressivity of the tax structure and the issue therefore, that the year in which you pay the tax may matter if you're in different brackets. Otherwise, a tax on wage and salary income is equivalent to one on consumption.

Senator **Roth** [presiding]. Dr. Feldstein and gentlemen, I would regret that I missed your testimony, but unfortunately I had an amendment on the floor.

If I understand, Dr. Feldstein, what you are saying is that and I agree, that the individual tax cuts of course is no real tax cut in the current situation.

I think the President tried to make that clear to the American people in his address 2 weeks ago to Congress.

I think I also understand your saying that if you look at the increase in Federal revenue over the next 5 years if there is room to do something more that it would not be inflationary as the critics are claiming.

Am I correct to that extent?

Dr. **Feldstein**. Yes.

Senator **Roth**. Isn't it a fact that Federal revenues are roughly going to jump from $500 billion to $1 trillion in 1985?

Dr. **Feldstein**. I don't know the number offhand. Senator Roth. Those are figures that have been cited by CBO so this is a very substantial increase in revenue for the Federal Government.

Would you agree that it is important that not only what the President is talking about, but that we even go further in these years ahead in trying to take the tax drag off the American economy.

In other words——

Dr. **Feldstein**. Yes, I would. I think that the tax cut that is being discussed is just a give back of the extra revenue that is likely to come in and that it therefore isn't going to have any of the supply-side advantages that are being touted.

Primarily, except for some of the reductions in high marginal rates, it is a wash with respect to marginal tax rates and that only by continuing to reduce Government spending as a share of income can you actually reduce tax rates below their 1980 levels and move them back to where they were in the 1970's.

Senator **Roth**. So, that if you are really going to have the supply-side effects that some of us think is essential for a growth economy, you really need a larger package than that which is now being offered.

I recall back in the Joint Economic Committee, some time ago, that you made the point that you just made earlier that you could have an impact on savings even if the effective date was postponed several years. Are you still of that opinion?

Dr. **Feldstein**. Yes, I am. I think that phasing it in, rather than simply postponing it, would make it much more visible and would therefore have a larger effect. So, I would phase it in starting at a small level now and make for larger amounts later in order to make people aware that this growing incentive is there.

But, I think the basic point that anticipated lower tax rates in this area can do the same job is correct.

Senator **Roth**. Now, the President has indicated on a number of occasions that in addition to his initial proposal he supports a second tax bill that would permit some of these other savings and other inequities to be incorporated. So, from the economic point of view, you think that is perfectly consistent and feasible.

Dr. FELDSTEIN. It is if you stretch out the current 4-year, 27-percent cut into, say, a 5-year cut. That would leave you with room to do additional tax cutting even without going beyond the President's proposals for spending cuts.

Senator ROTH. But, as I understand the President, he is proposing another $8 or $9 billion or there has been some talk about another $8 or $9 billion beyond the initial tax cuts.

Dr. FELDSTEIN. As I said before you came, nobody knows enough to know in a $3 trillion economy whether $8 or $9 billion more or less will matter. Whether $8 or $9 billion of Government debt with a $1 trillion worth of debt out in the market will have any impact on rates so I think one has to judge in terms of their incentive effects.

Dr. PECHMAN. I said earlier that I disagree that you can just disregard an $8 or $9 billion increase in debt. As I said in my testimony, I would reserve judgment on how much of a tax cut to allocate an individual. I think that the business tax cut should go through—liberalized depreciation allowance and investment credit.

But, I think you ought to wait until the end of the summer to see how much you have actually cut from the budget—not only the from the fiscal year 1982 budget, but also from the budget for the fiscal 1984 and beyond.

The fact of the matter is that, in 1984, the administration proposal to cut taxes by $150 billion below what they would be if present law applied.

Senator ROTH. It is true, of course, that revenues are rising very substantially.

Dr. PECHMAN. Your analysis is exactly correct. Revenues are rising even if we didn't increase tax rates because of inflation. However——

Senator ROTH. Can I ask you a question right there? Do you have any question that if we let this increased revenue come into Government that Congress, I don't care who controls it, won't spend it?

Dr. PECHMAN. No, I would say that it is equally plausible—and I hope that Congress would do it—that a good share of it would be allocated to reducing the deficit and increasing national saving. You have an opportunity right now, to use the fiscal resources of the Federal Government to increase savings simply by reducing the deficit. I would reduce the deficit first and then reduce taxes. You may object that that is increasing the tax burden on the economy and that is correct. One of the reasons why it is difficult to control inflation, but not the exclusive reason, is that we have been living on borrowed money at the Federal level. I don't see any reason why, under the circumstances, we should cut taxes in advance before we know how much we are going to spend.

Senator ROTH. Dr. Pechman, I have been in Congress 14 years now, most of which I sort of lived with that theory that we should balance the budget and then cut taxes. That never happened and it never will. I just don't think that you will ever witness what you are suggesting.

I think the only way you are going to relieve the tax burden on the American people and hold down Federal spending is by doing what the President is proposing.

My only problem is that we are not moving fast enough on the whole matter. I think we have two more Senators. Senator Matsunaga.

Senator MATSUNAGA. Thank you, Mr. Chairman. I apologize for not being here to listen to your testimonies, however, I do have copies and I intend to read your testimonies.

If you have already answered the questions, you may disregard. I will look at the record, but my question is I have been approached by a number of small businessmen who are pretty much concerned about the accelerated depreciation allowance saying that it would benefit big businesses but not us small businessmen.

They suggest investment credits for research and development to stimulate small, high technology businesses for example.

Now, what are your views, if I might put this question to the panel? Do you have any suggestions relative to providing incentives for small businesses?

Dr. BROWNLEE. It is my impression that the amount of research and development which is done by small businesses is relatively small and that if small businesses claim that the proposed depreciation changes would benefit big businesses more than small businesses, I am surprised that they are asking for this kind of change.

Senator MATSUNAGA. Are you saying that the proposal comes more from small business than big business?

Dr. BROWNLEE. I don't know for sure where the proposal for further investment credits for research and development comes. It would seem to be somewhat strange that it came from small businesses.

My general preference is don't structure things to favor either small businesses or large businesses. Try to make the tax structure neutral, if you wish to call it that, with respect to these. I don't see why the proposed depreciation allowances would favor large businesses rather than small businesses.

They affect the age distribution or the lifespan of the assets which you choose to purchase. But, this I think is neutral, more or less across size of business.

Senator MATSUNAGA. Well, some of the small businessmen are saying that they don't—the profits that big businesses do enjoy that extra depreciation allowance. Most of their income is derived from labor and services while big businesses would have a full benefit of the capital equipment which they normally use.

Anyhow, I am merely conveying the question which was put to me. I am trying to find the answer.

Dr. FELDSTEIN. Let me make two comments, if I may Senator.

Senator MATSUNAGA. Yes, Dr. Feldstein.

Dr. FELDSTEIN. One is I think the real reason for the accelerated depreciation bill that is before the Congress now is to offset the adverse effects that have been created by inflation and historic cost depreciation in the past. So, it is not a new subsidy. It is really going back to where the law was in the mid-1960's, undoing the adverse effects of inflation.

That, of course, has not had a corresponding effect on labor intensive firms. A firm that didn't have depreciable property, didn't experience this increase in effective tax rates between the 1960's and now.

So, I don't think there is a parallel that justifies going out of one's way to do something for labor intensive firms.

With respect to R. & D., I think there is a very strong case, if one could really do it, for finding ways of encouraging more R. & D.

My problem, and I don't know whether it is an overwhelming objection, is the accounting problem of actually identifying R. & D. If you give a 10-percent additional or a 25-percent additional investment tax credit for R. & D. there will be a very strong incentive to define all kinds of things as R. & D. activities.

It might be worth trying it for a few years in order to gain experience and see whether it works, but explicity have it in place as the ITC was originally as a temporary thing in order to see whether it just creates a whole host of audit problems and definitional difficulties.

Senator MATSUNAGA. Dr. Pechman.

Dr. PECHMAN. May I just add that we already give research and development expenditures the most favorable treatment under the code. We allow them to expense those expenditures right away.

I agree with Martin that, if you go beyond that, you are opening up Pandora's box. Whether it will benefit small or large business depends upon whether you put a cap on it.

If you don't put a cap on the R. & D. credit, Dr. Brownlee is right. That is going to be a tax cut for large business rather than small business, because small business doesn't account for a very large percentage of sales, outlays, and R. & D.

I want to add, since you are interested in this area, that I think the Congress has gone too far on gimmicks to help small business through taxes.

I am sympathetic to the equity problems of small business. It is a rough life. Profits are difficult to make for a small enterprise, but it is not the fault of the tax system. Congress has wasted an enormous amount of revenue by introducing graduation into the corporate tax which hasn't helped.

We have a lot of special provisions in the tax law for small business and they are still complaining. The same complaints I hear today were made 30 years ago when I was in the Treasury. What we have done is wasted an awful lot of revenue. So I would hope that you go easy on gimmicks for small business and use the tax resources that you have available to simply cut tax rates generally. You will do better in the long run.

Senator MATSUNAGA. As a cosponsor bill on accelerated depreciation, I am not speaking against it any way. I thought perhaps the small business spending as much as they provide 70 percent of the jobs available that maybe we ought to do a little more for them. They are the ones, of course, who appear to need the most help. There are too many bankruptcies going on these days. We would like to save as many of these small businesses as we possibly can.

I notice my time is just about up. We have a vote on. I see Senator Bradley here. I am sure he wants to ask you questions.

I thank you all. I'll take a look at your testimonies.

Senator DANFORTH. Thank you.

Senator Bradley, we do have a vote on and there is probably about 10 minutes left on the vote.

Senator BRADLEY. What is your intention?

Senator DANFORTH. Do you want to come back?

Senator BRADLEY. Well, we only have 3 minutes here.

Senator DANFORTH. Could you gentlemen stay around another half an hour? We will be back here in 15 minutes.

Senator BRADLEY. I would prefer that than just try to rush through.

[A short recess was taken.]

Senator BRADLEY [acting chairman]. The meeting will come to order. I have been given the rare privilege of being the chairing minority.

I don't think Senator Danforth is going to come back so I would like to just pursue another line of questioning, if I could.

As I came in, I thought I heard Senator Danforth talking about something that I have been looking at too; namely, that if you want savings and if your problem is too much consumption, why shouldn't we either tax consumption or eliminate the tax on savings. What are your views? Why shouldn't we simply eliminate all taxes on savings and indeed, as one of you pointed out, convert the income tax to a progressive consumption tax.

Dr. PECHMAN. If it were necessary to curtail consumption, I would be in favor of that approach. There are some mechanical, if you wish to call them that, problems in the transition, but I think that they can be solved. If it were necessary for economic reasons and politically feasible, I would support it.

Aside from the problems that Professor Brownlee talked about, unless you coupled the consumption tax with a very effective tax on estates and gifts, it would really generate a substantial inequality in the distribution of income. This would hurt the country a great deal more than the improved economic performance you might get from higher saving.

As I said earlier before you came, Senator, I am not as persuaded as my colleagues that the saving shortage cannot be alleviated by other means. The easiest way you can do it without getting into the inequities of a consumption tax would be to eliminate the Federal deficit.

Before tampering with the tax system to the extent that is being talked about, I would like to see the deficit eliminated and then see whether we don't have enough saving in the economy. I would predict that we would.

Senator BRADLEY. Has that been a position that you have always advocated?

Dr. PECHMAN. Yes. I and many of my colleagues, some of whom are called Keynesians. I think it is unfortunate that that epitaph is used to identify people as supporting deficits. It is just not true. The people who talk about functional finance, in general, argued for surpluses to promote savings and investment in this country.

As a matter of fact, in the 1960's that was the major justification for some of the things that President Kennedy proposed.

I think there are times for deficits, but there are also times for surpluses. We need more investment in this country. We ought to have more saving and the thing to do is to make sure that we don't dissave at the Federal level before we destroy the tax system.

Senator BRADLEY. What about you Dr. Feldstein?

Dr. **Feldstein**. I think that the appropriate basis for taxation is consumption. That is in some sense what we mean about the quality or standards of living, not income but consumption.

An ideal tax system would be aimed at taxing consumption rather than income. If that were done along the lines that the Treasury developed in its blue prints for tax reform some years ago, while it would have complexities of its own, it would be a simpler system than our current income tax system and it would indeed encourage a higher level of saving and investment.

Senator **Bradley**. So, you think that it would be good idea. The reason that Dr. Pechman doesn't think it is a good idea is that he thinks it would lead to a real shift in the distribution of income or wealth.

Dr. **Pechman**. Distribution of wealth. That is exactly right.

Senator **Bradley**. Maybe the following would be a useful question. Do you think that the very rich, say the top one-tenth of 1 percent of the population have more consumption or more taxable income?

Dr. **Pechman**. My guess is that they have more taxable income.

Senator **Bradley**. You think they have more taxable income. I doubt that I guess.

Dr. **Pechman**. But, in any case, I think the important thing is that Martin disregards the distributional effects of the consumption tax. I think that is unfortunate.

Now, if you told me that you wanted to use a consumption tax that applied, say to the top 10 percent of income recipients and used the revenue to reduce the marginal tax rates on income, that would make more sense to me.

You would have a basic income tax, which I think most people regard as fairer than a consumption tax, and at the same time you would be taxing some of the consumption of the rich and the near rich.

Senator **Bradley**. What's the idea again?

Dr. **Pechman**. The idea is called a supplementary consumption tax. That is you would enact a consumption tax that would exempt, through a personal exemption, the bottom 90 percent of the income distribution.

Senator **Bradley**. I see.

Dr. **Pechman**. For the rest you would have a consumption tax. The rates might go from zero to 30 percent or something like that.

That would give you revenue which would permit you to reduce the top marginal rates on higher incomes. This is a proposal that has been made in the literature many times.

Senator **Bradley**. Sure. Dr. Brownlee.

Dr. **Brownlee**. If you are serious about this, it is possible, of course, to have also a progressive expenditure tax. The first $10,000 of expenditure can be taxed at a different rate than the next $10,000, et cetera. Lifetime differences in the ratios of consumption to income are a lot smaller than year-to-year differences. We find some people whose consumption is very large relative to their income in one year and relatively small in comparison with their income in other years because of fluctuating income.

I think Dr. Pechman's fear of inequalities or inequities or whatever you wish to call them from the consumption tax are based upon looking too much at the distribution of current income and not enough at the distribution of lifetime income.

Dr. PECHMAN. You don't think that the distribution of lifetime income is unequal?

Dr. BROWNLEE. It is unequal, but I don't think that consumption taxation would make for a greater inequality than income taxation does.

Senator BRADLEY. Well, let's just say that this is one idea for augmenting savings. There are problems with it, but nonetheless it clearly would increase savings and investment. There is no doubt that that would happen. Maybe you would have some distributional problems.

Dr. BROWNLEE. Well, it certainly is going to redistribute consumption against the current generation and in favor of future generations, I, among the ancients, would probably lose.

Senator BRADLEY. What about the idea of the comprehensive tax? Is there any way to make the comprehensive tax progressive? I mean if we are moving in the direction of reducing marginal tax rates, why don't you reduce the upper tax rate from 70 percent to 20 percent and eliminate all tax expenditures? A very simple idea. Across-the-board cut, lowest rate 10 percent, highest rate 20 percent, no exemptions, no tax credits, no deductions?

Dr. PECHMAN. Well, as you know, I have spent most of my career promoting the idea of a comprehensive tax, but I think you went too far. The progressivity of the income tax is quite moderate, but it isn't that moderate. I would guess that the average rate on income goes from zero to about 30 to 35 percent in the top brackets when you include all income in the denominator of the effective tax burdens.

I would say that what you should do is adopt the comprehensive income tax approach and use the revenue to reduce the marginal rates so that the present degree of progressivity in actual tax payments is maintained.

Your proposal would redistribute the tax burden from the wealthy to the lower income classes and I would object to it on equity grounds. However, the basic point that you make, namely that we ought to make the income tax to be more comprehensive, I certainly agree with.

Senator BRADLEY. What about the other two gentlemen?

Dr. BROWNLEE. By the way, the Kemp-Roth or Roth-Kemp proposal would increase the ratio of taxable income to total income and move in the general direction which you are advocating.

Senator BRADLEY. I understand that and there are some proponents in the new school which is the old school, but it is new on television, that indeed went in that direction. My point is, if we are moving toward reducing the marginal tax rate to improve the quality of investment, meaning tax shelters wither away, why don't we be honest about from the beginning and just cut the tax rate dramatically and eliminate the tax expenditures? Phase it in over a couple of years for the adjustments and then we have a much simpler tax system.

One of the problems that I have seen in reading some studies on this question is that the revenues that come from a comprehensive tax are much lower, dramatically smaller, than the present revenues.

I have two questions. One question is is there any way in your view to make a comprehensive tax. With rates that range from 10 to 20 percent, progressive so that you don't have the distributional problems that you eluded to Dr. Pechman?

Dr. **Pechman**. No, if you limit the top rate to 20 percent you can retain some progressivity, but as I indicated the average rate in the top brackets on total income is now above 30 percent. So if you are cutting the top rate to 20 percent you are going to lose distributional equity. You can't avoid it.

I don't see why you have to go that far. You can do what you suggested and set the top rate at 40 percent. I think everybody would agree that a tax system that goes from 7 percent in the bottom bracket to 40 percent in the top bracket and taxed all income alike would be much better than the present system.

Dr. **Feldstein**. I think it is a will of the wisp. I said, I think perhaps before you came, that last year total capital gains accrued by Americans was about $1 trillion.

Now, I don't know how much of that Joe counts as a tax expenditure. I suspect rather little of it, but if you included all of that, all $1 trillion of it, and you taxed it that would produce about $400 billion and allow you to eliminate all the rest of the income tax.

Even if you put it in and just taxed it at 10 percent it would produce $100 billion worth of revenue. I don't think anybody would seriously propose doing that.

Senator **Bradley**. You are saying the total capital gains last year——

Dr. **Feldstein**. Nominal capital gains. The stuff that Joe——

Dr. **Pechman**. No, no——

Senator **Bradley**. You are saying the total capital gains last year were $1 trillion and a 40 percent tax on $1 trillion is $400 billion.

Dr. **Pechman**. You're off base.

Dr. **Feldstein**. Why isn't that part of the tax expenditure?

Dr. **Pechman**. The trillion dollars you are talking about is a cumulative capital gains.

Dr. **Feldstein**. No, no, the annual gain last year.

Dr. **Pechman**. Oh, come on.

Dr. **Feldstein**. What is the capital stock in the United States? What was the inflation rate last year? What did the stock market do and what happened to housing prices? A trillion dollars was the gain in the value of assets held by people in this country.

Dr. **Pechman**. But they weren't sold.

Dr. **Feldstein**. They weren't sold, but Joe would, of course, I think want to include that in income.

Dr. **Pechman**. I would include that in income.

Dr. **Feldstein**. See, then you have to put it subject to the tax——

Dr. **Pechman**. I am not talking about a wealth tax.

Dr. **Feldstein**. That is the will of the wisp. Where do you draw the lines? That is an accretion. A comprehensive Joe Pechman tax is an accretion tax. You include all trillion dollars in it and you tax it at even 15 percent——

Senator **Bradley**. Well, let's assume that we are not reacting to the traditional Joe Pechman comprehensive tax——

Dr. **Feldstein**. Then it is a will of the wisp.

Dr. **Pechman**. Then I am going to join Martin Feldstein. You better watch out.

Senator **Bradley**. But, we are trying to devise a tax system that is a lot simpler, a lot clearer, that provides just about as much revenue, maybe a little less, and that is as equitable.

Now, the administration is, according to one school, heading in that direction and the way they will do it is to reduce the marginal tax rate so that tax shelters wither away and then you may be able to make the next step and the next step, particularly if you have the revenue feedback effect from the marginal tax rates.

Now, not to ask you to believe in the feedback effect, but let's try to structure such a tax. How would you structure it to achieve this objective? If it can be structured properly, I certainly would like to see it done.

Dr. **Pechman**. Well, just to repeat. I would eliminate practically all the deductions in the system and eliminate the exclusions and——

Senator **Bradley**. That gives you about 200——

Dr. **Pechman**. Reduce the marginal rates to a top of 40 percent.

Senator **Bradley**. That gives you about 268 billion if you eliminate all the expenditures in the present system. So you would eliminate all tax expenditures and have a top rate of 40 percent.

Dr. **Pechman**. Right.

Senator **Bradley**. How would you design it, Dr. Brownlee?

Dr. **Brownlee**. This trillion dollars if it consists of nominal capital gains, we have talked about indexing the system for inflation. Obviously, that has to be done if we are going to go to this kind of tax structure, in my estimation.

Dr. **Pechman**. I would approve of indexation if we did it for all assets rather than just for some financial assets.

Dr. **Brownlee**. Then we are back to will of the wisp, I guess.

Dr. **Feldstein**. How about taxing consumption? It eliminates all the deductions. It eliminates all the exemptions. It gives you a large base and you can have a progressive——

Senator **Bradley**. So, you are arguing for what kind of consumption tax? A value-added tax?

Dr. **Feldstein**. No, a scheduler consumption tax where people, in effect, pay tax on the difference between their total cash receipts from all sources including sale of assets and withdrawal of proceeds and the cash that they put into savings accounts or used to purchase other assets. The residual has to be consumption and you pay a scheduler tax on that.

Senator **Bradley**. Well, you are arguing for the progressive consumption tax.

Dr. **Brownlee**. That's right.

Dr. **Pechman**. May I just put a caveat on that? Martin slipped in an ideal consumption tax and is comparing it with an eroded income tax. How about comparing an eroded consumption tax with an eroded income tax? Which would you prefer?

I don't know which one is better. That is what you have to contend with. Let us be clear about it. I can't imagine the U.S. Congress enacting a consumption tax that would tax housing services which are not taxed under the income tax today, and that would tax other consumer durables in full. When you buy a car that costs $8,000 the marginal tax rate of the average taxpayer might be as high as 40 or 50 percent on the purchase price of that car.

What is Congress going to do? It is going to give a little deduction for the poor consumer. So, before you know it, you have a riddled consumption tax and that is what you ought to compare with income tax.

Senator BRADLEY. Maybe we ought to pass a constitutional amendment on deductions so we don't have any deductions.

Let me move away from those two dreams to some more practical questions.

Yesterday in the hearing, Secretary Regan made the point that Japan's budget deficit is the equivalent of a $230 billion budget deficit in the United States and yet they don't have any serious inflationary problems because they have higher savings rates and tight money.

Let's deal first with the savings rates. In this country, the savings rate is roughly 4 or 5 percent, maybe 6 percent. It is much higher in Germany, Japan, and elsewhere. Do you think we have the proper definition of savings in this country? What is the economic definition of savings? When you calculate the savings rate you include savings accounts, CD's, money markets. What else is included?

Dr. FELDSTEIN. I think the other way of doing it, the national income account way of doing it and the economists way of doing it is to look at income not used for either public or private consumption. So it is what's left over available to finance investment and on that basis, we do much, much worse than Germany or Japan.

Senator BRADLEY. If you look at how our systems have evolved though, and they way our Tax Code has biased things in many different ways, it seems to me that on a microlevel when people are contemplating what to do with an extra $2,000 or $1,000, a lot of people decide that they would just as soon invest in their home. In large part this is due to the bias toward owner-occupied housing created by the Tax Code.

Now, that is a savings. They are saving by investing in their home instead of in the stock market or the bank or whatever. Only we don't include that in savings.

Dr. FELDSTEIN. We do.

Dr. PECHMAN. We do.

Dr. BROWNLEE. We do. In fact, one of our problems is, in my estimation, that too much of our capital stock consists of housing—residential housing.

Senator BRADLEY. We do include that in the savings rate? So that is not considered consumption.

Dr. FELDSTEIN. Therefore, the figures that you have mentioned, 6 percent, really hide how bad the situation actually is.

Half of the net investment goes into housing and inventories.

Senator BRADLEY. So, you really have to raise about 2½ percent.

Dr. BROWNLEE. Yes, something like 3 percent of income is available for investment or has been invested in assets other than residential housing and inventory.

Dr. PECHMAN. I think you can't blink the fact that the Japanese people save more than the American people do and therefore, there is room for dissaving at the central government level which is what has happened.

But, even after you take that into account, they still save more on balance even after you take account of their deficit and we don't.

Senator BRADLEY. OK.

Dr. BROWNLEE. But, Joe we are not going to call all of the budget deficit dissaving.

Dr. PECHMAN. Why not?

Dr. BROWNLEE. Imagine that all of the Government expenditure were made for capital equipment.

Dr. PECHMAN. Oh, I see.

Dr. BROWNLEE. I mean, if it all goes into consumption then you can treat it differently.

Dr. PECHMAN. I agree that you should.

Senator BRADLEY. On the way to this progressive consumption tax, there have been a number of suggestions here in the Congress in the last 6 months or so. The one that is best known is that you take a little segregated account and you give a tax exemption for it if the funds are used and loaned out for housing. To follow up on your point, it doesn't improve the productivity or competitiveness of America in any real sense.

Dr. FELDSTEIN. But, I think those schemes typically are not if the funds are loaned out for housing, but if the purpose of the saving is stated to be for housing.

Is that false?

Senator BRADLEY. No. This is the Bentsen approach. The Bentsen approach applies to a segregated account in a bank where the funds can only be loaned out for housing.

Dr. FELDSTEIN. By the bank.

Senator BRADLEY. By the bank.

Dr. FELDSTEIN. Money is sufficiently fundable that if I open an account at the Chase Manhattan Bank for "housing" they will do at least that much housing, but at the margin it won't have to change.

Senator BRADLEY. Politically, since the fungibility issue is not one readily understood by people I speak to in Perth Amboy or wherever, the first step toward that system might be a segregated account for housing. But that does not produce the kind of productivity punch that you want.

Dr. FELDSTEIN. It does, that is the point, because the financial institutions, when they get the money, will conform in name only to the housing requirements. If it actually leads people to save more and put that money into savings banks or commercial banks, those institutions will rechannel that money into the capital market as a whole.

Senator BRADLEY. So, it is your view that why limit it as a segregated account for housing. Why not a segregated account for reinvestment, for retooling, plant and equipment?

Or, why not limit segregated accounts to this purpose as opposed to housing?

Dr. **Brownlee.** I don't think this would hurt. Let's take the consumption analog. Imagine that I give you $40 a month, conditional upon your spending it on food. If you are already spending $40 on food, the restriction that I have imposed has no impact on your behavior.

I think what we are saying about these segregated accounts, is that as long as the bank is lending out more than this amount of money for housing anyway, these accounts have no impact.

Senator **Bradley.** Fine. Let's not say housing. Let us say plant and equipment. Clearly the statistics, investments, percentage of GNP or whatever, show that we do not have an investment rate that is high enough.

Dr. **Feldstein.** If you had an overwhelmingly large increase in inflow of funds into these segregated accounts it might make a difference into what the financial institutions did with the money because these constraints would be binding.

But, if you are talking about money coming into institutions that are currently putting money out for plant and equipment, then the fact that they have to put some part of this earmarked money out for that, really won't change what they do.

They simply will put aside some of the money they are currently putting into it.

Senator **Bradley.** Very well. You shot down both of those ideas. The question is then, How can you be assured of new savings? We want new savings. We do not just want the savings and loan people to put it in the money market fund and then put it back into segregated account and then—how do we get new savings?

Dr. **Pechman.** Then you go to the graduated consumption tax that these people have recommended, which I think would be a horror. But you would get new savings out of it.

Dr. **Feldstein.** More modestly, I think if you had IRA accounts available for everybody, you would undoubtedly get some additional saving.

Senator **Bradley.** How do we know that?

Dr. **Feldstein.** Well, we don't absolutely know anything, unfortunately.

What we know now is that the IRA accounts that are currently available for the people who are least likely to be in a position to save will want to save. People who don't have mainstream jobs basically, or who are too young or too old to take advantage of it.

If people are going to respond at all to rate of return incentives, the IRA would work.

But, I think it does something more than that and that is why in answer to some questions earlier this afternoon, I said that I thought one should do more than just interest and dividend partial exclusions; one should have IRA's.

For a lot of people, this target, you put the $1,000 or $1,500 aside, Uncle Sam will pick up part of the tab, is just too good to pass up.

Simply saying to people that they can have interest and dividend exclusion on some fraction of their interest and dividend doesn't have that dramatic appeal that IRA's and Keogh's have.

Senator **Bradley.** So, you figure what amount? Assume that you can eliminate——

Dr. **Feldstein**. If you make it too low then you are not getting anything extra for it.

Senator **Bradley**. The bill last year in the Finance Committee had IRA's up to I think, $1,700, and LERA's up to $1,000.

Dr. **Brownlee**. Well, it is 15 percent of income under present arrangements; isn't that the case?

Senator **Bradley**. A maximum.

Dr. **Brownlee**. OK, but let's take off the maximum. That is equivalent to a 15-percent cut in the tax rate.

Dr. **Feldstein**. Not for IRA's.

Dr. **Brownlee**. Well, the IRA——

Dr. **Feldstein**. What would you do under your proposal?

Dr. **Brownlee**. Well, under present arrangements, 15 percent of your income can be set aside in a pension, not subject to current tax; isn't that right?

Dr. **Feldstein**. Up to a dollar limit.

Dr. **Pechman**. Up to $1,500.

Dr. **Brownlee**. Sure. Raise it to $30,000, if you want to.

Senator **Bradley**. Raise the——

Dr. **Brownlee**. Raise the upper limit.

Senator **Bradley**. From $1,500 to $30,000?

Dr. **Brownlee**. From $1,500 to $4,500, if you wish.

Senator **Bradley**. I see.

Dr. **Brownlee**. I don't see any reason why there should be a limit at all. But in effect, we would be reducing by a substantial amount, the effective tax rate.

Dr. **Feldstein**. We currently for Keogh's have a limit based on $50,000 of income.

Dr. **Brownlee**. Yes, $7,500 per year.

Dr. **Pechman**. May I simply object to the general tenor of the conversation. I think that increasing IRA's or special gimmicks of that sort will simply provide more elbow room for people like me to take advantage of tax-exempt sources of financing and will not increase savings in total.

Senator **Bradley**. You don't think it will increase savings?

Dr. **Pechman**. No, it will not.

Senator **Bradley**. Why?

Dr. **Pechman**. It hasn't done it.

Senator **Bradley**. What evidence do you have?

Dr. **Pechman**. We have had Keogh plans for about 15 years. We have had IRA's for more than 5.

Dr. **Feldstein**. What is the evidence the Keogh plans have not increased savings?

Dr. **Pechman**. You are still lamenting that total saving economy is too small.

Dr. **Brownlee**. I increased my savings substantially on account of what is called the Mill's bill.

Dr. **Pechman**. At the expense of Government revenues. You may not have increased your personal savings. All that happened was the Federal Government siphoned some money to you. I object to that.

Dr. **Feldstein**. Joe, I don't understand why saving went up substantially.

Dr. **Pechman**. Including the Federal rebates.

Senator BRADLEY. Very well. Let's pause a minute, now. Give the reporter a break.

I think I see the range of debate here. Could we move on to the second part of what Mr. Regan said yesterday which was that the Japanese don't have the problem we do because they have high interest rates and controlling the money supply is what keeps that inflation rate down.

Now, do you see any correlation between the Japanese financial markets being relatively closed versus the U.S. financial markets which are totally open and their ability to control money supply.

It has only been in the last year that the Japanese have even begun to open their markets for sizable investments.

So, my question is, don't you find a situation in this country where you raise the interest rates to reduce inflation by cutting the money supply or you set out ranges of money supply and interest rates go wherever they want.

The result is that U.S. investment securities become highly attractive compared to French or German and you get an enormous influx of Eurodollars into the U.S. market. As soon as those dollars come in they are part of the money supply figures.

This means you raise interest rates and you tell people to expect that high interest rates will get the money supply down, when in fact it has the opposite effect. The money supply figures come out, money supply is up when it should be down and people's expectations remain highly inflationary.

Tell me, in your view, what is wrong with that analysis.

Dr. FELDSTEIN. I think you are basically right about a qualitative story, but there isn't dollar-for-dollar offsetting of the sort that your story suggested.

That is, the Fed has to work harder to keep the money supply from expanding, because as it contracts the money supply domestically, that does suck in funds from abroad, in response to the higher interest rates.

Senator BRADLEY. Yes.

Dr. FELDSTEIN. So, contract the money supply domestically, that would tend to push up rates and that brings up funds from abroad, but not dollar for dollar.

So that it just means——

Senator BRADLEY. What is the ratio? Not dollar for dollar?

Dr. FELDSTEIN. I have seen estimates——

Senator BRADLEY. How do we know?

Dr. FELDSTEIN. Well, there have been econometric estimates of what the impact is. I guess, perhaps, more telling, is the fact that nobody in the debate about the Fed's ability to control the money supply seems to be worried about this, neither the monetarists nor the antimonetarists seem concerned.

So, that says the practitioner's experience supports academic evidence on that point. We don't have such responsiveness of international money to the United States that it is impossible for us to determine our own money supply; we can.

Dr. BROWNLEE. What is the question?

Dr. FELDSTEIN. The question is can the——

Senator **Bradley**. The question is: How can you keep the money supply on a downward path, when high interest rates attract an enormous inflow of foreign capital.

Dr. **Brownlee**. Can the Federal Reserve control the money supply, given——

Dr. **Feldstein**. That's right.

Dr. **Brownlee**. Sure. My answer is the same as Dr. Feldstein. It may have more difficulty.

Senator **Bradley**. Explain it for me in economic terms. The money supply is, say, at this level. Interest rates go up. The money supply——

Dr. **Feldstein**. The Fed withdraws a dollar.

Senator **Bradley**. Right. Begins to drop.

Dr. **Feldstein**. And 50 cents worth of D-marks come in from abroad.

Senator **Bradley**. When the interest rate goes up, you have this inflow of money out of the Eurocurrency markets. So the money supply then goes back up.

Dr. **Feldstein**. Then the Fed sells bonds and withdraws that amount of money from the markets. It has instruments to offset the increase in money that would occur as a result of that. It is tougher to do.

Dr. **Pechman**. In selling bonds it increases the interest rates slightly, which of course, has been the problem. The Fed, I think, has been reluctant, although I shouldn't be psychoanalyzing it, has been reluctant to permit as much fluctuation in interest rates as perhaps should take place.

But, I thought earlier you asked a question about the relationship between Japanese inflation and the Japanese deficit.

Senator **Bradley**. I was quoting Secretary Regan, to get at the savings question and the interest rate question. That was my primary interest.

Well, I have to close. Before I do, let me just ask you a few of the normal questions that you probably heard.

If we have a 10-percent tax cut each of the next 3 years, what do you think the probability is that those individuals receiving that tax cut will save it?

Dr. **Brownlee**. All of it? Some of it?

Senator **Bradley**. Save more than they have been normally accustomed to saving in the previous 5 years.

Dr. **Brownlee**. The probability is one, that they will save more than they—I am certain they will save more than they have been saving. How much more is another question. But, savings will certainly increase.

Dr. **Feldstein**. I agree the sign is in that direction. My guess is——

Senator **Bradley**. Why is it then, when I have a room full of people, whether they are accountants or steelworkers, and I say, "You are going to get a tax cut this year of $200. What are you going to do with that money?"

They all reply that they'll spend it. I haven't had one person raise his hand and say, "I am going down to the savings and loan and or put it in the money market fund," or even say, "Invest it in my house."

Dr. FELDSTEIN. If you asked them the question, "How much are you going to spend in 1982, and how is that going to depend on your cash flow for the year," my guess is you would find, not at the bottom end of the distribution but at the places where taxes are being cut, you would find they would say there isn't anything like a one-for-one relationship between their aftertax cash flow and what they spend.

Therefore, if it turns out, when the year is over, they pay less tax, some of that is going to end up in savings. They don't adjust dollar-for-dollar the way the person making $10,000 a year does.

Senator BRADLEY. No. The question is: Is Kemp-Roth inflationary? will save a little more. How much more, nobody knows. We also don't know whether it will be enough to prevent a little blip in the inflation rate, because there is more spent on consumption.

Dr. PECHMAN. It wouldn't increase savings enough to matter much.

Seantor Bradley. No. The question is: Is Kemp-Roth inflationary? If the answer is yes, it means you have to assume they are going to spend it and not save it.

Dr. PECHMAN. Kemp-Roth in itself, I don't know how to answer that unless you tell me what the rest of the budget is like. If you reduce expenditures by the amount that Kemp-Roth cuts taxes, then I would say it is not inflationary.

Senator BRADLEY. We haven't done that.

Dr. PECHMAN. Right. My testimony says——

Senator BRADLEY. We are $150 billion on the stimulant side.

Dr. FELDSTEIN. I think that is bad arithmetic. What I tried to lay out in the prepared remarks is the arithmetic which says that basically the tax cut over the next 2 years, for sure, and probably over the 2 years after that, the tax cuts that the administration has asked for just offsets the increased tax revenue that would otherwise come about because of the progressive structure of rates.

Senator BRADLEY. That figures in the marginal rate reduction included in that next 2 years?

Dr. FELDSTEIN. That is right.

Senator BRADLEY. It assumes what inflation rate?

Dr. FELDSTEIN. It assumes that nominal income rises at about 11 percent a year. That is to say, inflation plus real growth. The administration is talking 13, most of the private forecasters are talking more than 12.

So, this is a cautious kind of number. It says that on that basis, you don't need any spending cuts to have no net stimulus from the tax reduction.

Senator BRADLEY. Do you agree with that?

Dr. BROWNLEE. I agree with that, but that is based on the assumption that you won't have any expenditure increases.

Dr. PECHMAN. I don't see how Martin could avoid the question of what is going to happen on the expenditure side.

Dr. FELDSTEIN. I didn't avoid it.

Dr. PECHMAN. He just assumes that the cuts that are proposed by the administration will be adopted by Congress. Now that involves making decisions that Congress has not yet made.

All that has been decided is that Congress is going to take the first leg, approximately the first leg of the Reagan plan

Out in 1984, there are still $40 billion of expenditure cuts that haven't identified.

Dr. FELDSTEIN. You could have Government spending increase in proportion, at the same proportionate rate that income increased. You still wouldn't be doing anything to change the net balance.

Dr. BROWNLEE. Sure. It is a constant ratio equivalent expenditure.

Dr. FELDSTEIN. If Government spending increases a lot, then it is a mistake from an inflationary point of view, to cut taxes. I guess that is what it comes down to.

But, it seems to me that the mood in these two Houses is very clearly against increasing spending. If the budget passed in both Houses actually comes into effect, it is a $25 billion real decrease in expenditure between 1981 and 1982.

Dr. PECHMAN. I agree with that part of the arithmetic. My point is that I would not throw it away on tax cuts at the present time. Why not just reduce the deficit and increase savings to that extent.

Senator BRADLEY. Well, thank you very much for staying around and giving me a chance to ask a few of these questions.

Dr. FELDSTEIN. Thank you, Senator Bradley.

Dr. PECHMAN. Thank you.

Dr. BROWNLEE. Thank you very much.

Senator BRADLEY. I appreciate it very much.

[Statements follow:]

STATEMENT BY JOSEPH A. PECHMAN[1]

I am pleased to have the opportunity to appear before this Committee to discuss the potential impact of tax cuts on the econcomy. It is being argued that tax cuts would greatly stimulate work and saving incentives and generate a large increase in economic growth; a few believe that tax cuts would more than pay for themselves. I believe that even the more modest claim that there will be a large supply response is not supported by the evidence; the extreme position that tax cuts will pay for themselves is simply a gross exaggeration.

Economic incentives are critical to the efficient operation of the economy, and tax policy is a very important element in the overall structure of these incentives. On this point, there is no disagreement among economists. The issues that divide us concern the magnitudes of the effects and how to balance the objectives of efficiency and equity in the determination of tax policy. Obviously, one might sacrifice equity if the efficiency gains from particular types of tax cuts are certain to be large. But it would be unfair to make such a sacrifice if the efficiency gains are uncertain or likely to be small.

The claim that large tax cuts will have large supply effects is based on the presumption that present tax rates have already impaired incentives to a significant degree and that a reduction in these rates would greatly increase productivity and economic growth. The Brookings Institution has just completed a book entitled "How Taxes Affect Economic Behavior" which reviews the evidence and provides new estimates of the effect of tax changes on work effort, saving and investment and other types of economic behavior. The evidence in this book suggests that tax cuts would improve incentives to some extent, but the effect on output and productivity cannot be nearly as large as the extreme proponents of the supply response view are implying.

INVESTMENT

Perhaps the most empirical work on supply responses has been done on the effect of the cost of capital on investment. The enactment of the investment credit and liberalized depreciation during the Kennedy administration were predicated on the assumption that investment responds to reductions in the cost of capital. There was an increase in the ratio of investment to the gross national product in the mid-1960s

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[1] Director of Economic Studies Program, the Brookings Institution. My views should not be attributed to the officers, trustees or other staff members of Brookings.

(see accompanying table), but even now it is unclear how much of the increae was due to a rise in demand and how much to the reduction in the cost of capital. Some economists have argued that the reduced cost of capital was the major reason for the rise in investment at that time, but other equally reputable economists believe that the demand effect was much more important. The econometric analysis in the Brookings book, which was based on data for that period and for more recent periods, concluded that both demand and the cost of capital are important.

NONRESIDENTIAL FIXED INVESTMENT AS A PERCENT OF GROSS NATIONAL PRODUCT IN CURRENT AND CONSTANT DOLLARS, 1947-80

	Current dollars	1972 dollars
Year:		
1947	9.8	10.4
1948	10.1	10.4
1949	9.4	9.3
1950	9.5	9.3
1951	9.5	9.1
1952	9.0	8.7
1953	9.4	9.0
1954	9.3	9.0
1955	9.6	9.3
1956	10.4	9.7
1957	10.6	9.7
1958	9.3	8.7
1959	9.4	8.8
1960	9.6	9.1
1961	9.2	8.8
1962	9.2	9.0
1963	9.2	9.0
1964	9.6	9.4
1965	10.5	10.5
1966	11.0	11.0
1967	10.5	10.4
1968	10.4	10.4
1969	10.7	10.7
1970	10.5	10.5
1971	10.0	10.0
1972	10.2	10.2
1973	10.8	11.0
1974	10.9	10.9
1975	10.2	9.7
1976	10.1	9.7
1977	10.7	10.2
1978	11.2	10.7
1979	11.6	11.0
1980	11.2	10.6
Averages		
1947-54	9.5	9.4
1955-64	9.6	9.2
1965-74	10.6	10.6
1975-80	10.8	10.3

Source: Bureau of Economic Analysis.

It should be noted in this connection that, contrary to the impression given by many, gross business fixed investment during the recent past has been high by historical standards. The portion of the gross national product that went to nonresidential fixed investment in the last 15 years was much higher than it was in previous post-World War II years, whether the figures are expressed in current or constant dollars. The average for the 15 years, 1965-80, easily exceeded the averages for the previous decade and even exceeded those for the immediate postwar decade, when investment was high as a result of war-created shortages. Furthermore, the investment ratios in 1978, 1979, and 1980 were the highest in the entire post-war period.

Thus, contrary to the popular impression, the investment ratio has been increasing in recent years, though the rise has been modest. It is true that capital per worker declined after 1973, but this drop was due to the large increase in the labor force, not to a decline in investment or to any particular feature of the tax system.

The fact that investment has been high recently does not mean that it should not be higher still. But we should not exaggerate the potential effect of taxes in achieving higher productivity growth through increased investment. Most analysts agree that an increase of one percentage point in the ratio of investment to the gross national product—about $28 billion in 1981—would generate a 0.2-0.3 percentage-point increase in the annual rate of productivity growth. Thus, even if the business taxes were cut by $28 billion a year and the entire tax cut were funnelled into investment, the effect on the growth rate would be modest.

SAVING

The case for tax incentives to promote saving is that more saving is necessary to provide the resources necessary to increase business investment. However, the evidence on the effect of increasing the rate of return on saving is unsatisfactory. Some economists have made calculations suggesting that the response of saving to the rate of return on saving is fairly high, but other calculations suggest that the personal saving elasticity is close to zero. The prevailing view is that there is some interest elasticity to saving, but we really don't know what it is. The Brookings book confirms that it is extremely difficult to be certain about the effect of tax cuts on personal saving.

There is the additional complication that higher private savings may not translate into a higher level of total saving or increased business investment. For one thing, given the larger tax and other advantages accorded to residential construction, much of the additional saving might find its way into the housing sector rather than the business sector. Furthermore, if there is a problem of inadequate business capital formation in the United States, it may be more the result of the uncertainties about the payoff from investment rather than a shortage of saving. The uncertainties have been particularly acute in the recent years of serious inflation and severe recessions. In such circumstances, cuts in income tax rates or the introduction of new tax preferences for saving may have very little payoff. Finally, when the economy is operating at high levels, a reduction in dissaving by government (i.e., a reduction in the budget deficit) offers a more certain method of increasing funds for private investment than would tax cuts or tax preferences.

LABOR SUPPLY

A series of econometric studies dating back to the 1960s concluded that the labor supply of prime-age males is not highly sensitive to changes in net earnings, but that the labor supply of wives and other family members does respond to changes in the rewards for working. According to interview studies both in the United States and England, tax rates have little effect on work effort of high-bracket taxpayers and of professional groups.

The econometric work by Professor Jerry Hausman of the Massachusetts Institute of Technology, who wrote the lead article in the Brookings book, confirms that the labor supply response of supplementary family earners to earnings changes is significant; he also found that the response of prime-age males may be higher than we have believed in the past, although it is still relatively small.

The econometrics required to obtain such estimates from the available data are difficult and a lot more work needs to be done to evaluate these new findings. The evidence does suggest that reductions in tax rates for working wives would have a significant supply response (although recent increases in labor force participation of married women can hardly be accelerated very much). However, even using the most generous estimates of the elasticity of total labor supply, it is clear that tax cuts will not raise output enough to pay for themselves.

IMPLICATIONS FOR POLICY

In view of the tenuous nature of the evidence, there is no basis for assuming that reductions in income tax rates—even as much as the 30 percent reductions under the Kemp-Roth bill—will increase incentives and productivity growth by the very large amounts claimed by some of the extreme supply-side economists. The recent decline in the rate of growth of productivity is worrisome, but the problem will not be solved by such a simple expedient as a general income tax reduction. Moreover, incurrent and foreseeable circumstances, federal tax resources must be carefully husbanded and it would be irresponsible to accept significantly higher deficits in the expectation that higher tax receipts would erase the deficit.

It should be noted that three-quarters of the Kemp-Roth tax cuts are necessary just to prevent inflation and economic growth from increasing real tax burdens through bracket creep. In fact, in the lower tax brackets, the rate cuts would not offset the tax increases caused by inflation, because no adjustment is proposed for the reduction in the real value of the personal exemptions and the standard deduction since they were last adjusted on January 1, 1979. Only for incomes above $35,000 would there be significant net cuts from the 1980 marginal rates. It is doubtful that the increase in work and saving of those above this level would be sufficient to have the dramatic effects on the economy claimed by the adherents of Kemp-Roth.

The evidence does suggest that two tax measures would have reasonably good, though not spectacular, payoffs. First, a reduction in the cost of capital either through an increased investment credit or higher depreciation allowances would stimulate investment, which would in the long run result in a modest increase in productivity growth. Second, reductions in the marginal tax rates of married couples with two earners relative to those of single-earner couples might encourage some spouses to work longer hours.

The conclusion to be drawn from this review of the evidence is that depreciation allowances should be liberalized as soon as possible, preferably by adopting the first-year capital recovery system developed by Alan J. Auerbach and Dale W. Jorgenson. Moreover, the new depreciation provisions should be made retroactive to the beginning of 1981 to avoid delaying business investment decisions while the tax bill moves through Congress. To increase the work incentives of two-earner couples, some method of alleviating the so-called "marriage penalty" under the income tax should be adopted. My preferred method would be to provide a generous deduction for such couples, say, 10-20 percent of the earnings of the spouse with lower earnings. This provision is in my view, less urgent than the depreciation reform and should be made effective when other income tax cuts become effective.

There is considerable interest in an element of the Kemp-Roth proposal the president did not embrace, lowering the top marginal tax rates on unearned income to 50 percent (the maximum rate now applied to earned income). Such a move would be justified if the annual revenue loss of $4 billion were recouped by closing some of the tax loopholes that distort economic incentives (for example, by denying tax-exempt status to industrial development bonds issued by state and local governments).

As to the general income tax cuts, I believe that it is too early to make a decision both on the size and the nature of the cuts. The expected deficit in fiscal year 1982 before congressional action on the budget is in the neighborhood of $60 billion. Assuming the outlay cuts envisaged in the Senate and House budget resolutions are implemented, some reductions in income taxes (including adjustments for the erosion of the real value of their personal exemption and the standard deductions) would be appropriate. But we should not prejudge how much the actual outlay reductions will be. I don't think the economy will suffer if the income tax cuts are delayed until October 1, 1981 or January 1, 1982, so that it will be possible to estimate with some degree of accuracy how much elbow room there will be for cuts in fiscal 1982 and later years.

I do not believe that there will be enough room in the budget over the next three years for a 30 percent cut in income tax rates as well as for other necessary adjustments. It is unwise, therefore, to act on the rate cuts first and hope other needed adjustments can be packaged into a second tax bill to be enacted later. The entire income tax structure needs to be reviewed carefully and it would be unwise, in my opinion, to rush ahead with large rate reductions that will preempt the revenues needed to develop a balanced tax program.

TESTIMONY BY MARTIN FELDSTEIN

Thank you, Mr. Chairman. I am pleased to have the opportunity to appear before this distinguished committee and to comment on the very significant budget proposal that Congress is now considering.

I believe that the Administration's proposal is basically a good one although I do not agree with all of the arguments that the Administration has offered in support of its recommendations. Indeed, much of the criticism of the Administration's proposal is based on taking these arguments too literally and concluding that, if the arguments are wrong, the program must also be unsound. The confusion is compounded by a failure to distinguish the current budget proposal from the policies that President Reagan advocated in the early part of his campaign.

In fact, there has been a remarkable change over the past year in the economic policies advocated by President Reagan. A year ago, the President's campaign rhetoric was still full of wishful thinking about major tax cuts without any reductions in government spending. Despite all of this early supply side hyperbole, the President's actual program represents a total repudiation of the naive Laffer curve theory that across-the-board tax cuts are self-financing. In its place, the Administration has coupled a moderate tax cut with wide-ranging and generally well chosen cuts in government spending.

The Administration's proposals for spending reductions beyond 1982 are not yet definite. How Congress will react to this call for further spending cuts is even more uncertain. I will therefore focus my remarks on the proposed tax reductions for 1981 and 1982 and comment only briefly on further cuts.

The Administration is of course quite optimistic about the favorable effects of its program. Its forecast calls for a rise in the growth rate of real GNP to 4.2 percent in 1982 (up from zero last year and less than two percent in 1981) and a fall in the inflation rate as measured by the GNP deflator from 9 percent in 1980 to 8.3 percent in 1982. By 1984, the real growth rate is projected to increase to 4.5 percent and the inflation rate to decline to 6.0 percent. I believe that this forecast, especially the anticipated rapid growth of real GNP, is probably too optimistic.

But if the Administration is overly sanguine in its forecast, the critics who charge that the proposed tax cuts are dangerously inflationary are likely to be even more inaccurate. In my judgment, the Administration has proposed a deflationary package that would slow the growth of demand. The resulting increase in unemployment and the additional slack in the economy would help to reduce inflation but would not produce the rapid growth that the Administration forecasts.

SPENDING REDUCTIONS

The principal cause of this deflationary pressure is of course the major reduction in government spending. For the fiscal year ending in October 1982, the Administration has proposed cutting some $50 billion in outlays from President Carter's proposed 1982 budget of $740 billion. If these cuts are accepted, federal government spending will increase only 6 percent between 1981 and 1982, or, after adjusting for the general rise in prices, will actually fall by about 4 percent.

In addition to direct spending reductions, the Administration also proposes to cut loans and loan guarantees by $20 billion in fiscal year 1982. While some of these loans might come to the market even without federal assistance, the higher cost of funds would no doubt discourage a substantial portion of this debt-financed demand.

The Reagan program calls for a substantial $26 billion increase in defense spending between 1981 and 1982 on top of the $24 billion rise between 1980 and 1981. The $189 billion proposed defense outlays for 1982 represent a 15 percent real increase in two years. Although opponents of increased military spending charge that the expanded defense budget would fuel inflation, the basic fact remains that real government outlays would fall 4 percent between 1981 and 1982 despite the increased defense spending. Moreover, the Reagan budget requests only $4 billion more in defense outlays in 1982 than the final Carter budget for 1982.

SMALL TAX CUTS

In comparison to the major spending cuts, the tax cuts proposed for 1981 and 1982 are negligible. The 15 percent reduction in personal tax rates planned for 1981 and 1982 will essentially just offset the increase in real taxes that would otherwise occur as inflation pushed taxpayers into higher brackets. The continual public debate between the Administration's supporters who emphasize the potential favorable effects of a tax cut on supply incentives and the Keynesian critics who argue that the tax cut would only serve to stimulate inflationary demand makes it easy to lose sight of the basic fact that there is no real tax cut in the Administration's proposals for 1981 and 1982.

It is easy to see why this is so. Because tax rates increase sharply with income, each one percent of additional personal income raises the government's income tax receipts by about 1.6 percent. Thus the increase in personal incomes of at least 22 percent that will occur between 1980 and 1982 would raise tax receipts by 35 percent if tax rates were unchanged. The proposed 15 percent reduction in rates would still leave a 20 percent increase in tax revenue, enough to offset the two year rise in prices and leave a net increase in real personal income tax payments.

The Administration emphasizes that its tax package will cut marginal tax rates and will therefore provide stronger incentives for work effort, saving, and portfolio investment. In fact, without the tax cuts inflation would cause the marginal tax rates of almost everyone to rise, with the marginal rates of some individuals increasing by more than 15 percent while the marginal tax rates of others increases by less. A 15 percent cut in tax rates would therefore still leave some individuals with higher marginal rates in 1982 than in 1980. For most individuals there would be very little net change. Nevertheless, the 15 percent reduction would bring the top rate down from 70 percent to 60 percent and, more generally, would reduce marginal tax rates for high income individuals. Any positive "supply side" effect of these marginal rate reductions would further reduce the pressure of demand.

It is important to remember also that any given tax reduction does not result in an equal increase in consumer spending but adds to personal saving as well. Half of a proportional across-the-board tax cut goes to taxpayers with incomes over $30,000 and 30 percent of the cut goes to taxpayers with incomes over $50,000. Families with these relatively high incomes do not spend all of their after-tax income every year. Their spending responds only slowly to changes in their income, with variations in saving absorbing the difference.

This slow response is particularly true when the increase in spendable income reflects a tax reduction that may only be temporary. Even though the Administration's plan calls for a "permanent" reduction in tax rates, inflation would soon push most taxpayers back up to their previous tax rates. The likely response among middle and upper income groups to such a temporary and uncertain tax cut would be a small increase in spending and a relatively large increase in saving.

FURTHER TAX CUTS

Although I have focused on the tax cuts for 1981 and 1982, my analysis has implications for the additional 15 percent of tax cuts that the Administration has proposed for 1983 and 1984. Most of such a tax cut would merely offset the extra tax revenues that would otherwise result as inflation pushed taxpayers into higher brackets. If the combination of real growth and inflation raised incomes by another 22 percent in 1983 and 1984, a 15 percent tax cut would still leave the ratio of taxes to income higher in 1984 than in 1982.

Of course, money incomes might rise less than 22 percent in these two years. A very cautious compromise with the President's proposal would be to reduce the taxes by 25 percent now instead of the 30 percent that has been requested, i.e., legislating now a 15 percent tax cut for 1981 and 1982 and 5 percent cuts for 1983 and 1984. As long as money incomes in 1983 and 1984 rise by at least 9 percent a year, these 5 percent tax cuts will not be enough to prevent a rise in the ratio of taxes to income. As subsequent budget cuts are enacted and the likely growth rate becomes clearer, Congress could enact further tax reductions.

There are good reasons for keeping the current tax bill simple and dealing with other structural reforms at a later time. But if changes in the tax proposal are going to be made, high priority should be given to reducing the maximum marginal tax rate to 50 percent immediately and to providing significant incentives for more personal saving.

A combination of 5 percent rate cuts in 1981 and 10 percent rate cuts in 1982 would reduce the maximum tax rate to 60 percent. A further reduction to a maximum of 50 percent in 1982 would lower tax revenue by only an additional $2.5 billion even on the assumption that this rate reduction did nothing to increase the taxable income reported by taxpayers who would otherwise pay rates over 50 percent. In fact, such a rate reduction would undoubtedly discourage some use of tax shelters, unlock some capital gains, and in other ways raise taxable income. It would not be at all surprising if such a tax rate reduction for very high bracket individuals has virtually no effect on tax revenue. It would, however, eliminate some of the worst distortions and disincentives in our personal tax system.

I have testified before this Committee in the past about tax changes that could stimulate personal savings. I realize that I do not have enough time this afternoon to consider this issue as part of my prepared remarks. I am, however, providing a copy of a study on this subject that I recently completed with a colleague at the National Bureau of Economic Research[1] and would be pleased to return to this issue during the general discussion.

CHANGING DEPRECIATION

In addition to the personal tax cut, the Administration has proposed a major acceleration of business depreciation modeled along the lines of the "10-5-3" depreciation bill that had previously attracted very broad Congressional support. A substantial depreciation reform of this type is needed to offset the dramatic increase in effective tax rates on investment that has occurred in the past decade as inflation has eroded the value of historic cost depreciation. For equipment investment, the Administration's proposal would approximately offset the effect of inflation at a rate of about 8 percent a year, falling short at today's higher rates. For investment

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[1] Martin Feldstein and Daniel Feenberg, "Alternative Tax Rules and Personal Savings Incentives: Microeconomic Data and Behavioral Simulations," National Bureau of Economic Research Working Paper, 1981.

in structures, the impact of the proposed change would be much smaller. The Administration's bill may not be the best one that could be devised by man, but it is a good bill that would provide a valuable long-run stimulus to business investment.

Although the resulting increase in the capital stock could make a significant contribution to raising output and productivity during the coming decade, supply side effects in the short run are bound to be small. Indeed, there is always the danger that the immediate impact of a favorable change in depreciation rules would be to stimulate demand for plant and equipment and thereby increase inflationary pressure. It is fortunate, therefore, that the Administration plans to phase in the shorter depreciation lives over a period of five years, thereby avoiding a sudden increase in the incentive to invest. Moreover, some firms will discover that it pays to postpone some investments until the change in depreciation lives is completed. As a result, total investment should expand only gradually over the next few years with little or no inflationary pressure on the capital goods industry.

When the pieces are put together, the picture that emerges is of a rather deflationary budget for 1982. Real government spending falls four percent below the 1981 level, a decline of $25 billion. Because of bracket creep, the 15 percent cut in personal tax rates still leaves a small increase in the real tax burden on individuals. And the business tax cut is phased in over five years in a way that weakens the investment incentive in early years.

Yet despite all of these deflationary aspects, critics have claimed that the budget is inflationary because a 1982 deficit of some $50 billion would remain. Of course, totally eliminating such a deficit through higher taxes or a greater cut in spending would make the budget even more deflationary. But the result could be an undesirably sharp rise in unemployment and drop in output. Moreover, the level of the deficit is a poor measure of the short-run impact of budget changes. A decrease in government spending resources demand by a dollar for every dollar of reduced spending while a decrease in taxes has a much smaller effect on demand.

While it may in fact be better to reduce taxes or spending by $10 billion more or less the administration has proposed, there is no way to know. Even the most ardent advocate of fine tuning cannot pretend to such precision in our $3 trillion economy.

TIGHT MONEY

The deflationary effect of the budget would be reinforced by the very tight monetary policy that the Federal Reserve is now pursuing. Last year, the Fed's target for M_{1B} growth called for a maximum increase of 6.5 percent between the fourth quarter of 1980 and the fourth quarter of 1981. Despite the turbulent changes that resulted from the credit controls imposed by the White House in the early spring, the actual M_{1B} growth was less than 7 percent and down sharply from the average growth of nearly 9 percent during the previous three years. This year's maximum M_{1B} growth rate is 6 percent and next year's is unlikely to be greater than 5.5 percent.

Past experience with the relation between the money stock and GNP suggests that such a slow growth of M_{1B} is likely to be inconsistent with a 1982 nominal GNP growth in excess of 10 percent, especially if interest rates are not substantially higher. This in turn means that 1982 is likely to be a year of significantly lower inflation, slow real growth or, what is most likely, both slow growth and a decline in the rate of inflation.

Although this picture of the economy over the next two years is not nearly as favorable as the one painted by the administration, it is still the basis for considerable optimism. These two years would mark an end to the continuing growth of government spending and an actual decline in the share of the government in the national economy. A rise in personal tax rates would be averted and the very highest tax rates that cause so much distortion and waste would be permanently reduced. A major program of depreciation reform would begin to provide the incentives for a significant increase in the rate of business investment.

Finally, the declining rate of inflation that results from continuing economic slack would be good news in itself and, even more important, should begin to change the expectations that have made the increasing rate of inflation so difficult and costly to reverse. By 1983, two years of actual declines in inflation and of a consistent Federal Reserve performance of keeping money growth within the target range could provide the prerequisite for a subsequent rapid reduction in inflation without excessive slack in the economy.

If all of this comes to pass, the Administration's program will clearly have been the right one, even if not for the reasons that they assert.

[Whereupon, the hearing adjourned at 4:43 p.m.]

TAX REDUCTION PROPOSALS

MONDAY, MAY 18, 1981

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

The committee met, pursuant to notice, at 9:30 a.m., in room 2221, Dirksen Senate Office Building, Senator Symms (acting chairman) presiding.

Present: Senators Dole, Heinz, Durenberger, Grassley, Symms, Byrd, Bentsen, and Matsunaga.

Senator SYMMS. The Committee on Finance will come to order.

We will continue our hearings on the tax reform package that will be before this committee in the very near future.

Chairman Dole will be with us shortly. He has asked me to go ahead and commence the meeting and extend the welcome to all of those witnesses that are with us this morning.

Our first panel is a tax section of the American Bar Association.

We welcome you here this morning. We have Harvie Branscomb, accompanied by Margorie A. O'Connell, and then Edward N. Delaney.

So we welcome all three of you here this morning and please go right ahead. I think you are all very familiar with our committee. We do try to have our witnesses make their statement in 5 minutes and then question the panel.

You have 15 minutes total time to—so you can divide it any way you wish to do it.

STATEMENTS OF HARVIE BRANSCOMB, ESQ., ACCOMPANIED BY EDWARD N. DELANEY, ESQ., TAX SECTION, AMERICAN BAR ASSOCIATION, AND MARGARIE O'CONNELL, CHAIRMAN, DOMESTIC RELATIONS TAX PROBLEMS COMMITTEE

Mr. BRANSCOMB. Thank you, Mr. Chairman.

Mr. Delaney, on my right, is a vice-chairman of the section of taxation.

Margorie O'Connell is the chairman of our Domestic Relations Tax Problems Committee and one of the particularly well informed people on the marriage tax penalty.

My name is Harvie Branscomb, Jr. I am from Corpus Christi, Tex., and the chairman of the section of taxation.

This is an organization of 23,000 tax lawyers throughout the country and we appreciate the opportunity we have had to appear before this committee to make suggestions for the improvement and simplification of the tax laws.

The American Bar Association has authorized us on its behalf to make a number of recommendations to this committee related to the improvement of the portions of the tax laws that related to capital cost recovery and related matters.

There are several specific proposals in the depreciation and similar areas which in our opinion would simplify and clarify the tax law, which would make it serve its purposes better, and which would not have substantial revenue consequences.

One of those is a proposal which would allow accelerated depreciation for personal property in the same manner as other properties. There is a complicating distinction in the law which had its genesis prior to the adoption of certain provisions known as section 1245. These provisions eliminate, in our view, the necessity to continue those accelerated depreciation distinctions.

By the elimination of the separate treatment of used property as compared with new property, the law would be simplified without any adverse consequences to the revenue system, in our judgment.

A second proposal which we would like to bring to the attention of the committee is the proposal that the investment tax credit be allowed to offset 100 percent of tax liabilities rather than 80 percent this year, and 90 percent next year, and that the carryforward not be limited to a specific number of years.

In our judgment, the existing provisions are complicating. They do not accomplish anything of significance and our tax laws would be simplier and more workable without them.

The third proposal in this area is that we index the basis of assets for depreciation, amortization, and depletion in order to make an allowance for the effects of changes in value of the dollar.

We have a comprehensive proposal which has been submitted for the record. Our proposal would relate to assets held over 2 years on the ground that assets held 2 years or less would not embody sufficient change in price to necessitate the implementation of indexing.

We also have a proposal of a technical nature relating to depreciation and depletion between the estates and income beneficiaries trust, which is further described in the written material we are submitting for the committee.

We would ask the committee to give serious consideration to the inclusion within the internal revenue code of a provision for the amortization of intangible assets. The law in this area at the present time is confused. It provokes litigation and controversy and we would submit to the committee that it would be improved by such change.

In this area also, we have a proposal for the elimination of salvage value and the determination of depreciation. Untold hours and complexities are involved in the computation of salvage value by taxpayers. We feel we would have a better tax law, without any material adverse effect either to the revenue or otherwise if salvage value does not require a separate computation, and depreciation rates are determined in a manner so that separate salvage value need not be determined.

There are also complexities involved in the disposition of assets, where the class life assets depreciation methods are used. If charges to the reserve can be made in such cases, as suggested further in our materials, we think the committee will have been responsive to national concern which has been expressed over the extreme complexities of tax laws as they relate to both large and small business.

We also feel that the reduction in classes of depreciable property would be a simplifying and useful step.

Mr. Chairman, at this moment if I may, I would like to discuss for a moment the very serious problem of retirement plans for self-employed taxpayers.

As you know, it is a high level priority program of the entire American Bar Association and many other professional associations in this country, to eliminate this discrimination so that self-employed retirement plans may be computed and provided for on a basis comparable to retirement plans for corporate employees.

At the present time, we see the widespread proliferation of professional corporations and even professional organizations which are partnerships in which each member is itself a professional corporation. These are artificial means of organization. They are undesirable and in our judgment, a major long-term savings incentive would be achieved if self-employed were permitted to make provisions for their retirement on a basis comparable to that of corporate employees.

This would, we feel, provide a unique method of encouraging investment and the accumulation of funds for capital.

Some of the targeted savings incentive proposals tend to provide an incentive to save, but it may be difficult to determine whether such savings are merely a shift from one form of investment to another.

In the case of the type of savings which would be induced by the modification of retirement plans, it is apparent that these are savings of funds which would otherwise almost entirely go to consumption, and in our view, such an approach would have a very significant impact on the accumulation of funds for capital investment in this country.

It would also make a substantial reduction in the pressure for the use of social security benefits as a means of providing for retirement. Permission, on a nondiscriminatory basis, for professional people to provide for their retirement in a manner similar to corporate employees, would enable them to provide, not only for themselves, but their own employees, and therefore produce further savings from funds accumulated with respect to such persons. In our view this would be an important and significant step which this committee could take in the national interest.

Next, we would like to speak briefly to the committee on the matter of the marriage penalty tax.

There is widespread recognition in this country at the present time, that married couples on occasion, under some circumstances, pay a greater tax than they would pay if each member of the marriage were single.

There are even occasions arising now where couples get a divorce on December 31 and remarry on January 1. The Revenue Service has taken the position that this is a sham, in order to avoid the unjustified extra tax on married couples.

The significant thing about the proposal of the American Bar Association in this area, is that it takes a moderate approach that would not have as great a revenue impact as some of the alternative proposals, and which we feel would be simpler and easier to administer than some of the other proposals which deal with this area.

It is our proposal that the statute address only the subject of earned income, that is, a couple which has earned income would be entitled to a credit which would reduce the total tax on that income, to the tax which it would have paid on that income, had each been a single taxpayer.

The statistics available from the Treasury Department indicate that the bulk of marriage penalty tax is paid by taxpayers who do not have large amounts of investment income.

There are many complexities involving investment income in the marriage penalty tax computation.

We feel that the simpliest way, and the way which avoids unnecessary revenue loss, would be the provision of a simple credit under which there would be a reduction in the tax due by such couples, equal to the amount of the extra tax which is being paid at the present time on their earned income.

Finally, Mr. Chairman, we would like to submit to the committee the importance of action in the area of fringe benefits. We are aware that the Treasury has suggested that it may be possible to deal with this matter by regulation, but we respectfully submit that it is going to require a change in the statute to deal adequately with the fringe benefit area.

The present tax law provides that everything of value received during the course of, or in connection with, a person's employment is taxable income.

There are recognized practices in this country which have been widely used and accepted for business employees and in our opinion a reasonable approach to this subject is difficult to achieve unless Congress authorizes it.

To this end, the section of taxation has developed proposals approved by the American Bar Association, which would provide reasonable general guidelines, which we could discuss with you in further detail if you desired, under which there would be a series of general criteria enacted by Congress, which the Revenue Service could then administer, which in our opinion, would achieve several purposes.

First, the elimination of unjustified abuses in the fringe benefit area, some of which have attracted national attention.

Second, the continued authorization of reasonable practices in the course of employment which are widely recognized and accepted and which do not involve substantial amounts of money.

Third, and perhaps most important of all, the provision of guidelines under which some degree of unformity would be achieved in the administration of the law in this area.

We unfortunately have a substantial degree of divergence and practice in various parts of the country in connection with fringe benefits because of lack of a uniform set of national rules.

We do not feel that a reasonable degree of uniformity throughout the country in the treatment of fringe benefits can be achieved unless Congress provides some guidelines to apply to the administration of the law in this area for the country as a whole.

We would be happy to try to respond to any questions which you might have.

Senator SYMMS. Thank you very much. It was a very helpful statement, I am sure, and it also, of course, has great technical recommendations.

I do not know whether I missed it, but did you say you support a passage of the President's first tax proposal that he sent down here?

Mr. BRANSCOMB. The American Bar Association has not taken a formal position on whether it does or does not support the basic tax reduction provisions as this is regarded by us a policy matter that does not involve our technical expertise in the tax laws of this country.

We, however, are anxious to provide any support we can to seeing that whatever statute that is adopted by the Congress is technically as good as we can make it, and deals with some of these problems which are involved, we feel, in the basic statute.

Senator SYMMS. Well, the reason I asked that is there is a great deal of conversation of about whether or not we are going to have one tax bill or two tax bills, and are many of these recommendations you make, do you think, could be delayed until a second tax bill, rather than to delay the expeditious passage of the first. Will recommendations be on that?

Mr. BRANSCOMB. I feel again that we might be a little out of our place to try to suggest which way the Congress would proceed on that issue.

We are aware that the issue is not resolved within the Congress and we felt that we should submit some of these things at this time. If they are considered within the second bill, then of course that would be the time to do it.

We do feel, however, that some matters such as the marriage tax penalty and the fringe benefit area justify attention at a very early time. If the Congress sees fit not to include them in the first bill, we would certainly hope it would give priority consideration to those matters at an early date.

Senator SYMMS. I know that you and the ABA have taken the lead in what has been, up to now anyway, a losing battle, Tax Code simpification.

It seems like every time the Congress tampers with the Tax Code it gets more complicated, not less, and how does this present bill stack up as far the general direction? Does it simpify things or will we still be in the same complicated——

Mr. BRANSCOMB. Senator, it is my view that in general the bill tends in the direction of simplification.

It has been widely observed that many of the complexities and some of the abusive tax shelters are in fact in part motivated by the pressure of high rates and the very high tax burdens that fall on some taxpayers. Efforts in the general direction of dealing with those issues and making the tax law fairer and more equitable for everyone, it seems to me, decrease the pressure on the types of things that require very complex laws to deal with those areas.

Senator SYMMS. Let us suppose for a second that we are going to have two tax bills, but there is always the risk that if you wait till you have put your package on the second tax bill that something happens to it along the way, so if you could tell this committee, one of the technical recommendations that you are making, in tax terms, it would be the most important ones put on the first tax bill. Which one would you tell us to do, if you thought we would get one of them in, but maybe we could not get all of them in at the present time, which one would use?

Mr. BRANSCOMB. Mr. Delaney, which one would you suggest?

Mr. DELANEY. Well, I would like to suggest that on a timing basis, certainly fringe benefits because the Congress has on two occasions now extended the moratorium. The moratorium expires in June of this year and if the Congress doesn't begin to take some action in that area, you either let the moratorium expire and leave the issue entirely to Treasury, or you extend the moratorium and don't solve the fringe benefit problem.

Certainly, on a savings and raising of capital basis the provisions with respect to elimination of discrimination between self-employed and employees are very important.

Mr. BRANSCOMB. Mr. Chairman, I believe that from the standpoint of the American Bar Association, although it hasn't been officially called to answer your question, that it would concur with the suggestion that Mr. Delaney has made that the equitable treatment of a self-employed individual would be in its view the most important of all.

We would see a very substantial favorable impact by improving H.R. 10 rules on savings within this country. We do feel that you would be transferring savings from one saving to another, but, that you would be going from consumption to savings. The $7,500 limitation for retirement funds, which is now in effect, has not been modified for 6 years.

On the other hand, corporate plans can authorize as much as $41,000 and they are indexed and have provision for further increases. There is a very widespread feeling among the self-employed in this country that the Congress would be doing a great deal for the benefit of the entire economy if it sees fit to act in this area at an early date.

Senator SYMMS. Thank you very much.

There are some of our witnesses who, according to some of the written testimony that we will hear this morning, are thinking that, and there have been other members of this committee who have been concerned about it also, that some of our business tax cuts in the present bill will create an enormous tax shelter. What is your view on that?

Mr. BRANSCOMB. Mr. Chairman, I am not convinced that the individual provisions will provide tax shelters, provided adequate attention is given to the technical aspects of the language as it proceeds through Congress. The tax section of the American Bar Association has among its membership highly qualified technicians in the various specialized areas. We'll expect to provide detailed information in technical areas, if acceptable to the committee or its staff, for the purpose of attempting to avoid any unintended tax shelter development.

We recognize and have been working actively in the area of attempting to see that as the tax law goes forward, unintended tax shelters do not develop which preclude the equitable operation of the tax laws for the benefit of the entire country.

Senator SYMMS. Thank you.

Senator Byrd.

Senator BYRD. With regard to tax shelters, if the top marginal rate is 70 percent——

Mr. BRANSCOMB. Mr. Chairman, I believe it's widely recognized that the very high rates are one of the things causing the great interest in tax shelters, and that anything that reduces rates would tend to reduce the pressure to divert funds from their normal investment area into some area which is perceived as especially favored under the tax laws.

Senator BYRD. With regard to accelerated depreciation, looking at it purely from a technician's point of view, you prefer the 10-5-3 proposal now before the committee, or would you prefer the 10-7-4-2 proposal, or is there any substantial difference between the two?

Mr. BRANSCOMB. Senator Byrd, the section of taxation of the American Bar Association have felt that the policy considerations are so substantial in that issue that it was difficult for us to respond from a purely technical standpoint. But from a purely technical standpoint, we would be pleased to provide suggestions with respect to either to see that of the technical problems are minimized and that the operation of the statute is made as simple and as workable as feasible.

I realize that I haven't really answered your question, but it is a little difficult for me to answer in the capacity in which I speak.

Senator BYRD. That is satisfactory.

Thank you.

Just one other question. In your statement, you recommend a system of indexing as a basis for depreciation, amortization—as well as computing gain or loss if this position was adopted.

What do you mean by indexing basis for depreciation?

Mr. BRANSCOMB. Mr. Chairman, the American Bar Association is on record as in favor of an indexing plan, and it has a detailed proposal for the operation of indexing. It provides that assets held over 2 years will be subject to indexing. I am not personally familiar with the details of the mechanics of the indexing computation.

Are you Mr. Delaney?

We have submitted a written proposal as to precisely how indexing might be effected. We've spent a great deal of time in studying that proposal over a period several years, and we believe that if the committee is interested, if it will consider that proposal, it will find one that has been very thoroughly thought out.

Senator BYRD. Well, if the Congress were to go to the 10-5-3 depreciation schedule, would there be any need?

Mr. BRANSCOMB. Mr. Chairman, proposals such as 10-5-3 provide a certain amount of relief against the impact of inflation on assets in a short period of time.

The indexing proposals face the fact that the problem of inflation to taxpayers increases as the years go by, so that the impact of inflation in the tenth year of the ownership of a building with a 30-year life, for example, is much greater than the impact of inflation in the second, third, and fourth years. While we recognize that the

10-5-3 and similar proposals are addressed to inflation, we feel that the indexing proposals are addressed to a different facet of the inflationary pressures.

We are not suggesting that the committee should set aside its consideration of other matters, but that especially with assets which have longer lives where the difference between replacement costs and original costs has become very decisive because of the substantial passage of time there is a real inequity in the existing law.

Senator BYRD. Thank you.

Senator SYMMS. Thank you very much, Senator.

I had one other question I would like to get into is in area of fraud penalty.

I have been intending to introduce a bill which would correct what I think is inequity in the fraud penalty, and that is, say if there is a taxpayer who does have fraud exist on their tax form, that there is no additional penalty for someone who has a very large fraud, as opposed to say a small fraud.

Would you like to comment on that, and make a recommendation?

Mr. BRANSCOMB. Yes, I would like to comment.

The Section of Taxation is concerned that the fraud penalties, as they now exist, are inadequate to achieve their objective of seeing that the penalties for taxpayers who deliberately disobey the tax laws are sufficient to deter such conduct.

The Section is now studying proposals in the area of those which you are considering designed to achieve similiar purposes.

We have not developed a concrete proposal which we can present today as the official one supported by the Section, but we can say that the Section believes that this area is in need of study and attention, and I believe we will conclude that it is in need of legislation. The Section also has under consideration the question of whether it may be workable to have other types of penalties designed to address the problem of taxpayers who repeatedly take deductions for which there is very little justification, with the hope that in the audit process, they will be overlooked. We recognize there is a problem in seeing that the tax laws are complied with in practice, in addition to seeing that the statute itself is as good as can be developed.

Senator SYMMS. Thank you very much.

For the purpose of our record, our hearing record will be open for another week or two at least, maybe longer, and if you do happen to complete those recommendations, of course your entire written testimony will be part of our record, and it will be certainly—I would like you to go ahead and forward it over so we can have that on fraud penalty area, if you have completed it, if it is convenient for you to submit that to the record also.

Do you have any more questions, Senator Byrd?

Senator BYRD. No, Thank you Mr. Chairman.

Senator SYMMS. Do you want to make another comment?

Mr. BRANSCOMB. Mr. Delaney wanted to comment——

Mr. DELANEY. Senator, we looked at the problem of the assertion of the fraud penalty to the total deficiency when the fraud item is a very small part of the total return.

It has resulted in a number of cases, some corporations where it has resulted in an immense fraud penalty that arises out of a relatively small part of the deficiency that might be attributed to a fraud. That has resulted in fraud penalties not being asserted, and we have looked at that and have some recommendations as to limiting the fraud penalty to the fraud item, but possibly increasing the rate.

The same problem exists in the negligence area also which is another area that should be looked into.

Senator SYMMS. That is what it appeared to me like, that it would increase the rate of the fraud but limited to what the fraud part was, that it might be equitable, and address what the problem is. Otherwise, there are some taxpayers who may have a very small fraud, but then they pay a high penalty in comparison with the—there could be somebody who has a high fraud number and then the penalty is really relatively small.

It seems to me like it would be better if the rate were higher, but specify in the tax code.

Is that your general position?

Mr. BRANSCOMB. I think that would correctly state our general position.

We do feel, and we are on the record as feeling, that the existing penalty does not address the problem adequately in the situation to which Mr. Delaney refers.

The situation to which the Senator refers is the other side of the coin. It is of serious concern to us also, and we will attempt to have some further input to the committee in a short period.

Senator SYMMS. Thank you very much.

I appreciate you being here this morning, and I appreciate your testimony.

Mr. BRANSCOMB. Thank you.

Mr. DELANEY. Thank you.

[Statement follows:]

STATEMENT OF

HARVIE BRANSCOMB, JR., CHAIRMAN
SECTION OF TAXATION

Mr. Chairman and Members of this Honorable Committee:

I am Harvie Branscomb, Jr., of Corpus Christi, Texas, and I appear as Chairman of the Section of Taxation of the American Bar Association. We appreciate the opportunity we are given from time to time to present to the Congress the position of the American Bar Association in vital tax issues; the 23,000 tax lawyers and academicians who are members of the Section of Taxation have sponsored important contributions to improvement of the tax system over the years which have been adopted by Congress.

There are four matters of substantial importance which are relevant to the tax bill now before this Committee and on which the American Bar Association has taken formal positions. We offer them for your thoughtful consideration.

Capital Cost Recovery

The Tax Section is reviewing the current capital cost recovery proposals from a simplification and technical viewpoint, and will be submitting technical comments and suggestions to the staff to assist their efforts to draft a bill with the fewest possible complexities and ambiguities.

Several outstanding legislative recommendations of the American Bar Association should be incorporated in the capital cost recovery legislation. These are:

1. Recommendation No. 1979-5, which would allow accelerated depreciation with respect to used personal property.

2. Recommendation No. 1978-5, which would allow investment tax credits to offset 100 percent of tax liability

and would allow unused credits to be carried forward indefinitely.

3. Recommendation No. 1978-18, which would index the basis of assets for depreciation, amortization and depletion.

4. Recommendation No. 1966-12, which would allow depreciation and depletion deductions to be apportioned between an estate and its income beneficiaries in accordance with the provisions of the will, or absent such provisions, on the basis of the estate income allocable to each beneficiary.

5. Recommendation No. 1975-1, which would allow amortization of intangible assets over a period of not less than 60 months not more than 480 months under class lives established by Treasury Regulations.

Simplification

The Section of Taxation strongly supports simplification of the tax laws. We urge the Committee to attempt whenever possible to adopt simplifying rules. In the area of capital cost recovery, provisions which simplify the system include the following:

1. elimination of salvage value in the determination of depreciation;

2. accounting for disposition of assets by adjustments to the depreciation reserve rather than by computing gain or loss on each disposition;

3. elimination of distinctions between new and used property.

4. reduction in the numbers of classes of depreciable property.

Depreciation of Used Personal Property
(Recommendation No. 1979-5)

Present law denies accelerated depreciation to used personal property. This restriction was intended to prevent the conversion of ordinary income into capital gain by rapid depreciation of used assets followed by their sale at a capital gain. However, this objective is now secured by the recapture provisions of section 1245. Accordingly, there is no need to continue this restriction. Moreover, the restriction contributes to complexity because taxpayers must maintain separate depreciation accounts for new and used property.

For these reasons we urge that the distinction between new and used tangible personal property be eliminated. We note that the capital cost recovery proposals now before the Committee would accomplish this goal.

Unused Investment Credit Carryovers
(Recommendation No. 1978-5)

Certain taxpayers are unable to use investment tax credits because they have insufficient tax liability. If existing deductions for depreciation are increased, this situtation will become even more prevalent.

Present law allows the credit to offset 90 percent of tax liability beginning in 1982 (80 percent for 1981), and it allows unused credits to be carried back three years and forward seven years.

We recommend that the credit be permitted to offset one hundred percent of tax liability. The purpose of the credit is to offer incentives to business investments, and there is no reason why it should be able to offset only 90 percent of tax liability.

We recommend also that a taxpayer be permitted to carry-forward unused credits indefinitely. Proposals currently before the Congress would extend the carryover period from seven to ten years. We believe that they do not go far enough in solving the problem.

Impact of Inflation on Depreciation Allowance
(Recommendation No. 1978-18)

Current tax law generally fails to take account of the declining purchasing power of the dollar. When costs stated in earlier, more valuable dollars are matched against receipts stated in current, less valuable dollars, there is an overstatement of income in economic terms. This situation is more pronounced in the case of longer lived assets because the difference between historical dollars and current dollars becomes more pronounced.

Since the effect of this disparity is greater in the later years of an asset's life than in its earlier years, the compensating adjustments should occur in the later years. Certain special allowances, such as the ADR system, the investment tax credit, accelerated depreciation, and long-term capital gain rates have sometimes been viewed as representing at least in part a compensatory mechanism to offset the tax effects of inflation. However, except for the capital gain tax rate, these other provisions have their effect in the early years rather than the later years. Some of the capital cost recovery proposals currently before the Congress would have the same effect.

We recommend that a system of indexing basis for depreciation, amortization, and depletion, as well as in computing gain or loss on dispositions, be adopted. Because mismatching does not occur to a great extent in the early years of an asset's life, the indexing adjustment should apply only to assets held for more than 24 months.

Allocation of Depreciation Between An Estate and Its Beneficiaries

(Recommendation No. 1966-12)

Under existing sections 167(h) and 611(b)(4), depreciation and depletion deductions are "apportioned between the estate and the heirs, legatees and devisees on the basis of the income of the estate allocable to each." Under a leading case (In re Nissen's Estate, 345 F.2d 230 (4th Cir. 1965)), individuals who are income beneficiaries of residual trusts and to whom the executor has discretion to distribute income from the residue of the estate entitled to any portion of depreciation or depletion deductions because they are not considered to be "heirs, legatees, and devisees" under the local law of trusts and estates.

There is no logical basis for denying a portion of the deductions to certain income recipients solely on the basis of such distinctions under local trust and estate law. Accordingly, we recommend that the words "income beneficiaries" be substituted for "heirs, legatees, and devisees" in order to make clear that, for purposes of sections 167 and 611, all income beneficiaries of an estate will be treated the same way, whether or not they are heirs, legatees or devisees as those terms are defined under local law.

Our proposed amendment would also conform the rules for allocating the depreciation or depletion deduction for estates with the rule applicable to trusts. This result is accomplished by providing for apportionment on the basis of the pertinent provisions of the will.

Under current law, sections 167 and 611, require that depreciation and depletion deductions for estates to be allocated on the basis of income. By contrast, the provisions as to trusts, provide for apportionment in accordance with pertinent provisions of the instrument creating the trust, if any.

There is no apparent reason why different rules should be applicable to trust and estates, and the legislative history is silent as to why different rules were adopted. Accordingly, our amendment would conform the language for estates to that for trusts by adding that the deductions will be apportioned "in accordance with the pertinent provisions of the will, or, in the absence of such provisions, on the basis of the estate income allocable to each." We anticipate that regulations would allow the deduction where a reserve is required or permitted by local law as well as by will, as is done with reference to trust. This would cover the situation where there is no will or where the will does not contain any relevant provisions.

Retirement Plans for the Self-Employed

A top-priority tax program of the American Bar Association calls for elimination of the existing severe discrimination against the self-employed in the matter of qualified retirement programs. Although self-employed persons through H.R. 10 or Keogh plans must cover their employees on a non-discriminatory basis, as in the case of corporate pension plans, they have far less opportunity to provide adequately for their own retirement savings than do corporate employees. This has led to widespread formation of professional corporations, and even partnerships of one-person professional corporations, to avoid the H.R. 10 limitations, creating artificial forms of business organizations to circumvent the unreasonable and discriminatory effects of existing law on self-employed persons.

The solution we propose is to eliminate the special H.R. 10 limitations and restrictions, thus treating self-employed persons in exactly the same way as corporate employees. This would have the very salutary effect of providing a major long-term savings incentive of unique importance. It is in every respect a companion measure to the broadly-supported proposals for an expanded IRA deduction for employee contributions to qualified retirement plans, but it would be even more effective in inducing increases in long-term savings.

It is demonstrable from available economic evidence that both an increased H.R. 10 deduction and an expanded IRA deduction would induce a higher level of savings than would otherwise occur. They are preferable to other targeted savings incentives because they do not simply result in a shift of savings from one form to another; they clearly induce an increase in net over-all savings in the U.S., and on a long-term basis for retirement purposes. They serve in important ways to minimize pressures for increased Social Security benefits by providing instead for retirement benefits from private savings which are allocated to their most efficient uses in the economy.

The elimination of the H.R. 10 restrictions would be even more effective than an increased IRA deduction because in order to enjoy the increased tax benefit, self-employed persons would be required to make greater provision for virtually all of their employees. This would increase even more the current allocation of business profits to long-term saving and investment, would extend coverage of the private retirement system substantially, and, as previously stated, would reduce the need for increased Social Security benefits.

More specifically, under existing law, contributions to qualified defined-contribution retirement plans may be made for corporate employees up to $41,500 per year on a non-discriminatory basis. This limit for corporate employees is adjusted annually for cost-of-living changes. In the case of self-employed persons, however, the limit is only $7500 per year, as it has been for the last six years, with no adjustment for cost-of-living changes. Even greater disparities exist in defined benefit aggregate-funded plans, where self-employed persons suffer the most egregious discrimination. In addition, there are many other special limitations and restrictions on H.R. 10 plans which are no longer necessary after adoption of ERISA, the Employee Retirement Income Security Act of 1974.

The American Bar Association is strongly of the opinion that these differences in treatment are not justified and should be eliminated. The President's Commission on Pension Policy in its recent final report called for elimination of these differences and recognized the unique and powerful effect of such changes as a savings incentive, along with an expanded IRA deduction. Eminent economists such as Martin Feldstein of Harvard University have recently told this Committee that elimination of the special H.R. 10 limitations would be an effective incentive for increases in net long-term savings in the United States. We urge this Committee to include such provisions in the tax bill; we will provide your Staff in due course with a complete draft of statutory changes to accomplish this result.

Avoidance of Marriage Penalty Tax

The American Bar Association supports legislation designed to eliminate the so-called "marriage penalty" resulting from the additional tax which a husband and wife will incur due to their marital status in situations where each spouse generates earned income. Under the Internal Revenue Code, a higher tax rate will apply to the taxable income of married individuals if each spouse earns 20% or more of the total income, than the rate of tax which will apply to an equivalent level of taxable income realized by an unmarried individual. The amount of the so-called "marriage penalty" depends on the amount of the aggregate income of the husband and wife and the ratio of their incomes, one to the other.

In this connection, the American Bar Association has adopted its Recommendation No. 1978-6, which proposes that the Internal Revenue Code be amended to allow married individuals a credit against the tax imposed on their income equal in amount to the taxes which married individuals pay on their earned income in excess of the sum of the taxes each individual would pay on his or her earned income if unmarried. The objective of the recommendation is to provide that no married individual having earned income will pay a greater tax thereon because of marital status. The ABA recommendation is designed to provide relief without affecting the opportunity of married couples to file joint returns or increasing the tax rates applicable to unmarried individuals.

It is submitted that our recommendation has two significant advantages over other pending proposals:

(i) The ABA recommendation is geared solely to the earned income of the spouses so as to focus relief on the largest adversely affected group (that is, working couples) and to avoid problems of allocation of joint unearned income; and

(ii) The ABA recommendation would provide for a credit, which could be computed without troublesome allocation of deductions and other credits between spouses.

Other proposals in this area include the following:

(i) S.775, introduced by Senator Moynihan and H.R. 2474, introduced by Representative Shannon, which involve a credit approach similar to the ABA Recommendation.

(ii) S.171, introduced by Senator Sasser and H.R. 177, introduced by Representative Conable, which allow a deduction of some percentage of the earned income of the lesser-earning spouse.

(iii) S.2, introduced by Senator Mathias and H.R. 1700, introduced by Representative Fenwich, which give married individuals the option of filing jointly or as two unmarried individuals' rate schedule.

Specific comments on each of these approaches can be found in other materials we have prepared.

We feel that the recommendation of the ABA reflects the best approach to the problem although we support any measure designed to establish a structure under which no married individual having earned income will pay a greater tax by reason of marital status.

Amortization of Intangible Assets

(Recommendation No. 1975-1)

Under current law, intangible assets can be amortized for income tax purposes only where the assets have reasonable ascertainable useful lives. Present depreciation law has no classification for intangible assets. As a consequence, taxpayers and the Service frequently become involved in disputes as to whether a particular intangible asset has a reasonably ascertainable useful life.

Certain, specific intangible assets can be amortized under special provisions of current law. Code sections 248 and 709 allow amortization of corporate and partnership organization expenses, respectively. The deductibility of business start-up costs has been an area of increasing tension between taxpayers and the Service, and we are pleased that section 195 was enacted last year to deal with this problem.

Examples of intangibles which are often involved in audit desputes are goodwill, going-concern value, covenants not to compete which do not specify a term, secret processes and formaulae, contract rights, customer lists, and franchises with indefinite lives.

It would be appropriate for the Committee to deal with this problem in connection with its deliberations on capital cost recovery. We recommend that a taxpayer be allowed to amortize intangible assets over a class life prescribed by the Treasury Department. Under our proposal, Treasury would establish class lives of not less than 60 months nor more than 480 months.

A class life amortization system for intangible assets would remove a substantial area of audit dispute and would achieve significant simplification in the administration of the tax law.

Taxation of Fringe Benefits

The American Bar Association has developed a legislative proposal (No. 1980-1) for determining whether certain fringe benefits will be taxable income to employees. We think our proposal is superior to any of the other solutions to this vexing problem which have been recommended to the Congress, and we urge that it be given careful attention.

The appropriate tax classification of fringe benefits has received increasing interest during the last four years from both Congress and the Treasury Department. The efforts by Treasury in March of 1977 to deal with these problems by proposed regulations met with substantial Congressional resistance, evidenced by the introduction of a number of bills intended to prevent the Service from issuing regulations or rulings concerning fringe benefits. The "freeze" was formalized in Public Law No. 95-427, which initially prohibited the issuance of (i) final regulations on the subject before January 1, 1980, or (ii) proposed or final regulations which had an effective date before January 1, 1980. The freeze was extended until June 30, 1981, by Public Law No. 96-167.

The legislative proposal of the American Bar Association would establish a general rule under which a fringe benefit would be included in gross income unless it is within one of four specific exclusionary rules. In addition, the proposal would prescribe the method of valuing taxable fringe benefits.

Under the first exclusionary rule, a fringe benefit would not be includible in income if (i) it is incident to the employer's trade or business, (ii) it is provided on a non-discriminatory basis, and (iii) the marginal cost of providing the benefit is insubstantial. Under the second exclusionary rule, a fringe benefit would not be included in income if it is provided primarily for the benefit of the employer rather than the employee. Under the third exclusionary category, a fringe benefit involving recreational, social or similar activities (including facilities therefor) would not be includible in income if the expense of supplying the benefit is deductible by the employer due to Section 274(e)(5) of the Internal Revenue Code, dealing with employer-provided recreational and social programs. Finally, the value of a fringe benefit would not be includible in an employee's income if the benefit is of an insubstantial value and is not provided on a frequently recurring basis.

If a fringe benefit does not meet one of these standards for exclusion, the amount includible in gross income would equal the excess of the fair market value of the benefit over the amount paid therefor.

The legislative recommendation of the American Bar Association provides for substantuation rules which, in some cases, resemble the regulatory rules proposed by the Department of the Treasury and, in some cases, differ significantly from such rules. The most significant difference between the Treasury Department position and that recommended by the ABA is that the ABA favors statutory rules rather than a regulatory approach.

The primary difficulty with a regulatory approach lies in the fact that the tax law in its present form provides comprehensively that gross income includes "all income from whatever source derived." This broad rule of taxation indicates that the only feasible method of providing for types of fringe benefits which would not be taxed is to enact specific statutory exclusions. While certain regulations, rulings and court decisions have provided some authority for the exclusion of some fringe benefits, many benefits involved in the proposals are not the subject of any prior specific authority. Indeed, the lack of any specific statutory authority has resulted in a lack of consistent treatment of similar items by the Internal Revenue Service and by the courts on a nationwide basis.

The ABA approach to the fringe benefit problem is to establish a statement of general principles which are, in general, designed to preserve the status quo with respect to the most widely accepted fringe benefits. The standards proposed are sufficiently general to permit reasonable flexibility in actual administration.

Since an administrative approach is not authorized under existing law, we feel that statutory authority is necessary in order to permit the Revenue Service to administer the fringe benefit area on a consistent basis, and in a manner which will permit the continuation of accepted business practices, ordinarily involving insubstantial amounts of money, on a nondiscriminatory basis, and at the same time to disallow unjustified avoidance of tax liabilities by the use of improper fringe benefits.

Senator SYMMS. Our next panel, George E. Barns, David B. Bostian, and Oscar Pollock.

STATEMENTS OF GEORGE E. BARNES, DAVID B. BOSTIAN, JR., AND OSCAR S. POLLOCK

Mr. BOSTIAN. I would like to say at the outset, which I'm sure is the sentiment of most here, that the general direction of the Reagan administration initiatives is certainly to be applauded.

Second, in terms of the entire issue of tax cuts, our research leads us to believe that the inflation fears a great many of us may have had earlier are not a real problem.

We specifically believe that we are seeing a secular peak in both interest rates and inflation, for a number of reasons that range from oil prices starting to recede, to the disciplinary approach of the Federal Reserve and to an assessment of the economy, in terms of the demand for credit, which suggests that we're not going to see the tremendous explosion in demand that might have been thought earlier.

You can look through the Department of Commerce data, for example, and in nearly every sector of the economy, see real measures of economic activity that have not made new highs since 1979.

You can look at commodity indexes and see that they have been trending down for well over a year.

So, I don't think inflation is a problem one should be concerned about greatly and therefore the tax cut, whatever its nature, should be very aggressive in its size.

The across-the-board tax cut proposals of the administration certainly merit, and certainly they are an improvement over past years.

However, I think there are possibly two flaws in the historical justification for across-the-board tax cuts that should be addressed and studied very carefully.

The advocates for across-the-board tax cuts point to the Kennedy-Johnson tax cut in 1964 as the justification for the principles that are being advocated.

However, if you look back to that period, you will see that in 1962, President Kennedy instituted and was well in favor of both investment tax credits and accelerated depreciation.

Following page 4 in my statement is a graph of the real growth rate of capital investment which soared up dramatically beginning, not in 1964, but in 1962.

Specifically we believe that there was an entire set of proinvestment factors operating well before that 1964 tax cut and they came from targeted cuts not general cuts.

Productivity growth was also soaring upward beginning in the early 1960's, not in 1964, and likewise research and development expenditures as a percentage of gross national product.

Second, and this is a conceptual economic issue, but an important one, we have all read of the famous Laffer curve of economist, Arthur Laffer.

Following page 10 of my statement is that Laffer diagram of how tax rates and revenue interact in the economy.

It is my position that while there is truth in the Laffer curve, that is, if you lower tax rates the economy responds and you do generate greater overall revenue, the Laffer curve does not exist, so to speak, in a capital vacuum.

Specifically, if you have a technologically advanced and high productivity economy, the overall Laffer curve is much, much higher, and this is the variant of the Laffer curve that I refer to.

So again while there is merit in economist Laffer's position, there is one concept of that curve which he does not address.

Suffice it to say then that we strongly believe that targeted tax cuts need to augment across the board tax cuts.

My colleagues in the financial communities, specifically the Financial Analyst Federation, and the Securities Industry Association, have recommended a number of proposals to stimulate savings and investments, and certainly they have merit.

Reducing further the taxation of capital gains and reducing the unearned income tax, right now, toward 50 percent are proposals with merit.

While I favor those proposals as a better way to balance the tax bill, I still have one recommendation about which I have a strong conviction that is even more targeted.

Specifically, we have been recommending for the last year, a tax base productivity policy which in essence is R. & D. tax credits for research and development expenditures.

This is the most powerful type of targeted policy and it gets to the essence of long-term economic growth.

Senator SYMMS. Can you kind of summarize your statement? Your entire statement will be part of our records.

Mr. BOSTIAN. Yes, thank you.

If we do implement this R. & D. tax credit, and I noticed on the front page of the Wall Street Journal on April 29th, it was discussed, I think that we will see a return to long term economic growth that will approximate that seen in the 1950's and 1960's.

One last point, if you look at the graph following page 9, you will see that research and development expenditures as a percentage of GNP moved upward from 1½ percent to 3 percent between 1955 and 1965.

In that period, productivity growth, which we have all heard dismal stories about during the recent decade, soared upward from about 2 percent to almost 4 percent. That was one of the most economically healthy periods of 10 years in the history of this country and I submit that the expanding emphasis on research and development was one of the reasons for the economic health and consequently should be part of a balanced tax bill.

Senator SYMMS. Thank you very much for a very detailed and indepth thoughtful statement.

Mr. Pollock, are you ready to testify.

Mr. POLLOCK. Mr. Chairman, members of the committee, my name is Oscar S. Pollock. I am a limited partner of Ingalls & Snyder, members of New York Stock Exchange.

Thank you for the opportunity to testify.

Recently, I have written extensively on the impact of the 1978 capital gains tax reduction including its revenue effects.

The latest Treasury capital gains tax data, obtained by Senator Wallop, has a direct bearing on present tax issues. The administation's plan would lower the top tax rate from 70 percent to 50 percent over 3 years, finally removing a special penalty on saving and investment.

However, my research strongly suggests that it would be much cheaper and more effective to lower the top rate to 50 percent immediately. Let us consider what happened in the wake of the 1978 capital gains tax cut. At the lowered 1979 rates, the Treasury collected $1.8 billion more in capital gains taxes than it received at the much higher 1978 levels.

How was this record dollar increase obtained? Total realizations of capital gains were $72 billion in 1979, up 40 percent from 1978, but the greatest increases in realizations came at the highest income levels.

Taxpayers with adjusted gross incomes of the $100,000 or more, approximately doubled their realizations of capital gains in 1979 compared with 1978. Thus lowering capital gains tax rates from confiscatory levels induced a sharp upswing in investment and realizations by the upper income groups that more than financed that tax cut for all other taxpayers.

Bringing the top tax rate down from 70 percent to 50 percent could have an even more dramatic and positive impact on individual investment.

It should also work to raise rather than lower tax receipts for these reasons. This step would lower the maximum tax rate for long-term capital gains from 28 percent to 20 percent. At that level, there should be some additional acceleration in the realization of such gains, particularly of very large gains.

The maximum tax rate on short-term capital gains would fall from 70 percent to 50 percent. At that level, I would expect that there would be a very considerable increase in the realization of short-term capital gains, which are small now. This increase would add significantly to tax receipts because the effective rate on these gains would still be very high.

Funds employed in tax shelters would decline because individuals with high income would be forced to risk much more of their own capital in them.

There would be less individual interest in municipal bonds and more emphasis on taxable bonds and equities.

Individuals may borrow less money because interest expenses will become much more costly at the lower tax rates.

The cumulative positive effect of these responses on tax receipts should greatly exceed the $4.6 billion static revenue loss that has been attributed to the 70-percent to 50-percent reduction.

On the other hand, if this reduction is stretched over a 3-year period, these responses would be diluted. There would be revenue losses due to the lower rates and there would be considerable deferral of large capital gains, which would be expensive. A measure that could result in a net revenue gain, could become a net loser initially.

Most importantly, lowering the top rate to 50 percent will spur productive financial investing by individuals. Our country needs the added investment now, not 3 years from now.

This step reduces capital gains taxes for taxpayers in the highest income groups. It should be combined with a measure that lowers capital gains taxes for all taypayers, such as an increase in the exclusion for long-term capital gains.

Friends and foes alike are watching America closely. Can we take the critical steps needed to restore health and vigor to our economy? Can we regain our position of economic leadership? Ending the disastrous distinction between earned and unearned income, and lowering our high capital gains taxes can send clear signals to the world that we mean business.

Thank you again.

Senator SYMMS. Thank you very much for your statement and for the timeliness of it. You have it timed about right, it looks like.

Mr. Barnes.

Do you have a written statement, Mr. Barnes?

Mr. BARNES. Yes I have, but it only arrived a few minutes ago——

Senator SYMMS. OK. Thank you——

Mr. BARNES. As a matter fact, I didn't get word until Friday late that I was to appear today, but I'm here and ready to talk about taxes.

Senator SYMMS. Well, I appreciate it very much particulary on a short notice and your entire statement will be a part of our record.

Mr. BARNES. Gentlemen, I have filed a prepared statement, which I commend to you for your earnest consideration.

It contains a number of recommendations to strengthen and expedite President Reagan's well considered tax objectives, to curtail inflation and to turn our economy around.

It is my hope that you will share my enthusiasm in asmuch as the proposals recommended, accomplish major simplification in our tax code as well as do away with capital punishment in this country.

By capital punishment, I mean more than a monetary consideration, I mean punishment in the way of curing many, many needless complications and frustrations for taxpayers to determine their minimum tax each year with the various alternative tables and credits involved.

Capital punishment or mistreatment does not apply to corporations in this country. They are extended about the same treatment as firms in the principal European countries and Japan.

Our capital punishment is confined to individual investors who get kicked right in the teeth. Even in the case of other countries which are regarded as somewhat socialistic, they treat those who save and invest better than we are doing.

I condemn our present tax structure to a large extent for the inflationary predicament in which we find ourselves, with their rapidly replacing the foreign goods for the American goods to keep our people out of work.

The United States will continue to drift into a second classification until we reform our tax system from penalties to incentives.

Further we cannot solve a runaway inflation by continuing its deeply graduated wartime rates in peacetime. For example, under the Presidents proposal we'll have a restructure 3 years from now as high as 50 percent on from short-term sales of property and 20 percent of property held for more than 1 year.

Such punitive rates still would cause property to be withheld from marketplaces and not solve inflationary problems.

In fear of being repetitious, I refer you now to the summary on pages, beginning on the last of page 13, which gives you the information which in the way of reconditions, which I would like to have your committee consider, in order to change our tax system through a peacetime basis.

No. 1, treat investment income as earned income effective January 1, 1981, to eliminate taxpayers incrimination against.

This is the second item. Define retroactive provisions in the tax code as to what constitutes earned income and unearned income, to speed up settlements of long-time tax controversies, protects those engaged in service industries.

For example, in my own case, Uncle Sam hasn't been able to settle my taxes as far back as 1976, because they don't know how much of my income is earned or unearned, and yet 85 percent of my earnings are earned and only 15 percent unearned. They still haven't, they're waiting for, IRS is waiting for corrective legislation or court decisions and you magnify that by all the cases in this country of service industries, who don't know their tax status, for as long as, since 1977, while it's really a dilemma of your consideration.

Now the next item I have on the page 14 is two, repealed taxes on short-term gains as high as 70 percent and long-term gains of 28 percent in favor of the flat tax rate of not more than 10 percent on all capital transactions to be reported annually on a separate return without any exceptions or exemptions. This would automatically do away with establishing losses of up to $3,000 against ordinary income. The main purpose of this change is to stop inflation spiral and withholding property from marketplaces.

With capital gains taxed separately, from ordinary income, it would no longer be possible for taxpayers to offset losses from their tax sheltered investments, against capital gains, thus making it possible to do away with minimum tax table No. 4625. This would accomplish further simplification.

Three, provide an amendment to President Reagan's tax proposal for a 3-year moratorium on all capital transactions during the transition period of 3 years in the event that penalties for capital investments are not significantly reduced.

Four, to be made effective January 1, 1981, to take simple steps available for increased compliance by requiring the annual reporting by payers of interest on coupon or bearer bonds the same as on dividends, salaries and wages.

I was down here 10 years ago trying to get some action on the coupon interest and according to the Treasury, $16 billion unreported debt. It would be simplier for our firm and every firm in this country, every security firm, if we reported that all interest from coupon from both tax free and taxable bonds because now we have to have computer reruns to take us out of our mechanism in order to send it to Uncle Sam at the end of the year, and it would be a tremendous thing for the Government to accomplish and it's only because we haven't done our homework. It's so simple to do that would have the same simple procedure as we have of simply take their figures that they have, or their nominees, and sending it into IRS at the end of the year, now they're just the same as we are, they're taking it out of their computer, I mean reruns, at a cost to them, and the the banks would only be, have an increased burden would be the payers of interest, but they're going to be paid by the corporation.

So there is no reason in the world why they shouldn't report coupon interest the same as dividends, and then we recover the tremendous sum for this country.

I don't know if you realize this or not, but people feel fear and tremble if anything's reported.

I maintain that reporting is better than withholding, that is why I have always objected to withholding because reporting is a very, very effective means of collecting taxes.

Senator SYMMS. I see, you have point No. 5 and——

Mr. BARNES. No. 5 is this. Effective January 1, return to one table, one tax table. This will be accomplished by eliminating the income averaging table, the maximum and the minimum tax tables.

Now, the reason why you can eliminate the minimum tax is because the capital gains will not appear in 1040 and the taxpayers could not offset ordinary losses against the capital gains.

Under this program, capital losses would only be offset against capital gains and the 10 percent rate would more than equal the present revenues.

Senator SYMMS. Thank you very much for your testimony, all three of you and I have just a few questions. Do you have any questions Senator Grassley you would like to ask for an answer now.

Senator GRASSLEY. Yes, I do.

Under the President's proposal, which cuts marginal tax rates will affect capital gains tax so that eventually the real tax on capital gains is going to be 20 percent by 1984.

My question to any of you or all of you would be whether or not you think that capital gains tax reduction is going to require any additional legislative attention and I am specifically interested in whether or not there ought to be any change in the 60 percent exclusion.

Do any of you——

Mr. POLLOCK. Senator Grassley, as I suggested in my testimony, my recommendation is that the 70-percent rate be cut to 50 percent immediately. This would result in a cut in capital gains taxes for the highest income groups.

My feeling is that this step should be combined with an increase in the exclusion, which would provide a capital gains tax cut for all taxpayers.

Mr. BOSTIAN. As I indicated in my statement, we strongly believe that using tax reduction to spur research and development is a more economically useful way to structure the legislation. From our standpoint, we would be willing to accept the ultimate 1984 reduction to 50 percent that would come by virtue of the administration's proposals.

I am not against specific cuts, but we strongly believe that using the reduction to target research and development credits for all industry is the optimum way to benefit from the reductions for the Nation as a whole.

Senator GRASSLEY. Then, I also want to ask, generally——

Mr. BARNES. I would like to answer that.

Senator GRASSLEY. Yes.

Mr. BARNES. There are, talking about credits, 44 pages in our present 1040 tax form of which 22 are tax tables and then in addition to that there are 21 forms which taxpayers must get to take care of these credits. There are 21 forms and you can't get them from banks or post offices.

I wouldn't like to see any more credits. I would rather see a reduction in our tables. I have a table, 1867, that I can make out my tax returns from right now and come within very close approximation to my present tax. One page and there is no reason why we should be cluttering our tax laws with more credits. We already have 21 credits for which there are no forms available through banks and post offices.

I have had people wait for 2 or 3 months to get them from the IRS. The taxpayers in this country are not going to stand for all these inconveniences and frustrations of having such a complicated return.

Senator GRASSLEY. I missed some of your testimonies so forgive me if you have already spoken to this point. Each one of you have argued for targeted tax increases to stimulate savings and investment. Does this mean that basically you're rejecting the across-the-board tax cuts in rates for personal income taxes?

Mr. BOSTIAN. I am not rejecting it in my testimony. I argue for a balanced tax bill and while there are many definitions of balance, I would argue for a lower percentage across-the-board tax cut with the remainder of the tax cut being targeted.

One final point relative to the most recent commentary of Mr. Barnes. I can agree to cutting out a lot of individual income tax credits. The credit I am arguing for is based on our assumption that innovation is the motive force of long-term economic growth and I don't think my arguing for this and his statements are really inconsistent.

Mr. POLLOCK. Senator Grassley, from my viewpoint it looks like we have two very serious problems that we have to deal with.

One is that due to bracket creep and inflation the middle income groups, today, are paying tax rates that were intended for the upper income groups. That is problem No. 1.

Problem No. 2 is we have a very serious tax bias against saving and inflation. In lowering the top rate from 70 to 50 percent, I am not recommending any specific incentive to save. I am recommending the removal of a special tax penalty on saving and investment.

Now, I feel that the President's program really helps in solving the first problem. It eliminates the impact of a decade of bracket creep and inflation, but I believe that that program should be supplemented by specific incentives to save such as the widening of the capital gains exclusion which was successful after 1978 and of course, by eliminating the one major tax penalty on saving and investment.

Senator GRASSLEY. Some of our colleagues are arguing for it to be tilted and targeted more toward savings and investment than the

10 percent across-the-board reduction in rates. I consider the personal tax reductions to be a very integral part of the President's program.

I don't, of course, reject savings incentives. I think they will increase savings and I feel that when they talk about targeting the tax reductions it is almost like it is a denial of the fact that we should have targeted the tax increases of the last several years. They have been very targeted toward the working men and women of America and I think we are going to have to target our tax decreases to benefit them, particularly if we are going to have tax savings with accelerated depreciation for the corporations of America and particularly if we reduce the operate unearned income from 70 down to 50. That is targeted and I think legitimately so.

But, I think in order to be fair we are going to have the savings in taxes for the working men and women of America. That is going to encourage savings as well.

One of you suggested that the economic situation isn't, today, such as it was in the 1960's when President Kennedy's tax decrease went into effect and I will have to admit that we have 12 percent inflation instead of 1.5 or 2 percent inflation. But, it seems to me that if marginal tax rates are the reason people are choosing leisure over productivity then cutting those marginal tax rates would have the same impact this year, maybe even more so, than they did in 1963 or 1964.

Mr. Chairman, I am done.

Senator SYMMS. Thank you very much, Senator Grassley. Mr. Pollock, I have a question I want to ask you? Did you want to comment on that Mr. Barnes?

Mr. BARNES. I want to mention just one thing. I just think it would be wrong for us to wait 3 years to get down to a 50-percent basis because in the meantime you are going to have a continuation in the growth of tax shelters.

You have no idea what this tax shelter business is doing to the country and doing to the Government revenues.

For example, I had a secretary who I employed quite recently and one of the first things she came to me about was that her husband has a business and she said, "My husband wants me to buy some tax shelters." When a grandfather or a father gives his children securities, he is seeking a tax shelter.

Right now we have conferences going on all over this country, right today, on tax shelters. I attended a session, just out of curiosity, where they had 200 people there for cocktails and lunch on tax shelters. Now, that is wrong. We certainly don't want to kill the goose that laid the golden egg and I just think we make a serious mistake if we don't reduce that rate from 70 to 50 percent right now in order to curtail the growth of tax shelters.

Senator SYMMS. Well, I thank you very much. Mr. Pollock, you say on page 2 of your testimony that if this reduction is stretched over a 3-year period, these responses would be diluted and there would be revenue losses due to lower rates and there would be considerable deferral of large capital gains which could be expensive.

A measure that could result in a net revenue gain could become a net revenue loser. So I guess if you had one recommendation to make to this committee to put into the President's tax package it would be to lower the 70 percent rate to 50 immediately. Is that correct?

Mr. POLLOCK. Yes. I have done a lot of work on the 1978 capital gains tax cut and that establishes certain important precedents for some of the measures that you are considering.

I am convinced that if you lower the top rate immediately, it will work to raise revenues. The $4.6 billion cost associated with that measure will be overcome due to five factors that I have listed.

If you stretch out the reduction from 70 to 50 percent over a 3-year period, it is going to lose revenues. A very significant amount of long-term capital gains are very large long-term capital gains. About 20 percent of the long-term capital gains that are realized come from taxpayers with adjusted gross income classes of over $500,000, with a significant number over $1 million.

If these people are looking at a lower capital gains tax rate 3 years down the road, those types of transactions will be deferred and that will result in a significant loss of revenues because those gains are taxed at very high rates.

I feel that is a very important point.

Senator SYMMS. I think that is a very excellent point.

I wanted to ask another question. If we—I think that Senator Grassley asked you, Mr. Bostian, about marginal rate reductions.

If we tend to generally agree that marginal rate reduction will allow people to make those decisions, why is it that nobody is coming in here to testify?

In other words, have people make the decisions where they are going to invest their money rather than having targeted savings incentives, etc.

Why is it that no one comes in here to talk of lowering the corporate tax rate? It would leave more money instantly in—without having the Government trying to plan whether it is going to be 10-5-3 or 15-7-10 or whatever. Why don't we just talk about the reality?

In my personal opinion, the only reason you have a tax is to raise the revenue that is necessary to run legitimate purposes of Government. It ought to be equitably distributed to the public.

So, the weakness, in my opinion, on the President's tax bill is that the 10-10-10 for 3 years ought to be for 6 years in a row or maybe 10 years in a row to get the rates down so that we can finally come onto a day where we have one rate for everybody in this country and have a tax form like 1967 that anybody can fill out and they figure they have to raise $500 billion or $600 billion or whatever and they haven't figured out what the rate is this year.

You have to pay 10 percent to make the budget in Washington be equal and then if people come in and want more handouts from Government, we say well, OK, we are going to raise your rates next year to pay for it. That sounds simple, but it sure is a lot better than the system we have today.

Would you want to comment on that?

Mr. BOSTIAN. Yes, several quick points. I certainly am in favor of a reduction in marginal rates and nothing in my statement says that that is bad.

In terms of the corporate tax reduction issue, I think a great many people either believe that corporate profitability is not suffering and, for better or worse that cutting corporate tax rates might not garner a great deal of support.

I am not saying that that is rational, but I am saying it is a view which may be correct.

Senator SYMMS. Well, how about doing away with taxation of dividends so you don't tax it twice?

Mr. BOSTIAN. Well, I, about 4 or 5 years ago, did recommend that. I think it makes sense. However, there is one point that I wanted to make here, given what is being discussed at the current hearing, as opposed to generally cutting corporate tax rates. I think if you make an assumption about the sources of long-term economic growth certainly lower taxes and more incentives are part of that long-term economic growth.

If however, you look further and see that major technological innovations like the computer and various technologies connected with aerospace have been an integral motive force behind economic growth, you say to the corporation that you will have some type of tax advantage if you spur research and development. Then you are going to do something ultimately that is to the benefit of the company and the country.

There is one further point that I will make. There are many research and development types, both independent and associated with corporations, that continually complain about the short-term profit motive to report quarterly that corporations have. Therefore, they are not willing to fund basic R. & D. that may ultimately be in their own best interests or in the best interests of the country.

That is why I prefer tax reductions to spur technological innovation as opposed to just a generalized corporate tax cut.

Senator SYMMS. Thank you very much. Yes, sir?

Mr. BARNES. I think I answered your question about the corporation taxes because they compare very favorably with other leading industrial nations. Where we have real capital punishment is on the individual investor.

I am not concerned——

Senator SYMMS. In other words, you are concerned about the payment on the dividends.

Mr. BARNES. I beg your pardon.

Senator SYMMS. You want to see that lowered from 70 to 50 percent on unearned income or investment income, as I like to call it.

Mr. BARNES. No. I can give you in a minute and I have given this information before here in the way of a program for solving double taxation and you can't do that overnight.

But, what you could do is take your dividends for 1982 and report them at 90 percent. In 1983 you could report them at 80 percent and get down to a reasonable basis so we could eliminate part of the double taxation. But, you can't do that overnight.

Senator SYMMS. Well, I agree with you. You can't do it overnight. We have a budget problem.

Mr. **Barnes**. It can't be done. Another thing I would like to mention is that when you make a tax cut, people are going to take advantage of that tax cut and they are going to defer income and accelerate expenses. They can change inventories.

There are a lot of things they can do and that is the reason why I am so strong for making any tax cut in this country retroactive. That is why I put it in my statement that this is very, very important and I think that is a very important point.

Otherwise, the taxpayers are going to take advantage of it and you can't blame them. They are going to do whatever they can do to minimize their taxes. So, let's not leave the thing open for people to chisel on their taxes in the next 2 or 3 years.

I would get down to 50 percent and make it effective January 1, 1981, so that people cannot take advantage of reducing their taxes by changing their deferring income, etc.

Senator **Symms**. I think that is a very excellent point and I think, generally speaking, I would certainly agree with that. I would just say that whether the—curve or the Bostian curve is accurate, this is one Senator that is in favor of reducing rates anyway no matter how it works out because the less money they have down here in Washington, the less opportunity people are going to have to dream up schemes about how to spend somebody elses money to buy somebody elses vote.

I think that we will be better off in the long-run if we can start a long-term track of reducing rates and I think it should, in general, create a strong business climate and a sense of optimism and we can get this country moving.

Thank you all very much. We are now ready for the next panel.

[Statements follow:]

STATEMENT BY GEORGE E. BARNES, SENIOR PARTNER
WAYNE HUMMER & CO.

TO: THE HONORABLE ROBERT J. DOLE
CHAIRMAN OF THE COMMITTEE ON FINANCE
UNITED STATES SENATE

This opportunity is appreciated to support President Reagan and the Congress in their efforts to make comprehensive changes in our tax system to direct this country back to economic health by solving longstanding problems with increased reliance on the private sector. I speak for 16 Partners of our 50 year-old Stock Exchange firm which deals with both large and small investors throughout the country. As a public service, I started 63 years ago to help prepare income tax returns before there were regional offices of the Internal Revenue Service. This experience is mentioned because it has made me familiar with the willingness of our people to pay steeply graduated taxes during two world wars and their reluctance and resistance to paying such taxes, seeking tax shelters during peace times. I shall always remain grateful to the late Senator Everett Dirksen for giving me the opportunity to express my tax views before Congressional Committees with some degree of success. In later years, I have Senator Charles Percy and Harry F. Byrd, Jr., as well as other members of Congress from both sides of the aisle, to thank for encouraging me in continuing my tax studies. As you well know, our most serious economic problem is to lick the inflationary spiral which is destroying the purchasing power of our dollar, as well as causing unemployment with the abundance of foreign goods on our shelves and in our showrooms. For this condition, we have no one to blame but ourselves, inasmuch as we have been fueling the fires of inflation, and pricing ourselves out of business by carrying over a steeply graduated tax structure into peace times. If this were not true, we would not have resorted to price and wage controls during two world wars.

Our primary purpose in testifying here today is to emphasize the importance of President Reagan's well considered changes in our tax structure; but let's not wait three years to implement them. It would delay the recovery of a sick economy. It is our considered view that we should start, effective January 1, 1981, to end capital punishment and provide incentives for our people to work. Under the present tax system, this cannot be done as it deprives some taxpayers of as much as 70% of a portion of their top income and 50% from salaries and wages.

Moreover, such war-time steeply graduated rates are not income productive to the Government. Everybody loses, even Uncle Sam. In continuing them, we are actually contributing to the underworld economy.

In a time of peace, when we continue to have war time tax rates ranging up to 70% of "unearned" income, do we think that investors will abandon tax shelters to risk their investment capital for only 30% of investment income?

I grant that tax relief for the lower and middle income bracket people is highly desirable. But by the same practical token, there must be meaningful tax reform for those in all brackets. Otherwise, there just isn't sufficient investment capital for the new capital formation so imperative for our economic recovery.

Isn't it time for us to face up to the need for realism and change tax policy and tax laws? How else are we to make investment capital available for capital formation and employment of people which is so essential for lasting economic recovery?

There are other compelling reasons for not delaying action now - not three years from now. I wish that every member of Congress fully realized that our dual rate system, with its higher tax rates on investment income, is causing a real dilemma for those of us engaged in service industries, as well as the IRS. For example, as a partner of primarily a commission firm, (meaning income from service fees, and not from investments, underwriting, or security positions), the IRS has not been able to determine my federal income tax liabilities as far back as the year 1977. In all fairness, the IRS is not wholly at fault. The fault is that we are obliged to wait for either corrective legislation, or long-overdue court decisions to determine what portion of income is "earned" versus "unearned", for which there is no clear definition.

Multiply our case by the other partnership firms in the securities industry and all other service industries in the United States engaged in insurance, accounting, real estate management, repairs and so forth, and you would get some idea of the magnitude of the problem that now exists for individual taxpayers not knowing their tax status. A further example is the case of the executor of an estate of a deceased taxpayer, who is unable to file a final estate tax return until final income tax liabilities are determined. I am familiar with a taxpayer in the building management business, who received about 80% of his income from fees. The IRS is claiming that 100% of his income is unearned, subject to higher tax rates because there is capital invested in some real estate holdings.

Gentlemen, I did not come here to plead my case. I am here to plead that you end double standards in taxation, to save the government untold and unnecessary litigation costs and delays in the collection of taxes from those engaged in service industries across the land, to say nothing about the uncertainty, needless loss of time, and inconvenience to thousands of taxpayers.

As a means of solving this tax dilemma, I submitted a simple formula to the IRS to determine "earned income", but the regulations do not permit its acceptance. You will find the formula set forth below for your consideration. It is my hope that you will consider it as priority legislation, to clarify the issue for all taxpayers engaged in service industries for past years as well. There is no need to extend such legislation beyond the time that a dual rate structure is terminated, which I trust will be January 1, 1981. The formula follows:

> In a trade or business, the ratio of "earned income" of individual owners and partners from the business to the total "gross income", from all sources, shall be considered to be the earned income.

You will find it is simple as well as equitable for all taxpayers.

Fully ending "Capital Punishment" from January 1, 1981, and not three years from now would also accomplish major simplification in our tax laws in the interim. For example, many taxpayers are now obliged to go to the trouble of determining their minimum tax liability each year on four separate tables, namely Schedule G1040 for "Income Averaging"; TC1040, the regular table; Form 4726, "Maximum Table on Personal Service Income"; and "Minimum Tax" table number 4625. The "Income Averaging" table was introduced a few years ago to minimize taxes for those with wide income variances from year to year. Inasmuch as the Income Averaging Table goes beserk in not functioning in some of the higher income brackets, consideration should be given to its revision or termination. As an example, a client of ours sold his business last year, producing $867,704 in taxable income as compared with normal unearned income of approximately $250,000 for the previous three years. Believe it or not, there was no benefit to him whatsoever in averaging. Many taxpayers must be losing out because they are unfamiliar with income averaging. This compares with a reduction of 18% in taxes for a taxpayer with one-tenth (1/10) the income for the same five year period. (See accompanying Schedule G Tables).

As stated, taxing income of "earned" income and "unearned" income at the same rates would obviate such inequities, as well as accomplish major simplification by reducing the number of frustrating and lengthy tax tables. Just for curiosity, I have computed taxes on occasion over the years at current rates on the one page 1867 U. S. Income Tax form, and found no important variances to speak of in the tax liability there and under the current Form 1040. I would say that this leaves plenty of room for simplification for Congress to consider in the the days ahead. (Exhibit of 1867 return attached).

Your attention is called to the fact that present 1040 Federal Income Tax forms mailed to taxpayers consist of 44 pages, of which 22 are tax tables. There are 21 additional one page forms which are not included in the 44 pages, unavailable through post offices and banks. For these mostly tax credit forms, taxpayers are obliged to secure these from the regional offices of the IRS in order to complete their returns. It is not infrequent that there are mail delays in receiving them in time, thus requiring unnecessary requests for filing extensions.

It will be of interest that I visited a large regional IRS office early in April to secure information and tax credit forms on wind-fall oil programs. I was advised there was no knowledgeable staff member available to help me inasmuch as he was in Houston going to school. Another friend of mine received a letter of apology early in April from a large oil company to the effect that it was impossible to furnish holders of their oil programs with the necessary wind-fall tax credit information in time for filing due to its many complications. These incidents are mentioned to point out to you the need for tax simplification.

In testifying before the Congressional Committees previously, I have always endeavored to suggest ways of simplifying the preparation and filing of income tax returns as well as <u>providing better</u> compliances. Since my testimony a year ago before the Ways & Means Committee, I have been in touch with the Staff of the Treasury Department to this end, as well as suggesting ways of providing better enforcement of our tax laws for bearer bond interest where there is an unreported income gap of $16 billion annually. It is fortunate that, in our computer age, reporting of interest received can be accomplished the same as dividend income, with no burdens to speak of to the securities industry. On the contrary, such annual reporting would reduce cost burdens to our firm, since it now requires computer reruns to eliminate coupon interest income. The same should be true in the case of bank nominees. (See article attached, The Unreported $16 Billion in Investment Income).

In reforming capital gains tax structures, we would appreciate your earnest consideration of a tax return separate and apart from Form 1040, for the reporting of annual capital transactions, thereby removing them from any "income" category. If such gains represented income, capital losses would be fully deductable from ordinary income, and capital gains would be distributable as income to beneficiaries under estates and trusts. This change would greatly simplify income tax returns and eliminate the taking of any capital losses from ordinary income, to thus strengthen government revenues.

Present capital gains tax laws and rates constitute unreasonable restraints on trade and commerce - capital transactions. Therefore, drastic changes are needed to stimulate economic recovery. The holding term and distinction between short and long-term capital gains ought to be abolished and the tax rate reduced to a flat rate of not more than 10%. Such changes would bring many thousands of properties throughout the U. S., both real estate and personal property, into the market places, from which they are being withheld to avoid existing prohibitive capital gains tax rates.

As a result, government revenues would increase, just as a volume business at lower prices increases profits, along with the pickup in substantial revenues from taxpayers who would no longer be allowed to deduct up to $3,000 in losses each year from their other income. Under the present system, there are only incentives for taxpayers to take tax losses instead of gains. Moreover, the present overly-graduated tax rates are greatly contributing to inflationary values because the capital gains are usually added to sales prices.

Further, there may not be a clear understanding of the important purposes and value of short-term transactions in securities. As a former chairman of the Midwest Stock Exchange in Chicago, and a charter member and vice-president of the board of our national industry organization, the old Association of Stock Exchange Firms, now called the Securities Industry Association, I believe I have the qualifications and authority to cite these purposes.

Briefly, without short-term trading, there would be no liquidity in the stock or bond markets. The specialist and his associates on the floor of the Stock Exchange, and the investors whose transactions may or may not be short-term, depending upon individual judgments as time passes, are the backbone of liquidity on our Exchanges. Without them, there would be no market, no liquidity, and our corporations would be unable to raise capital efficiently through public offerings of their securities, as can be done with the assistance of short-term trading machinery.

In the area of capital transactions, proliferation of dubious tax shelters would be perceptibly slowed down. Also, there would be much reduced selling to establish tax losses, which presently reduces the government revenues. We would find that it would bring more stability and liquidity in our market places, not just for securities but for all classes of property. Further, it would narrow price fluctuations --- what the trade calls spreads between "bid" - "asked" prices. It is an affront to our economic sanity to think that we can solve inflation and speed our recovery with the continuance of a faulty tax policy that seriously interferes with freedom to exchange properties and contains disincentives for us to keep on investing, working and producing.

Our nation needs a strong body such as the Senate Finance Committee to come forward with a bold effort to stop the mistreatment and punishment of capital, and thus break the inflation spiral and cure a sick economy. Under the President's proposal, at the end of three years, short-term and long-term capital transactions would still be taxed, in a highly discriminatory way, as much as 50% and 20% respectively. This is simply too high a tax penalty and price to pay to attract new capital, even if our economy was well, and to meet world trade competition. It is especially too small an adjustment in tax penalties to attract private owners of business and property owners to enter the market either in cash or on an installment credit basis. Isn't it of further concern to you, the extent to which large combines are taking over smaller firms and creating one new monopoly after another because there is no other easy way out? Other leading industrial nations have recognized this fact of economic life long ago. It would be far better if your august body recommended to the President a three-year moratorium on the taxation of capital transactions and start building incentives into our economy right now.

It is my hope that I have conveyed to your Committee, the complications, frustrations and inequities of our steeply graduated tax system, which works in reverse in times of peace. Perhaps the worst crime that we have committed by carrying over a steeply graduated rate structure in peace times is to have priced ourselves out of international markets, in allowing foreign goods to become so commonplace on our shelves and in our showrooms, as well as keeping our people out of work.

A summation of my statement to curtail the inflation spiral and reform our tax system to a peace-time basis follows:

1. Treat "investment income" the same as "earned income" effective January 1, 1981, to eliminate taxpayer discrimination against such income.

   Define retroactive provisions in the tax code as to what constitutes "earned income" and "unearned income" to speed up settlements of long-time tax controversies for taxpayers engaged in service industries.

2. Repeal taxes on short-term gains as high as 70% and long-term gains of 28% in favor of a flat tax rate of not more than 10% on all capital transactions, to be reported annually in a separate return without any exceptions or exemptions. This would automatically do away with establishing losses up to $3,000 against ordinary income. However, the main purpose of this change is to stop the inflationary spiral in withholding property from the market places.

   With capital gains taxed separately from ordinary income, it will no longer be possible for taxpayers to offset losses from their tax sheltered investments against capital gains, thus making it possible to do away with Minimum Tax Table number 4625. This will accomplish further simplification as well.

3. Provide an amendment to President Reagan's tax proposal for a three-year tax moratorium on all capital transactions during the transition period of three years in the event that penalties for capital investments are not significantly reduced.

4. To be made effective January 1, 1981, take simple steps available for increased compliance by requiring the annual reporting by Payers of interest on coupon or bearer bonds the same as on dividends, salaries and wages.

5. Effective January 1, 1981, return to one tax table. This will be accomplished by eliminating the Income Averaging, Maximum and Minimum Tax Tables.

It is my hope that you will continue to call on me whenever you feel I can be helpful.

Respectfully submitted,

George E. Barnes
Senior Partner
WAYNE HUMMER & CO.
175 W. Jackson Blvd.
Chicago, IL 60604

May 18, 1981

Average Executive Reading Time: 6 min.

The Unreported $16 Billion In Investment Income

Our wartime double taxation structure restricts capital investment, but at the same time the government is losing legitimate tax revenues on investment income because of inadequate reporting procedures.

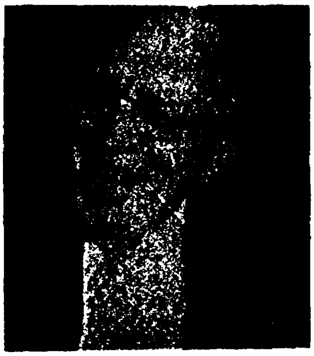
by George E. Barnes
senior partner
Wayne, Hummer & Co.

BASED ON the thesis that improved tax compliance is the best way to reduce the tax burden on investment income for everyone, I have devised a very simple plan for the Treasury to collect billions of dollars in taxes due, but not paid, on some $16 billion in annual income from investments owned by individuals.

It sometimes seems to taxpayers that the Internal Revenue Service must have eyes in the back of its collective head to implement the zeal with which it uncovers sources of taxable revenues. But the truth of the matter is there are large segments of unreported income throughout the economy—bearer interest coupons are a good example—on which no federal income taxes are paid.

IRS Study

This has concerned the IRS to such an extent that it recently published an elaborate study calculated to show the estimated extent of the shortfall in various areas of the economy.



Although, no doubt, the IRS is working hard in an effort to track down unreported sources of income on which federal taxes should be paid, it would need a small army of additional field personnel even to begin to make a dent in reducing the amount of unreported income of the self-employed or stemming from lottery winnings or pensions and annuities.

While it is true that because of withholding, 97% to 98% of wages and salaries were properly reported on 1976 tax returns, the year on which the study was based, there are many other areas which fail to show anything close to full compliance.

For example, the IRS study calculates that only 60% to 65% of rents and royalties are reported on tax returns, while the self-employed reveal only 60% to 64% of capital gains. Just 70% to 75% of alimony, lottery winnings, prizes and awards were reported. The study rounded out the breakdown by calculating that 84% to 88% of income from pensions, annuities, estates and trusts was duly recorded. For dividends the figures were 84% to 92%, which does represent good compliance, no doubt because of stockholder reporting requirements on the part of corporations. Taxpayers seem to fear and tremble about accounting for any income that is reported to the IRS. Therefore, there is no better device for tax compliance than reporting.

Increased Bartering

Moreover, the IRS has been monitoring very closely the rise in popularity of bartering in recent years. There are now in existence hundreds of barter clubs which enable individuals to exchange legal services for a new roof or a dental plate, or for two weeks in a Florida condominium in the wintertime. There are some estimates that place the total value of bartering at several billion dollars annually.

While the job of the IRS may be difficult in materially reducing the gap in nonreported income from some income of the underground economy, the self-employed, gambling winnings and others, there is a way of catching up with many offenders sooner or later by taking some simple compliance steps.

These steps were submitted by me in behalf of my firm recently for study in special hearings called by the Committee on Ways and Means at the request of President Carter to consider a formerly discredited withholding tax on interest and dividends to increase

Treasury revenues and as an anti-inflation tax measure. This request of the President is based primarily on collection of the nonreported income taxes claimed by the Treasury on investment income.

Overwithholding Problem

In my testimony, I emphasized again and again that any withholding plan, no matter how low the rate, results in overwithholding and there could be as many investors filing for refunds as paying taxes. This is because a large number of low and medium income recipients of dividends and interest otherwise would not have to file a return at all, except to claim a refund. It would be a hardship for such persons to be deprived of the use of the 15% withheld during the year. For example, an elderly couple with income from social security plus $8,600 from interest and dividends would pay an income tax of $137 at 1979 rates but would have to wait a long time for a refund of the $1,290 withholding tax of which they had been deprived during the preceding year.

The problems of withholding on interest and dividends seem insurmountable, with dependence on business to collect taxes together with the duplication of effort and deprivations of income.

For example, it would be a nightmare to think what would be involved by the insolvency of a collecting agent or an abuse of the tax funds. If banks and savings and loans were permitted to withhold and only remit annually, there would be an apparent loss to the depositor of interest rightfully belonging to the recipient. Another problem area would be dividends containing a portion which is a *return of capital*, not ascertainable until after the close of the year.

As a reminder, I stated that at one time it was impossible to redeem or cash in bearer coupons and bonds without an accompanying Ownership Information Certificate. It was required that these certificates be filed with the paying agent who in turn reported to the Federal Reserve Bank. We presented and thoroughly discussed with the House Ways and Means Committee and, subsequently, with Donald Lubick, assistant secretary in charge of national tax policy at the Treasury Department, and his staff a similar reporting plan for reinstatement on Form 1087 for all coupon and bond redemptions. It should be realized that nonreporting of income from coupon corporate and government bonds, on which there are and will continue to be hundreds of billions of dollars outstanding in bearer form for many years, amounts to a big shortfall of revenue collecting.

No Big Change

Such simple reporting by paying agents is no different from what all corporations are now required to furnish shareholders, with copies to the IRS, on dividend reporting. If the IRS taxpayer's computer record did not jibe with his income tax return, there would be enormous tax recoveries for Uncle Sam.

It is not general knowledge that corporate paying agents of interest coupons now receive on coupon envelopes full information to report annually to the IRS and the recipient; but they are not required to do so. Therefore, it would be only a simple matter for paying agents to file annual reports of this coupon interest on Form 1087, the same as dividends. Coupon bonds held by broker and bank nominees carry the full information of ownership of coupon redemptions but make no annual reporting of any kind. In fact, bank and broker nominees would find it less burdensome to report such bearer coupon interest since it now requires computer reruns to exclude this annual reporting to the IRS.

The only additional chore resulting from this bearer interest system would be on the paying agents. Since banks acting as paying agents are compensated for their efforts, they should welcome the opportunity to increase their revenues from the additional reporting service for corporations, states, cities, and income recipients.

For compliance in other important areas, the IRS could share this reporting on coupon and bond redemptions with the individual states (like Illinois, with an income tax) as well as serve as a tangible verification of both federal and state inheritance returns later. This is the area where the IRS would eventually catch up with the cheaters, to whom I referred earlier, for back income taxes as well.

In concluding, I would be remiss if I did not point out *that our steep-graduated-double taxation structure, a carryover from two world wars, encourages capital to hide and seek shelters.* Most certainly, we cannot expect savings and investments to come out of hiding, for example, by continuing the present maximum tax rate of 46% on corporate income or 54% after taxes, and 70% on individuals, leaving a tax take of 83.8% for Uncle Sam and only a miniscule 16.2% (70% x 54%), exclusive of any state and local income taxes, for those who supply the risk capital. With the continuance of disincentives like this, we can only expect more foreign-made goods on our shelves, more foreign cars on our highways and more of our own people out of work and on welfare.

Unrealistic Wartime Rates

It is indeed ironical that we gave both West Germany and Japan after World War II, as well as West Germany after World War I, monies and know-how for reconstruction and modernization of their plants and equipment for the benefit of their shareholders and at the same time overlooked the best interests of stockholders at home. Moreover, it is political and simply not productive of government revenues to try to keep wartime excess profits tax rates in times of peace.

Fortunately, there are leaders in Washington with whom we have been working closely these past few months, both Democratic and Republican, who are now recognizing what is needed, and there are more legislators on the way to remove the tax discrimination against those who save and invest. The United States is at the bottom of the ladder in its savings with which to supply capital to industry, as compared to other nations (U.S. 4.5%, Germany 14.6%, Japan 20.1%), and will remain so until our war tax structure is repealed. □

Reprinted from December 1980 issue of

COMMERCE

CHICAGOLAND VOICE OF BUSINESS AND INDUSTRY

(Taxpayer "A" based on present ceiling rate of 70% does not receive any benefits or tax savings whatsoever from "Income Averaging")

EXAMPLE 1

SCHEDULE G
(Form 1040)
Department of the Treasury
Internal Revenue Service

Income Averaging

▶See instructions on back.
▶ Attach to Form 1040.

1980
21

Name(s) as shown on Form 1040
TAXPAYER "A"

(An actual case of a 1980 taxpayer who sold his private business)

Your social security number

Base Period Income and Adjustments	(a) 1st preceding base period year 1979	(b) 2d preceding base period year 1978	(c) 3rd preceding base period year 1977	(d) 4th preceding base period year 1976
1 Enter amount from: Form 1040 (1977, 1978, and 1979)—line 34 Form 1040A (1977 and 1978)—line 10 Form 1040A (1979)—line 11	250,088	250,583	248,749	
2 a Multiply $750 by your total number of exemptions in 1977 and 1978		750	750	
b Multiply $1,000 by your total number of exemptions in 1979	1,000			
3 Taxable income (subtract line 2a or 2b from line 1). If less than zero, enter zero . . .	249,088	249,833	247,999	149,980
4 Income earned outside of the United States or within U.S. possessions and excluded under sections 911 and 931				
5 On your 1980 Form 1040, if you checked box 2 or 5 enter $3,200 / 1 or 4 enter $2,200 / 3 enter $1,600 . . in column (d)				1,600
6 Base period income (add lines 3, 4 and 5) .	249,088	249,833	247,999	148,380

Computation of Averageable Income

7 Taxable income for 1980 from Schedule TC (Form 1040), Part I, line 3 . . .	7	867,704	
8 Certain amounts received by owner-employees subject to a penalty under section 72(m)(5)	8		
9 Subtract line 8 from line 7	9	867,704	
10 Excess community income	10		
11 Adjusted taxable income (subtract line 10 from line 9). If less than zero, enter zero	11		867,704
12 Add columns (a) through (d), line 6, and enter here	12	895,300	
13 Enter 30% of line 12	13		268,590
14 Averageable income (subtract line 13 from line 11)	14		599,114

If line 14 is $3,000 or less, do not complete the rest of this form. You do not qualify for income averaging.

G

Computation of Tax

15 Amount from line 13	15		268,590
16 20% of line 14	16		119,823
17 Total (add lines 15 and 16)	17		388,413
18 Excess community income from line 10	18		
19 Total (add lines 17 and 18)	19		388,413
20 Tax on amount on line 19 (see caution below)	20		251,776
21 Tax on amount on line 17 (see caution below)	21	251,776	
22 Tax on amount on line 15 (see caution below)	22	167,900	
23 Subtract line 22 from line 21	23	83,876	
24 Multiply the amount on line 23 by 4 . . . . Note: *If no entry was made on line 8 above, skip lines 25 through 27 and go to line 28.*	24		335,504
25 Tax on amount on line 7 (see caution below)	25		
26 Tax on amount on line 9 (see caution below)	26		
27 Subtract line 26 from line 25	27		
28 Tax (add lines 20, 24, and 27). Enter here and on Schedule TC (Form 1040), Part I, line 4 and check Schedule G box	28		587,280

Caution: Use Tax Rate Schedule X, Y or Z from the Form 1040 instructions to figure your tax on lines 20, 21, 22, 25 and 26. Do not use the tax tables.

(No relief from income averaging - tax exactly the same)

(Taxpayer "B" with one-tenth (1/10) the average income of taxpayer "A" now receives a benefit of an 18% reduction in taxes on using the Income Averaging Table)

EXAMPLE 2
SCHEDULE G
(Form 1040)
Department of the Treasury
Internal Revenue Service

Income Averaging

▶See instructions on back.
▶ Attach to Form 1040.

1980
21

Name(s) as shown on Form 1040
TAXPAYER "B"

Your social security number

Base Period Income and Adjustments	(a) 1st preceding base period year 1979	(b) 2d preceding base period year 1978	(c) 3rd preceding base period year 1977	(d) 4th preceding base period year 1976
1 Enter amount from: Form 1040 (1977, 1978, and 1979)—line 34 Form 1040A (1977 and 1978)—line 10 Form 1040A (1979)—line 11	25,909	25,733	25,550	
2 a Multiply $750 by your total number of exemptions in 1977 and 1978		750	750	
b Multiply $1,000 by your total number of exemptions in 1979	1,000			
3 Taxable income (subtract line 2a or 2b from line 1). If less than zero, enter zero . . .	24,909	24,983	24,800	16,438
4 Income earned outside of the United States or within U.S. possessions and excluded under sections 911 and 931				
5 On your 1980 Form 1040, if you checked box {2 or 5 enter $3,200 1 or 4 enter $2,200 3 enter $1,600 . .} {in column (d)}				1,600
6 Base period income (add lines 3, 4 and 5) .	24,909	24,983	24,800	14,838

Computation of Averageable Income

7 Taxable income for 1980 from Schedule TC (Form 1040), Part I, line 3 . . .	7	86,770		
8 Certain amounts received by owner-employees subject to a penalty under section 72(m)(5)	8			
9 Subtract line 8 from line 7	9	86,770		
10 Excess community income	10			
11 Adjusted taxable income (subtract line 10 from line 9). If less than zero, enter zero			11	86,770
12 Add columns (a) through (d), line 6, and enter here	12	89,530		
13 Enter 30% of line 12			13	26,859
14 Averageable income (subtract line 13 from line 11)			14	59,911

If line 14 is $3,000 or less, do not complete the rest of this form. You do not qualify for income averaging.

G

Computation of Tax

15 Amount from line 13			15	26,859
16 20% of line 14			16	11,982
17 Total (add lines 15 and 16)			17	38,841
18 Excess community income from line 10			18	
19 Total (add lines 17 and 18)			19	38,841
20 Tax on amount on line 19 (see caution below)			20	12,089
21 Tax on amount on line 17 (see caution below)	21	12,089		
22 Tax on amount on line 15 (see caution below)	22	6,677		
23 Subtract line 22 from line 21	23	5,412		
24 Multiply the amount on line 23 by 4 . . . . Note: *If no entry was made on line 8 above, skip lines 25 through 27 and go to line 28.*			24	21,648
25 Tax on amount on line 7 (see caution below)	25			
26 Tax on amount on line 9 (see caution below)	26			
27 Subtract line 26 from line 25			27	
28 Tax (add lines 20, 24, and 27). Enter here and on Schedule TC (Form 1040), Part I, line 4 and check Schedule G box			28	33,737

Caution: Use Tax Rate Schedule X, Y or Z from the Form 1040 instructions to figure your tax on lines 20, 21, 22, 25 and 26. Do not use the tax tables.

STATEMENT OF
DAVID B. BOSTIAN, JR.
PRESIDENT
BOSTIAN RESEARCH ASSOCIATES
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
MAY 18, 1981
10:00 A.M.

ENHANCING LONG TERM ECONOMIC GROWTH THROUGH A BALANCED TAX REDUCTION BILL WHICH INCLUDES MAJOR INCENTIVES FOR RESEARCH & DEVELOPMENT AND TECHNOLOGICAL INNOVATION

Mr. Chairman and members of the Committee, I am David B. Bostian, Jr., and I am appearing today as President of Bostian Research Associates. It is a privilege to accept this Committee's invitation to state my views on the proper structure of a new national policy of tax reduction. Today, I am speaking as both an economist and as a member of the U.S. Senatorial Business Advisory Board.

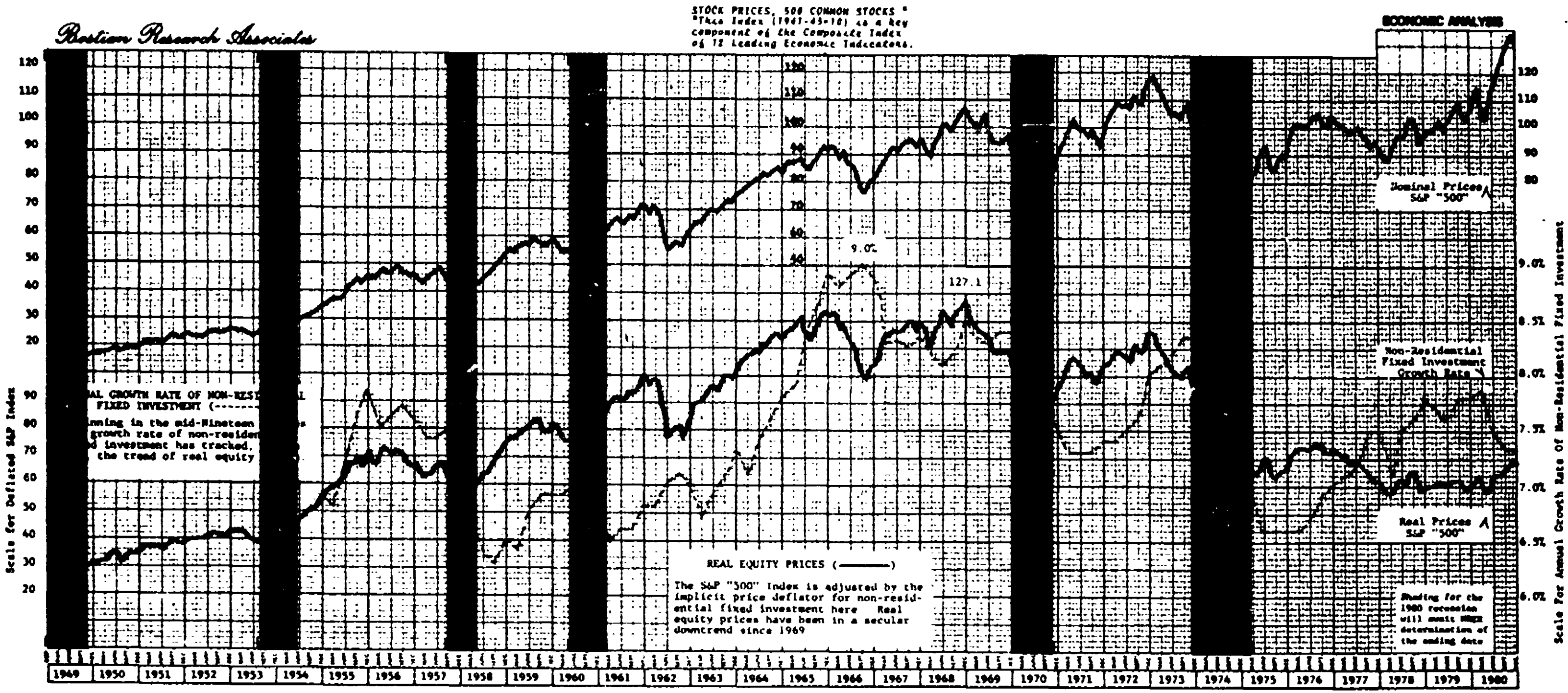
My firm provides economic and investment research and consulting services for institutional and corporate clients in the United States and Europe. We believe that our assessments merit the close consideration of this Committee not only because we had identified many of the economic and financial problems of the Nineteen Seventies at the beginning of that decade, but also because we were very prominent in our 1979 forecasts that the nation was about to make a pronounced shift toward conservative political and economic policies. While this new national direction is widely recognized today, the challenge before this Administration and this Congress is to carefully consider all policy recommendations in terms of their probable impact on real long term economic growth. Merely changing direction does not guarantee that our national economy will return, for example, to the high growth - low inflation climate of the Nineteen Sixties.

I would first like to emphasize that the policy principles upon which President Reagan campaigned hold considerable promise to <u>reverse</u> nearly all of the adverse trends that were directly and indirectly responsible for the distressing economic conditions that characterized much of the Nineteen Seventies. Those adverse trends included rapidly slowing U.S. productivity growth, a squeeze on real corporate profit margins, excessive fiscal and monetary stimulation in Washington, increasing governmental domination of the economy and lagging real capital investment. Because of this Keynesian legacy, it is not surprising that inflation rates and interest rates have soared to levels unimagined at the beginning of the last decade and business cyclical volatility has become almost violent.

General Tax Cuts Must Be Augmented By Targeted Reductions

While the general direction of the Reagan Administration's policy initiatives is to be applauded, across-the-board tax cut policies such as those identified with the philosophies of today's supply side economists are not the complete solution to achievement of the long term economic goals of the Administration. Noted economists such as Arthur Laffer surely have merit in their position that lower tax rates will enhance incentives to produce more goods. Nevertheless, there are other important determinants of the supply of desirable economic goods that are not considered by supply side advocates. Indeed, when the supply side camp points to the Kennedy-Johnson tax cuts of 1964 as proof that we are now being placed on the return road to "Economic Camelot," they are probably in error. Not only were there important differences in the capital sector in the Nineteen Sixties when contrasted with today, but President Kennedy also placed great emphasis on targeting tax relief to spur capital investment. When the failure of general supply side tax cuts to affect all critical supply enhancing factors is combined with the real risk that much of those general cuts would be spent on consumption, there is cause for careful consideration of alternative economic policies.

Though the Kennedy-Johnson tax cuts of 1964 appear to vindicate the theories of the supply side advocates at first glance, there were other important characteristics of the economy in the early Nineteen Sixties which probably explain a large measure of the economic buoyancy attributed to the 1964 tax cuts. Specifically, in 1962 President Kennedy backed the enactment of Accelerated Depreciation Rules and a 7% Investment Tax Credit to stimulate capital investment and, therefore, the supply of goods. The growth rate of real capital investment, as the attached exhibit shows, soared upward dramatically between 1962 and 1966, reaching a peak of 9% in 1966, a real growth rate not seen since that date. There were two other important characteristics of that period which may explain a great deal of the economic buoyancy seen then. Productivity growth was in a strong uptrend between 1962 and 1966, reaching a peak of 3.9% on a five year moving average basis in 1966! Also moving upward decisively in the early Sixties were research and development expenditures as a percentage of Gross National Product. This expanding emphasis on technological innovation peaked relative to the size of the overall economy in the late Sixties. Attention is called to that rising trend of research and development expenditures (relative to the size of the economy) in the Nineteen Sixties because it may have been a far more important determinant



STOCK PRICES, 500 COMMON STOCKS *
*This Index (1941-43=10) is a key component of the Composite Index of 12 Leading Economic Indicators.

AL GROWTH RATE OF NON-RESI AL
FIXED INVESTMENT (--------

nning in the mid-Nineteen s
growth rate of non-residen
d investment has tracked,
the trend of real equity

REAL EQUITY PRICES (————)

The S&P "500" Index is adjusted by the implicit price deflator for non-residential fixed investment here Real equity prices have been in a secular downtrend since 1969

Shading for the 1980 recession will await NBER determination of the ending date of productivity growth and productive capital formation than generally realized. In sum, it is entirely probable that the assumed success of the Kennedy-Johnson tax cuts was really the result of a different and pro-investment set of economic factors already in motion prior to 1964.

The greater incentives which the supply side economists seek are all well and good, but are not the complete answer in the search for sustained real economic growth. There is a considerable risk that the result of untargeted and across-the-board tax cuts will be an actual swing back toward pro-consumption economics with a far lower than hoped for portion of the tax cuts actually being saved.

Tax Cuts Are Clearly Warranted Today Despite Our Skepticism About The Effectiveness Of Untargeted Tax Reduction Policies

The recent Senate approval of a budget measure calling for $40 billion in expenditure reductions is extremely encouraging and has lessened my earlier concern that tax cuts would not be accompanied by meaningful budget cuts. Furthermore, our financial market research leads us to the conclusion that our economy is in the early stage of a major peaking movement in both inflation and interest rates due to a number of political and economic factors. This case is detailed at length in ANNEX "A" to this statement. Given the disinflationary trends that are already at work in the economy, tax cuts are now far less likely to create inflationary pressures. Numerous real measures of economic activity encompassing nearly every sector of the economy have failed to better peaks established in early to mid-1979. This economic review appears in my Supplementary Statement on The Investment Implications of The Conservative Political Climate.

A Balanced Tax Reduction Bill Should Certainly Consider Measures To Enhance Savings and Additional Capital Investment

While advocating the aggregate policy of tax reduction, I must state that there is a sound case for supporting targeted tax reductions such as those recommended by my colleagues in the financial community, specifically the Financial Analysts Federation and the Securities Industry Association. These targeted recommendations for tax reduction vary in detail but generally include the call for a further reduction in the capital gains tax and a reduction in the maximum tax on investment income. May I especially direct the attention of this Committee to the statement of Mr. Edward O'Brien, President of the Securities Industry Association, before the Committee on Ways and Means of the U.S. House of Representatives on March 26, 1981. Mr. O'Brien's statement makes a well documented case for the greater economic efficiency of targeted tax cuts. It is significant that the reduction in capital gains taxation in the Revenue Act of 1978, which my firm strongly supported, resulted in increased capital gains realizations that have offset nearly all of the revenue loss originally estimated by the Treasury. Additionally, new and growing businesses, a vital source of both new jobs and innovative ideas, prospered as a result of the targeted reductions in the 1978 Act.

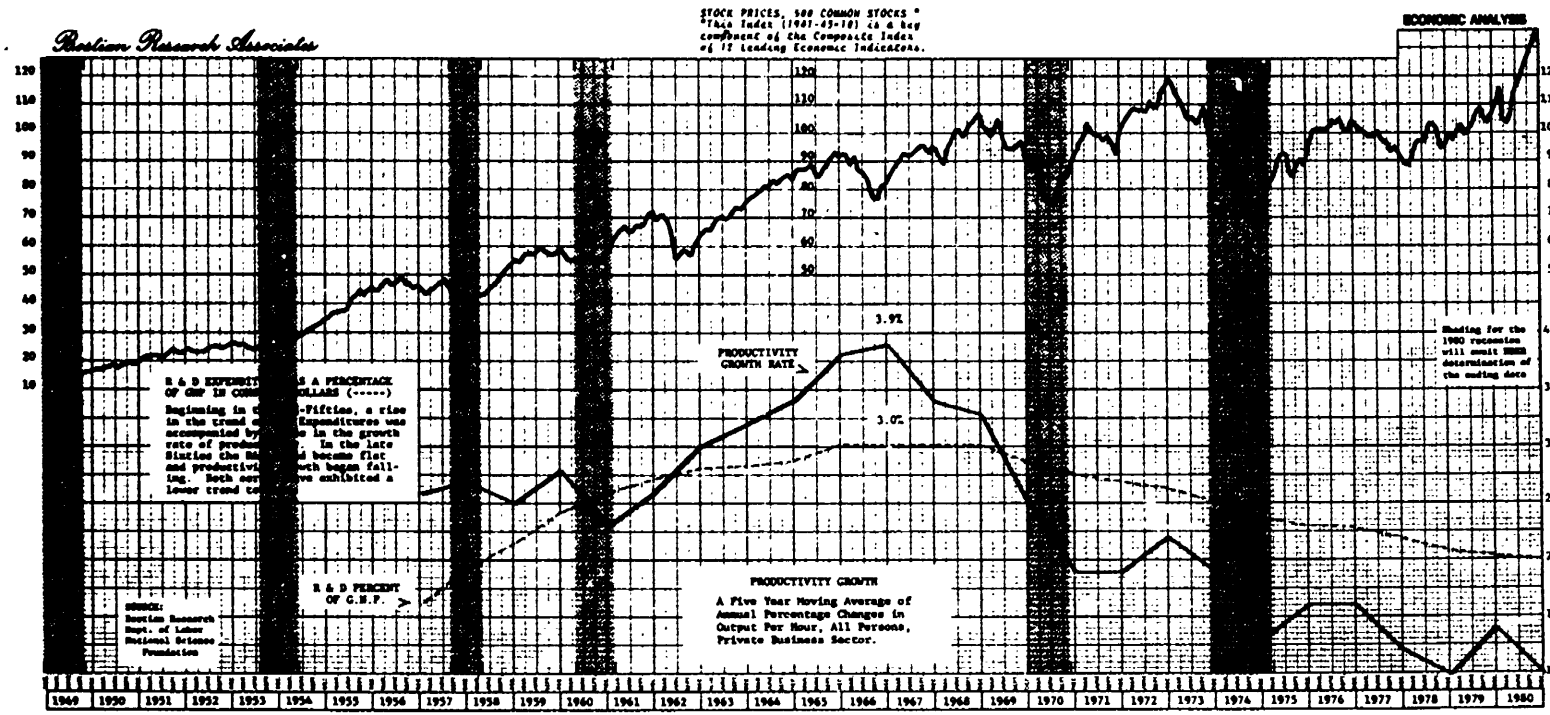
We Strongly Recommend A Targeted Tax Reduction Policy Providing Industry Major Tax Credits For Research And Development Expenditures

While targeted tax reductions to increase savings and, therefore, investment are clearly more economically effective than general tax rate cuts, it is our judgment that tax credits which spur research and development and, therefore, technological innovation, may well be the most economically powerful type of tax reduction in seeking the goal of sustained long term economic growth with low inflation and low unemployment. While econometric models cannot verify it, any objective assessment of economic history will reveal that major waves of technological innovation are prime motivating forces behind long term growth. Consider for a moment the development of the automobile, the airplane and the computer. My belief in the creative genius of the America people has led me to forecast, for example, that oil may not be the primary energy source of the industrial world by the end of this decade. I strongly believe that a prerequisite to the resumption of real long term economic growth is a "targeted" national policy of expanding research and development, and, therefore, technological innovation, in all industries.

I have recommended a national Tax-Based Productivity Policy (TBPP) in several financial and corporate addresses during the past year. The primary aim of this policy recommendation would be to stimulate research and development spending throughout all of industry through tax credits based, for one example, on the level of R&D expenditures as a percentage of sales for each individual company. Such a policy would provide the maximum national emphasis on technological innovation within the structure of the private economic sector. Steel companies would have as much access to these tax credits as would advanced technology companies. One can never be sure where technological "breakthroughs" will occur and, from the standpoint of our national productivity problem, basic industry needs productivity-enhancing innovations more than any other economic sector. The availability of specific credits would provide greater stimulus to R&D spending than presently available write-off techniques and would result in a more productive gross capital stock than the capital cost recovery proposals which favor existing plant and equipment technology. When I first expressed concern about the increasingly somber long term outlook for capital investment and productivity in 1972, there were few economists who shared my skepticism. Yet, on a five-year moving average basis, productivity growth rates in the United States have been trending downward since 1966. The correlation between the growth rate of productivity and R&D expenditures as a percentage of GNP supports our emphasis on national policies to expand R&D expenditures in all companies. Significantly, R&D expenditures as a percentage of GNP have tracked productivity growth very closely since the mid-Fifties. Both series peaked together in the mid-Sixties and have been trending downward since that period. See the attached exhibit. Our policy recommendation would utilize the tax system to double the percentage of Gross National Product devoted to research and development (now about 2%).

I was very encouraged to note a page one Wall Street Journal article noting the bipartisan support that is now developing for major R&D tax credits and I am hopeful that my statement will continue to increase support for this measure. See ANNEX "B" to this statement.

President Reagan has suggested a Presidential Task Force on Productivity. It is our hope that the vital role of greater R&D spending will also be recognized by that Task



STOCK PRICES, 500 COMMON STOCKS *
*This Index (1941-43=10) is a key component of the Composite Index of 12 Leading Economic Indicators.

R & D EXPENDIT S A PERCENTAGE OF GNP IN CON OLLARS (-----)

Beginning in t -Fifties, a rise in the trend o Expenditures was accompanied by e in the growth rate of produ . In the late Sixties the R d became flat and productivi wth began falling. Both ser ve exhibited a lower trend te

PRODUCTIVITY GROWTH

A Five Year Moving Average of Annual Percentage Changes in Output Per Hour, All Persons, Private Business Sector.

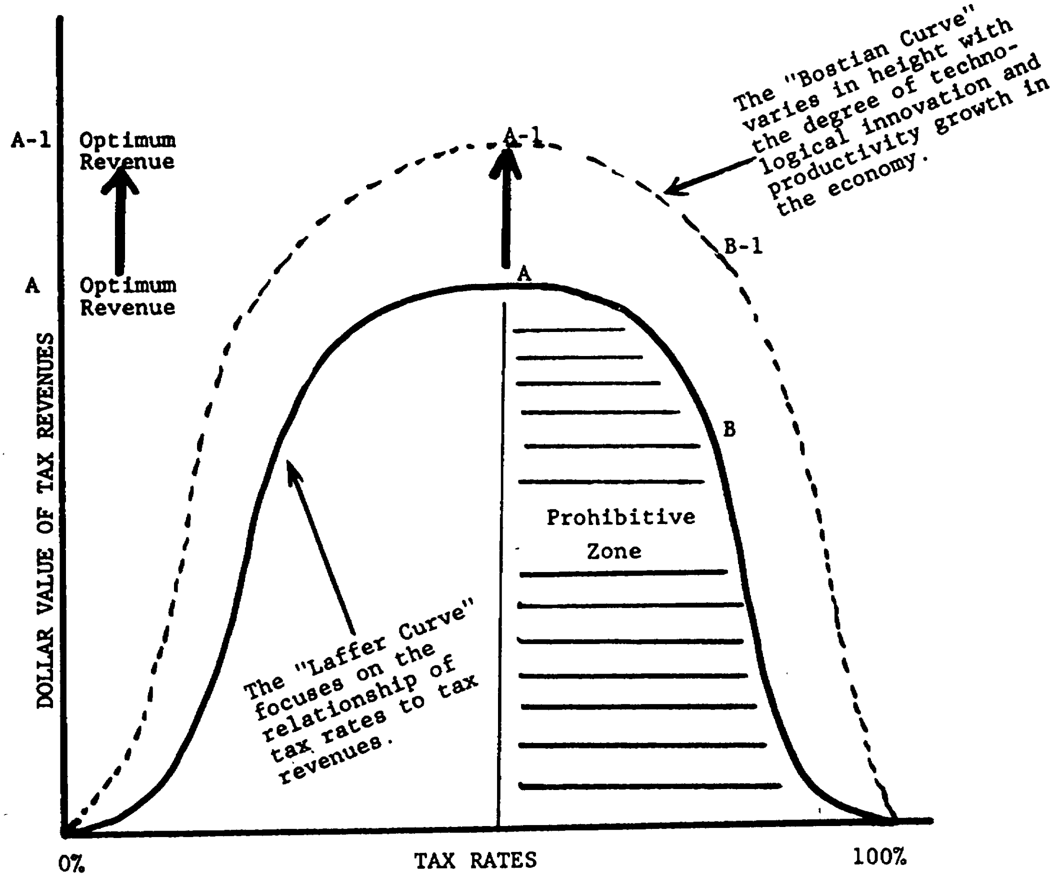
SOURCE:
Bostian Research
Dept. of Labor
National Science
Foundation

Shading for the 1980 recession will await NBER determination of the ending date

Force. R&D expenditures are not only an investment in greater productivity growth but also a vital way to strengthen our defense posture at the same time. Today, Russia spends approximately 3.4% of its GNP on research and development while the U.S. only spends slightly more than 2%.

Finally, it is important to relate the economic effects of our Tax-Based Productivity Policy to the famous Laffer Curve. Economist Arthur Laffer believes the U.S. economy is now in the "prohibitive zone" of the Tax Rate/Revenue Curve. (See Diagram.) By reducing tax rates, he hopes to increase government revenue by moving from point B upward toward optimum point A. However, the Bostian Curve variant of the Laffer Curve varies in height with the degree of technological innovation in the economy. An economy with an innovative and highly productive capital stock would produce greater revenue at all tax rates, including the optimum one. For example, an upward move from point B-1 toward optimum point A-1 would result from the same tax rate cuts yet provide greater revenue. The Laffer Curve does not exist in a capital vacuum. Specifically, if an investment innovation policy like the Tax Based Productivity Policy is implemented, the economy would generate more tax revenue at any tax rate, including the optimum one. Furthermore, an <u>innovative</u> capital stock would ultimately reduce structural inflation.

THE LAFFER CURVE IS NOT STATIC IN THE REAL ECONOMIC WORLD



THE LAFFER CURVE VERSUS THE BOSTIAN CURVE

Economist Arthur Laffer believes the U.S. economy is now in the "prohibitive zone" of his Tax-Rate / Revenue Curve. By reducing tax rates, he hopes to increase government revenue by moving from point B upward toward optimum point A. However, The Bostian Curve variant of The Laffer Curve varies in height with the degree of technological innovation in the economy. An economy with an innovative and highly productive capital stock would produce greater revenue at all tax rates, including the optimum one.

In essence, the Laffer Curve would be far higher today if the pro-investment conditions of the Nineteen Fifties and Sixties were recreated by economic policies targeted for same. My recommendation is not inconsistent with Laffer-type incentives resulting from generally lower rates of taxation, but would create economic conditions where enhanced incentives would result in even greater revenues and real wealth!

CONCLUSION

It is my strong conviction that a national policy to enhance technological innovation would contribute vitally to the long term health of the American economy. I believe also that the small revenue loss resulting from R&D tax credits would quickly be recouped from the growth in the economy which would result.

While general tax cuts are not without merit, targeted tax reductions to stimulate savings and investment are more effective in fostering economic growth and the most effective type of targeted cut is one which fosters technological innovation. The nation needs an innovative capital stock, not just additions to the existing plant and equipment. I would, therefore, recommend that the forthcoming tax bill (or bills) be balanced in recognition of the above assessments.*

Mr. Chairman, this concludes my statement. Thank you for your attention. I will now be glad to answer your questions.

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* I have always advocated a balanced approach in structuring new legislation. See my statement to the U.S. Senate Subcommittee on Financial Markets, September 27, 1973.

ANNEX "A" *
TO THE STATEMENT OF
DAVID B. BOSTIAN, JR.
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
MAY 18, 1981
10:00 A.M.

* The attached study on the case for A Secular Peak In Interest Rates And Inflation is important to consider in assessing the degree to which any tax cut would have an inflationary effect.

MAJOR PEAK IN INTEREST RATES AND SECULAR LOW IN BOND MARKET

Our economic and financial market research leads us to the inexorable conclusion that we are witnessing not only an important cyclical peak in interest rates, but a probable secular peak as well.

On January 31, 1981 we stated in an address before the annual Wall Street and the Economy conference in New York City that the bond market was forming an "important long term low."* Developments during February and March have only served to reinforce our position that the historically high structure of interest rates is not commensurate with the lower real underlying rate of inflation as measured by the GNP deflator.

Before considering the current conclusions of our quantitative financial market research, it is important to survey the political and economic case for a secular peak in both inflation rates and interest rates on a point by point basis. We believe that the fundamental mosaic formed by the developments enumerated here argues well for the case that the bond market is now recording its price lows for the Nineteen Eighties.

OIL

The recent weakness in oil prices and internal discord within OPEC are key bullish developments for the bond market that we began discussing as long ago as mid-1979. In a series of full page outlook statements in the financial media, we stated that soaring energy prices would "not be permanent" as an impediment to an optimistic investment outlook.** Our long term outlook statement further postulated that "OPEC's excessive price increases" would "make alternative energy sources financially feasible which would ultimately lessen the relative importance of petroleum." Likewise, we stated in mid-1979 that the extreme economic pressure being created by OPEC's excesses would "finally force the United States to take energy policy actions in our long run self-interest." The conclusion of our state-

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*"Investment Implications of the Conservative Political Climate," an address to the 15th annual New School Conference on Wall Street and the Economy. Copy available on request.

**A reprint of our long term outlook statement as it appeared on page 33 of the June 18, 1979 Wall Street Journal is available on request.

ment was that OPEC's excesses were "placing it in a position to be hoisted by its own petard."

This review of our long standing position on oil prices and OPEC is to emphasize that recent favorable developments are not an interim respite in a never-ending upward oil price spiral, but significant confirmation that the laws of the free market will ultimately prevail. While some observers may say that recent "glut" conditions in the oil market and weakening oil prices are merely the result of Saudi Arabia's continuation of production at high levels, the development of alternative energy sources and installation of new, energy efficient capital investments are fundamental developments that argue for a secular reduction in both oil consumption and oil prices. Indeed, because of our conviction that technological innovation is inherent in the resilient character of the U.S. economy, it is our belief that oil will not be a primary energy source at the end of this decade!

Clearly, whether our most optimistic expectations materialize or not, the end to the seemingly relentless upward trend in world oil prices will remove a primary engine of inflation from the economic scene and result in significantly lower future rates of inflation and therefore, meaningfully lower inflation premiums in the interest rate structure.

MONETARY POLICY

It is our strong conviction that the current leadership of the Federal Reserve has both the ability and the mandate to control the growth of the monetary aggregates, keeping them at rates of long term growth that are not inflationary. While the near term effect of this increased emphasis on the aggregates (which dates from the policy shift in October of 1979) can result in temporarily higher interest rates due to increased levels of rate volatility, the secular effects of restraint in monetary growth will be decidedly favorable. It is noteworthy that the monetary aggregate M1-A has been declining sharply since November of last year and the M1-B has moved only moderately above its peak last November. In sum, we feel that the Federal Reserve is serious in its anti-inflationary efforts. However, we discount fears that interest rates will soar later this year because monetary policy is bearing the burden of the inflation fight. There are other important disinflationary forces at work as well.

CREDIT DEMAND

While the extent of Congressional budget cutting enthusiasm is yet to be fully proven, we are increasingly optimistic that there is bi-partisan support for serious restraint in the rate of growth of federal government spending. Likewise, we are optimistic that the form of forthcoming tax cuts will be more pro-investment in orientation. Our position on tax cuts, incidentally, is that they should be more targeted toward investment than consumption.* In sum, while governmental demands on credit markets will be meaningful in the period ahead, it is our expectation that those demands will not be as great as the pessimists on interest rates expect. Likewise, private sector credit demand may also be restrained because our current assessment of the economic scene does not suggest that an "overheating" is likely.

Close study of Department of Commerce data reveals that real measures of activity in nearly every sector of the economy have failed to better peaks established in 1979. Despite the economic recovery in recent quarters, these measures of the economy have not recovered to new highs when viewed in constant dollar terms.

- Personal Income (less transfer payments)
- Industrial Production
- Manufacturing & Trade Sales
- Retail Sales
- Contracts & Orders for Plant & Equipment
- Residential Fixed Investment (annual rate)

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*Addresses recommending our Tax Based Productivity Policy include:

- Address to The New York Association of Business Economists, April 29, 1980, "The Economic Outlook"
- Address to The Security Analysts of San Francisco and The North Carolina Society of Financial Analysts, May 6, 1980 & June 5, 1980, "Capital Investment and Productivity"
- Address to the Listed Company Advisory Committee of The American Stock Exchange, September 24, 1980, "The Economic Outlook - A Corporate Perspective."
- An article discussing the economic importance of policies targeted toward innovative capital formation and the fallacies in the Laffer Curve is available on request.

- Non-Residential Fixed Investment (annual rate)
- Net Corporate Cash Flow
- Corporate After-Tax Profits (annual rate)
- M-1B and M-2 Monetary Aggregates

While it is important to continuously monitor these and other measures of real economic activity, the present macroeconomic picture they present does not suggest excessive private sector credit demand is a future prospect.

COMMODITIES

Major indexes of sensitive commodity prices have failed to make new highs in recent months despite widespread inflationary fears. Indeed, an index of spot market prices for industrial raw materials compiled by the Department of Commerce reached its high in the first quarter of 1980 and has been trending lower since then. The downtrend in commodity prices presents a stark contrast to the new lows in the bond market. The fear reflected in the bond market is illogical when the disinflationary trends reflected in commodity prices are studied carefully.

EXPECTATIONS

The extremely high peaks in interest rates seen in 1980 and early 1981 appear to us to be largely expectational in character, and, more in the nature of "irrational" expectations than rational. The underlying rate of inflation, as measured by the GNP deflator, does not warrant the present level of interest rates and future probabilities do not support the new lows being made in the bond market.

Significantly, today's structural inflation, resulting from increasingly wide employment of indexing and COLA's, has become entrenched as a result of inflationary expectations. While expectations of higher inflation can be a self-fulfilling prophecy, expectations of lower inflation can also have a long run beneficial impact on the underlying rate which is now assumed to be in the 9% to 10% area by many economists.

VOLATILITY

While wide swings in interest rates recently have resulted from deregulation of the financial markets, the shift in Federal Reserve policy in late 1979 and from rapid international money flows, this volatility is also a probable characteristic of a bullish long term trend change in the bond market. Many price series, whatever their nature, exhibit substantial volatility when their major trend is changing.

Let us now consider graphically the historical interrelationship between interest rates and the inflation rate. Note, incidentally, the extreme interest rate volatility that has characterized recent quarters.

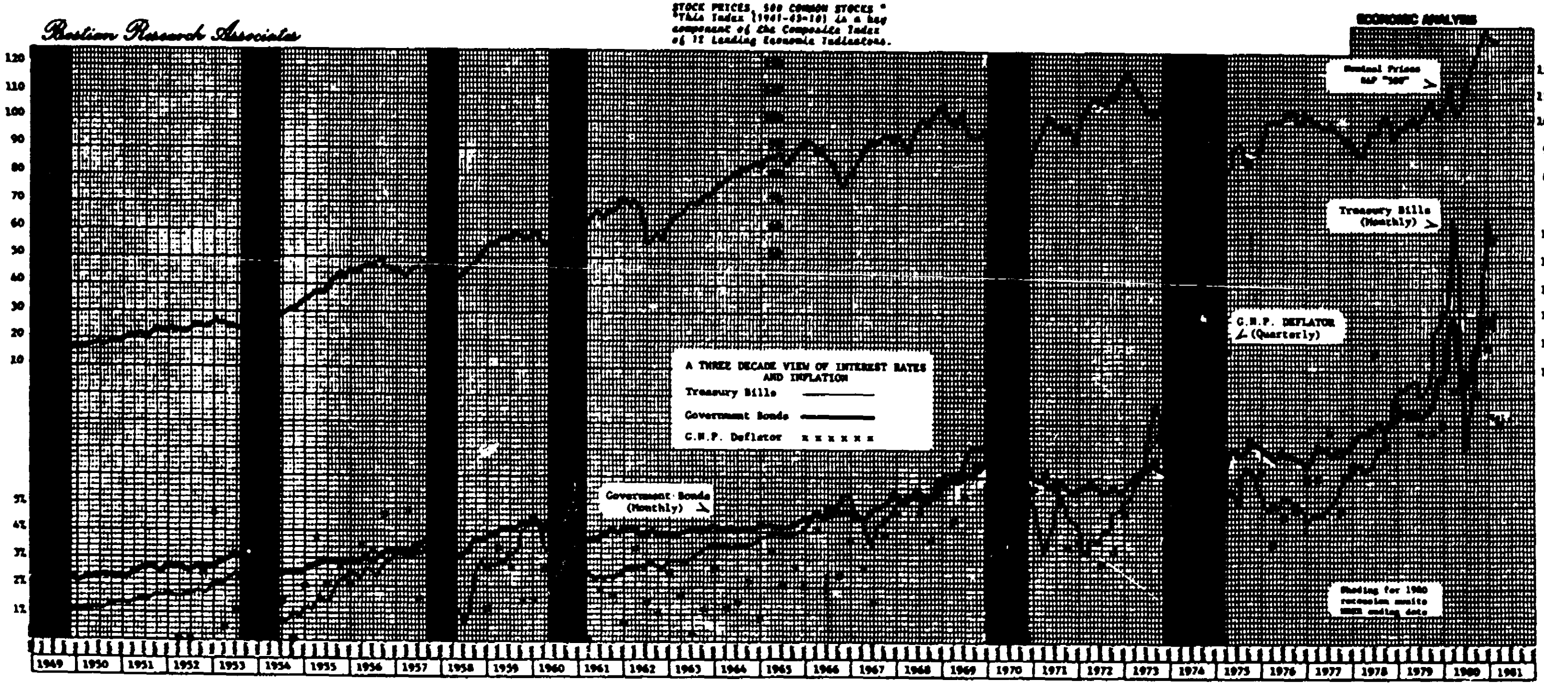
BOTH SHORT AND LONG TERM INTEREST RATES HAVE BEEN OVERCOMPENSATING FOR THE REAL UNDERLYING RATE OF INFLATION AS MEASURED BY THE G.N.P. DEFLATOR

The following multi-decade graph traces the history of both short and long term interest rates. This presentation utilizes treasury bills for short term yields and government bonds for long term yields. The series of "X"s that appear on a quarterly basis are plots for the Implicit Price Deflator for Gross National Product. The GNP deflator is the more realistic measure of inflation among those generally available today.

Note the sharp surge in inflation, as measured by the GNP deflator, following the OPEC oil embargo in late 1973. The inflation rate soared during the 1974-75 recession, yet the debt markets, especially government bills and bonds, never kept pace with that inflation rate, almost as though buyers of those instruments did not believe the inflation numbers.

In contrast to the relative behavior of inflation and interest rates during 1974 and early 1975, study the pattern during 1980. Both short and long term interest rates have soared to unprecedentedly high levels well above the real rate of inflation closely approximated in the GNP deflator. The average rate of inflation over the past two years, for example, has been only 8.8% as measured by the averaged quarterly readings of the deflator. Yet the monthly average of treasury bill rates has soared over 15% twice and the yields on long term government bonds have moved above 12%. The behavior of the prime rate, of course, is even more extreme relative to the underlying inflation rate, however it is measured.

We must conclude that buyers of debt instruments have become transfixed with a near-hopeless set of inflationary expectations. This is the type of market psychology that signals a secular bottom in the bond market and a secular peak in the overall interest rate structure.


Bastian Research Associates
STOCK PRICES, 500 COMMON STOCKS *
*This Index (1941-43=10) is a key component of the Composite Index of 12 Leading Economic Indicators.
ECONOMIC ANALYSIS
A THREE DECADE VIEW OF INTEREST RATES AND INFLATION
Treasury Bills
Government Bonds
G.N.P. Deflator x x x x x x
Nominal Prices S&P "500"
Treasury Bills (Monthly)
G.N.P. DEFLATOR (Quarterly)
Government Bonds (Monthly)
Shading for 1980 recession awaits NBER ending date
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There are also several of our more quantitative studies that reinforce our fundamental optimism on the prospects for lower interest rates.

OUR SHORT TERM INTEREST RATE FORECASTING MODEL HAS SIGNALED A MOVE TO SIGNIFICANTLY LOWER SHORT RATES, AN IMPROVING PATTERN WHICH ALSO ARGUES WELL FOR LOWER LONG RATES

Our short term interest rate forecasting model is a key facet of our quantitative research which supports our optimistic expectations. Our interest rate forecasts over the past four quarters speak for the merit of this model.*

The short term model is based on the discount rate for new issues of 91 day treasury bills and is plotted on a monthly basis. It signals a probable trend change when the short term rates move to extremes on either side of a "normal" zone. The probability of a rapid trend change is even

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*The following is a brief review of our posture on interest rates over the past four quarters:

- During the first quarter of 1980, as interest rates were rising to record levels, we went on record with the forecast that they would plunge with the same velocity with which they were advancing. Refer to our feature article in the January 7, 1980 issue of Pensions and Investments.
- Following an approximately 1000 basis point decline in short term rates early in the second quarter of 1980, our interest rate forecasting model developed a configuration that was the exact opposite of its position in March, i.e., it was signaling a major advance in rates just as the March data suggested a major plunge.
- On July 21, 1980, clients received a special bulletin warning of a rise in interest rates and our September 4th Economic Comment carried the headline that "Our Forecasting Model for Short Term Interest Rates Continues to Signal Higher Levels During The Months Ahead Despite Widespread Expectations of Lower Rates."
- In our 11/10/80 Economic Comment, we reviewed the fundamental rationale for the rise in interest rates we had been forecasting since July and concluded that the "Current Status Of Our Interest Rate Forecasting Model Does Not Yet Indicate That The Advance In Interest Rates Is Complete."

greater when the deviations of short term rates above or below the "normal" zone occur rapidly. The following multi-decade graph shows the history and current position of our short term model.

The norm line, crossing the center of this thirty year model, currently reflects a short term yield of 11.8%. The dotted lines on either side of the solid norm line depict a band of 75 basis points on either side of the norm. Over the past three decades, treasury bill rates have been within this norm band 73% of the time, another way of indicating the significance of deviations outside the norm which indicate a probable reversal of the existing trend of short term interest rates.

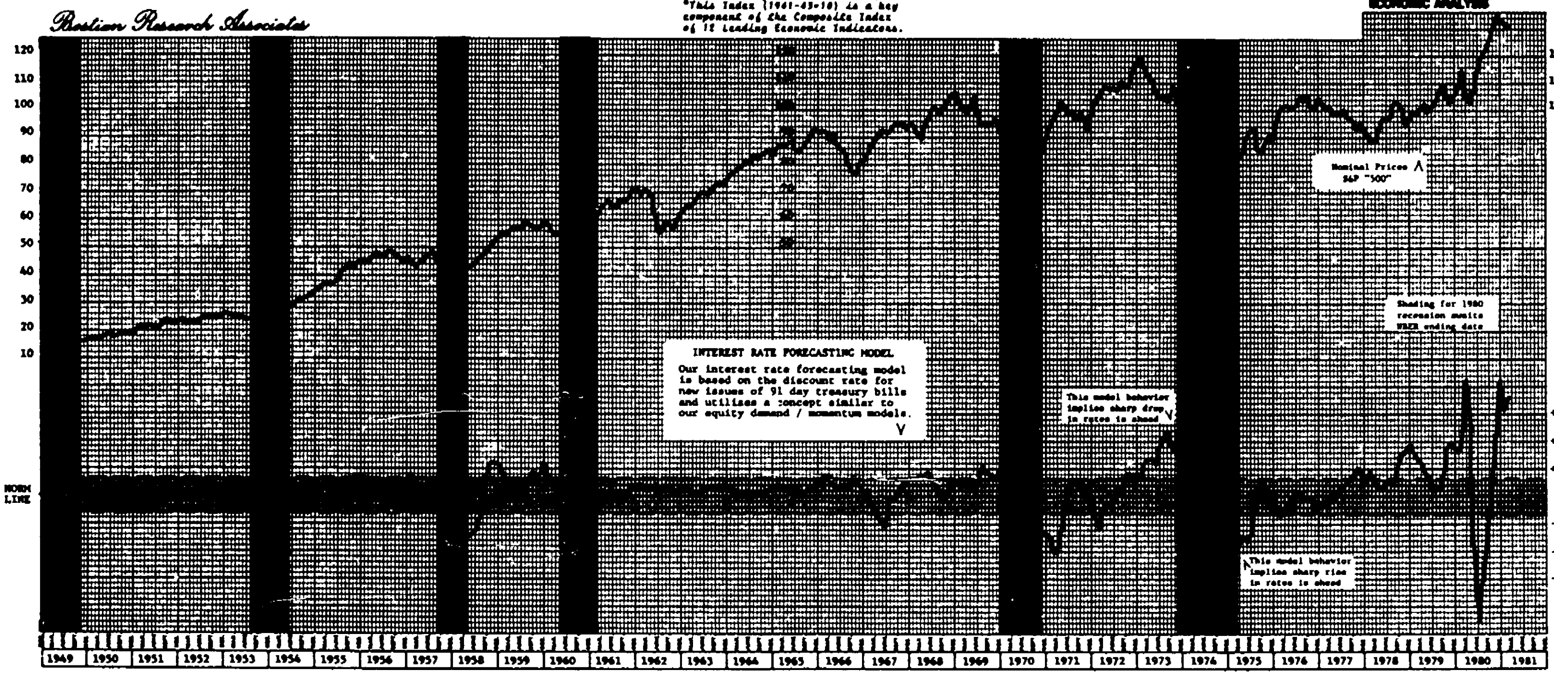
Following an extreme deviation on the upper limit of the model in March of 1980, short term interest rates collapsed approximately 1000 basis points. However, by June of 1980 an equally extreme deviation had occurred on the down side, signaling a return to sharply higher rates. By December of 1980, the model had returned to a position equaling March of 1980. The loss of upward momentum in the model in January and February of 1981 is interpreted as a clear signal that short term rates are destined to drop to the vicinity of the norm line, a decline of several hundred more basis points.

There is, however, the distinct possibility that short term rates will actually cross the normalized band and head even lower as they did in the spring of 1980. Certainly the historical tendency of the model to move to opposite extremes would suggest this possibility.

It is noteworthy that the signal of lower rates in the short term model has not changed despite the marginal new lows in the bond market (new highs in long term rates). We interpret this to indicate that the recent new lows in the bond market are against the overall downward tide in other sectors of the interest rate structure. Major movements in short term rates have seldom been without sympathetic movements in long term interest rates.

OUR INTERNAL BREADTH MODEL FOR THE BOND MARKET REINFORCES OUR POSITION THAT A SIGNIFICANT PEAK IN INTEREST RATES IS OCCURRING

We monitor all bonds listed on the New York Stock Exchange on a daily basis in terms of whether they advance or decline in price. A cumulative display of this data provides an important indication of the internal strength in the bond market.



STOCK PRICES, 500 COMMON STOCKS *
*This Index (1941-43=10) is a key component of the Composite Index of 12 Leading Economic Indicators.

Nominal Prices Λ
S&P "500"

Shading for 1980 recession awaits NBER ending date

INTEREST RATE FORECASTING MODEL

Our interest rate forecasting model is based on the discount rate for new issues of 91 day treasury bills and utilizes a concept similar to our equity demand / momentum models.
V

This model behavior implies sharp drop in rates is ahead V

This model behavior implies sharp rise in rates is ahead

It is noteworthy that this breadth model made its most recent low on December 16, 1980 and is now well above that trough even though brief periods of panic selling have caused widely watched bonds, such as the Treasury 12 3/4 of 2010, to drop to much publicized new lows.

The resilient behavior of our internal breadth model cannot be ignored as a harbinger of higher bond prices in the period ahead. *

THE RESILIENT BEHAVIOR OF THE INTEREST-SENSITIVE SECTOR OF THE EQUITY MARKET IN OUR COMPUTER BASED DEMAND MODELS ALSO POINTS TO A MAJOR PEAK IN INTEREST RATES

Other studies in our quantitative research which help to form the mosaic of evidence in support of a significant peak in inflation and interest rates are our equity market demand models. Each day our computer monitors over 90 industry groups composed of major listed and unlisted companies. Our computer is programmed to search for patterns of intraday price behavior that indicate persistent underlying demand whether or not the industry components are advancing in price or declining. Significantly, nearly every industry in the interest-sensitive sector of the equity market has been showing positive underlying demand patterns since late 1980! These industries include money center banks, regional banks, insurance companies, financial conglomerates, savings & loan companies, utilities and even real estate investment trusts.**

CONCLUSION: INSTITUTIONS AND CORPORATIONS SHOULD ACT ON THE PROSPECT OF SUBSTANTIALLY LOWER INFLATION AND INTEREST RATES IN THE YEARS AHEAD

Every aspect of economic and quantitative research leads us to the inexorable conclusion that inflation and interest rates will be headed lower during the coming decade. We strongly disagree with highly publicized forecasts in the financial community to the effect that interest rates are headed to disasterously higher levels later this year.

While brief periods of panic cannot be ruled out, the political/economic conditions for a secular decline in both inflation and interest rate inflation premiums finally exist today. Just as few observers would have envisioned the high levels of interest rates that were ahead from the

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* A graph of our internal breadth model for the bond market is available on request.

**Graphs of our proprietary demand models on individual companies within the interest-sensitive sector are available.

vantage point of the early Nineteen Seventies, so the consensus view today seems blind to the prospect that the Nineteen Eighties will bring substantially lower inflation and interest rates.

David B. Bostian, Jr., CFA
BOSTIAN RESEARCH ASSOCIATES*

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[*] Statistical assistance in the preparation of this report was provided by Ms. Geraldine Ouellette.

ANNEX "B" *
TO THE STATEMENT OF
DAVID B. BOSTIAN, JR.
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

MAY 18, 1981

10:00 A.M.

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* On April 29th The Wall Street Journal carried a front page article noting bipartisan support for R&D tax credits for all industries. This is the essential feature of the Tax Based Productivity Policy which we first began recommending one year ago in an address to the New York Association of Business Economists.

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REPRODUCTIONS NOT PERMITTED
ISSUE OF APRIL 29, 1981

Tax Report

A Special Summary and Forecast Of Federal and State Tax Developments

RESEARCH RESURGES? **Bipartisan support grows for "R-and-D" tax breaks.**

The long-term aim is to spur productivity. Sen. Danforth (R., Mo.) proposes 25% credits for increased research-and-development spending. Rep. Vander Jagt (R., Mich.) has 55 House cosponsors for a like bill. The lost revenue—$500 million to start—is "a small price" for the stimulus, says John Hamm, of Arthur Young & Co., once a Danforth aide. Senate Democratic leaders backed the plan in 1980. Now, House Ways and Means Chairman Rostenkowski (D., Ill.) wants more R-and-D incentives in the tax-cut bill.

Reagan policy-makers sympathize; they put special write-offs for R-and-D equipment in their tax bill. But they're resisting additions. Assistant Treasury Secretary Chapoton says R-and-D breaks will be considered for a follow-up bill. The prospects: Congressional staffers of both parties say that if Reagan is forced to compromise on tax-cut provisions, the 25% R-and-D credit is a good bet to be enacted.

Advocates agree the incentive must be drafted to prevent openings for R-and-D tax shelters.

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Reprinted from The Wall Street Journal

May 18, 1981

Testimony of
O.S. POLLOCK, INGALLS & SNYDER
before the
COMMITTEE ON FINANCE
UNITED STATES SENATE

Mr. Chairman, members of the Committee, my name is Oscar S. Pollock. I am a limited partner of Ingalls & Snyder, members of the New York Stock Exchange. Thank you for the opportunity to testify.

Recently I have written extensively on the impact of the 1978 capital gains tax reduction, including its revenue effects. The latest Treasury capital gains data obtained by Senator Wallop has a direct bearing on present tax issues. The Administration's plan would lower the top tax rate from 70% to 50% over three years, finally removing a special penalty on saving and investment. However, my research strongly suggests that it would be much cheaper and more effective to lower the top rate to 50% immediately.

Let us consider what happened in the wake of the 1978 capital gains tax cut. At the lower 1979 rates, the Treasury collected $1.8 billion more in capital gains taxes than it received at the much higher 1978 levels. How was this record dollar increase obtained? Total realizations of capital gains were $72 billion in 1979 - up 40% from 1978. But the greatest increases in realizations came at the highest income levels; taxpayers with adjusted gross incomes of $100,000 or more approximately doubled their realizations of capital gains in 1979, compared with 1978. Thus, lowering capital gains tax ~~receipts~~ rates from confiscatory levels induced a sharp upswing in investment realizations by the upper income groups that more than financed that tax cut for all other taxpayers.

Bringing the top tax rate down from 70% to 50% could have an even more dramatic and positive impact on individual investment. It should also work to raise, rather than lower, tax receipts, for these reasons:

* This step would lower the maximum tax rate for long-term capital gains from 28% to 20%. At that level, there should be some additional acceleration in the realization of such gains, particularly of very large gains.

* The maximum tax rate on short-term capital gains would fall from 70% to 50%. At that level I would expect a very considerable increase in the realization of short-term capital gains, which are small now. This increase would add considerably to tax receipts because the effective rate on these gains would still be very high.

* Funds employed in tax shelters would decline because individuals with high incomes would be forced to risk much more of their own capital in them.

* There would be less individual interest in municipal bonds and more emphasis on taxable bonds and equities.

* Individuals may borrow less money because interest expenses will become much more costly at the lower tax rates.

The cumulative positive effects of these responses on tax receipts should greatly exceed the $4.6 billion static revenue loss that is attributed to the 70% to 50% reduction. On the other hand, if this reduction is stretched out over a three-year period, these responses would be diluted; there would be revenue losses due to the lower rates and there will be considerable deferral of large capital gains, which would be expensive. A measure that could result in a net revenue gain could become a net loser initially.

Most importantly, lowering the top rate to 50% will spur productive financial investing by individuals. Our country needs the added investment now - not three years from now.

This step reduces capital gains taxes for taxpayers in the highest income groups. It should be combined with a measure that lowers capital gains taxes for <u>all</u> taxpayers, such as an increase in the exclusion for long-term capital gains.

Friends and foes alike are watching America closely. Can we take the critical steps needed to restore health and vigor to our economy? Can we regain our position of economic leadership? Ending the disastrous distinction between earned and unearned income and lowering our high capital gains taxes can send clear signals to the world that we mean business.

Thank you again.

Senator SYMMS. We have Dirk Van Dongen, James Stoll, and Harry Sullivan.

[A short recess was taken.]

Senator SYMMS. Mr. Van Dongen, are you ready to commence?

STATEMENTS OF DIRK VAN DONGEN, JAMES A. STOLL, AND HARRY R. SULLIVAN

Mr. VAN DONGEN. Thank you, Mr. Chairman.

I am Dirk Van Dongen, president of the National Association of Wholesaler-Distributors. There are over 300,000 wholesaler-distributors across this Nation. They have an intense and basic interest in the outcome of your current deliberations.

As detailed in our full statement, Mr. Chairman, wholesaler-distributors because of their asset base, which is typically composed of 40 percent investment and inventory and 40 percent in receivables, are impacted in immediate terms by the economic conditions which are sapping the vitality of our economic base with what seems to be geometrically accelerating force.

These businesses need help and we urge this committee to act promptly to implement the concepts underlying the administration's economic recovery program in the tax area.

In the time available to me this morning, I want to simply highlight my written statement by emphasizing four points.

First, we strongly support the administration's accelerated cost recovery system which is incorporated in S. 683. Depreciation reform is not the optimum tax policy change for wholesaler-distributors. Corporate rate reductions would be, but the measure will benefit our industry. It will also benefit our manufacturing suppliers and our diverse customer base.

We are concerned with the economic vitality of these concerns also. Without strong suppliers and customers, the wholesaler-distributors economic well-being becomes really an academic matter.

Second, the wholesaler-distributors principal fixed asset is his warehouse. Thus, the aspect of depreciation reform which most directly affects our industry is that dealing with structures.

In our view, depreciation reform as it deals with structures should be neutral as between various business uses of these structures.

The administration's proposal recognizes this by equally treating industrial, retail, and the wholesale-distribution facilities as 10-year property.

However, the Senate Finance Committee bill of last year, by contrast, specifically discriminated against wholesale-distribution facilities in its provision dealing with owner-occupied structures by limiting the use of the 15-year period to industrial buildings, retail stores, or catalog distribution centers, excluding wholesale-distribution facilities.

This is, frankly, inexplicable, Mr. Chairman. It denies to wholesaler-distributors as a class the same ability under the code to invest in new facilities as their suppliers and customers are granted.

Aside from the equity issues associated with this, serious practical concerns arise as well. To increase the size of the pump, so to speak, without increasing the size of the pipeline, makes little economic sense.

I am pleased to acknowledge that Senator Bentsen, a key leader in the depreciation reform effort among this committee's members has recognized this by indicating to us his support for the inclusion of wholesaler-distributors in any special depreciation category established for owner-occupied use structures.

We urge all members of this committee to follow suit and would be pleased to provide each of you with a detailed analysis of the importance of wholesale distribution as an industry to the economy in your respective States should you wish.

Third, we have great difficulty seeing any merit in an approach which makes a distinction between owner-occupied and leased structures which are used by wholesaler-distributors, their customers and suppliers.

Both, in our view, should receive 10-year treatment with accelerated depreciation.

Fourth and finally, Mr. Chairman, in supporting the administration's clean bill, we assume Congress' early attention to a second track bill containing corporate rate reduction and estate tax reforms as well as the other measures which are recommended in our prepared text.

The merits of most of these recommendations are well known. Those dealing with inventory evaluation reform, however, are just beginning to receive focused attention.

The rules relating to the treatment of inventory for tax purposes are complex. It is a, frankly, mundane topic requiring great discipline to even take in that portion of the tax bill. But, to the small businessmen these rules are equally as complex, resulting in too often his inability to use a tax approach, LIFO, theoretically available to him.

Subsequent barriers in the code to conversion to LIFO further exacerbates this problem.

I commend this committee's attention to S. 1180, introduced just last week by Senator Mitchell, known as the Inventory Simplification and Reform Tax Act of 1981 that achieves, in the area of inventory valuation, what the depreciation proposals achieve in their area.

It is a comprehensive measure which builds upon the work of the Senate and House Small Business Committees in the area of inventory valuation reform. This legislation is decidedly small business in orientation and has the strong support of a large, diverse number of trade associations including NAM and FIB and SBA, the Chamber of Commerce of the United States, and our organization.

We respectfully submit that it deserves your careful considered examination and in saying this we would urge that you also address the need to eliminate the Draconian retroactive effect of the Thor decision as well as its prospective negative effects building upon the efforts of Senator Moynihan in this regard last year.

Thank you, Mr. Chairman.

Senator SYMMS. Thank you very much and your entire statement will be a part of our record. Mr. Stoll, would you please summarize your statement, if you can, in 5 minutes? Maybe you can give it in 5 minutes.

Mr. STOLL. Mr. Chairman, my name is James A. Stoll. I am chairman-elect of the National Association of Retail Grocers of the United States, NARGUS.

I am a retail food store operator in New Philadelpia, Ohio. NARGUS is the national trade association representing local operators of grocery stores. The association has approximately 40,000 members.

My plan is to make a few brief remarks on the subject of the need of the retail grocers for a tax adjustment.

I begin with the general principle that to preserve the free competitive enterprise system in this country, tax reform must be provided in a way that will encourage, reward risk, promote new and small enterprise, and preserve the open economic system.

Capital formation or the availability of financing is a major problem for many small businesses today. High interest rates and tight money have a major impact. Capital cost recovery is more important than ever before. The tax system plays an important role in determining the rate of capital formation.

President Reagan, in his tax proposal to Congress, has recognized the need for increasing the tax initiatives for investment. The President has recommended an accelerated cost recovery system for commercial buildings, structures, equipment, and machinery that business requires to perform its function.

NARGUS supports the principle of this proposal.

Another tax problem the independent retail grocers have is changing over to last in, first out or LIFO, inventory evaluation system in order to properly compensate for the effects of inflation.

In a period of high inflation, LIFO is necessary to prevent fictitious inflated inventory values falsely appearing as increased profits.

LIFO reflects the current cost of goods sold and tends to minimize inflating profits. Present tax rules allowing small taxpayers to change over to LIFO are much too complicated and too expensive for small concerns.

NARGUS has worked with the Internal Revenue Service for several years in a thus far unsuccessful effort to correct this problem. Legislation is needed.

NARGUS supports simplification of inventory pulling requirements permitting the use of regularly published Government priced indexes and repeal of LIFO conformity requirements.

Another concern of retail grocers is tax simplification. A simpler cost recovery system, not based on such concepts as useful life and salvage value, would enhance taxpayer understanding. Repeal of the complex asset range, ADR system, would result in tax simplification, particularly to the small businesses.

NARGUS supports the Capital Cost Recovery Act commonly known as 10-5-3. The accelerated cost recovery system in S. 683 restricts class 1 investment treatment to buildings and structural components used by their owners.

Under this proposed system, the 15-year life with straight line depreciation is applied to leased buildings and structural components. NARGUS believes that owner-occupied and leased buildings should be under class 1 10-year life and accelerated depreciation.

For a cost comparison of a 10-year accelerated depreciation owner-occupied building with a 15-year straight line leased building, consider the following.

On a building approximately 31,250 square feet costing $1 million and renting for $139,063 per year assuming a corporate tax rate of 46 percent applies, and a 15-percent pretax return on investment, the increased cost of a 15-year life leased building over the 10-year life owner-occupied building would be $244,500 total for the 15-year period or $16,300 per year.

This amounts to substantial tax bias against those businesses occupying property on a leased basis. It would be more equitable if the tax law treated both owner-occupied property and leased property under the 10-year accelerated depreciation class.

In this way, the tax reform objectives of equity and fairness can be met.

In summary, the second need to simplify that LIFO tax regulation to allow LIFO taxpayers to use regularly published Government price indexes such as the Consumer Price Index, CPI, or the Producer Prices and Price Index, PPI.

Current tax regulations have practical effect of requiring many LIFO taxpayers to develop their own LIFO index for each LIFO inventory pull. The best remedy for this problem is to allow taxpayers in LIFO to use regularly published Government price indexes such as the CPI or the PPI.

Thank you very much.

Senator SYMMS. Thank you very much for your excellent statement. Now, Mr. Sullivan.

Mr. SULLIVAN. Mr. Chairman, some of the points that I am going to make have already been made so I will skip through my statement to keep my repetition down as much as I can.

The Food Marketing Institute endorsed the President's program for economic recovery including the spending cuts as well as the tax cuts.

We have one particular concern on the tax side and that is with unequal treatment which the administration proposes for building depreciation based upon whether the occupancy is by an owner or by a tenant.

We believe that depreciation based on occupancy is inequitable, unfair, and introduces a new principle in tax treatment that could lead to massive and unproductive reorientation of the method of doing business.

It presents the committee with a new question on basic tax policy which is, should like structures used for like purposes be denied and deprived of like treatment for tax purposes?

The administration proposes that cars and light trucks be treated equally irrespective of whether used by a lessee or by an owner. Why then is unequal treatment proposed for buildings based upon whether occupancy is by a lessee or by an owner?

Businesses with the financial strength to do so, will own under these proposals. Other businesses, including small businesses, may not have that option and will be faced with a competitive handicap of $27,298 a year. This is using the same example that Mr. Stoll had cited to you.

This does not sound like good tax policy.

One of the objectives of the capital cost recovery program is to simplify depreciation. The proposed treatment based on occupancy runs counter to that objective.

In hearings before the Committee on Ways and Means in the House in July of 1980, another retail association stated, "It would be a mistake to divide the business community into two segments and to provide increased cost recovery allowances for some businesses and not for others."

The witness for that organization perhaps said it best in stating, "These revised depreciation allowances should be available to all businesses, large and small, manufacturing and retailing, on an equal basis to achieve tax neutrality and equality."

We could not agree more. All retailing, including tenant-occupied facilities and owner-occupied facilities should be treated equally. This is especially important if we are to truly achieve the espoused goal of tax neutrality and equality before it can achieve equality with other businesses.

As a basic tax policy, there should be equality between industries, but to the extent that there is inequality it tends to become a little blurred. That is, inequality is sometimes hard to pinpoint because of basic differences between the industries. But, within an industry, unequal tax treatment would quickly become intolerable because it would give advantages to one competitor over another competitor in that same line of business.

Now is not the time to introduce new complexities or inequities, therefore, we urge your support of a 10-year life for all retail structures irrespective of occupancy.

Thank you, Mr. Chairman.

Senator SYMMS. Thank you all three very much. Two very brief questions I would like to ask.

Do all three of you support the Moynihan bill which allows for a 10-year firm to change from the first in, first out class? Do you all support that?

Mr. SULLIVAN. Mr. Chairman, I haven't had a chance to study that bill. We have been working with NARGUS and others for

LIFO reform and I assume that when I have a chance to look at that bill that we will. I gather we will if it follows along the same lines.

Senator Symms. Generally, I certainly support it. I think that is a good principle. I have talked to some local retailers in my State where the situation got so bad they hated to sell their inventory because to replace it they were finding out the more business they were doing, the more broke they were getting literally because of the inventory control and the way the tax agreement was.

Just one other question. On this differential between a 10-year writeoff in accelerated depreciation with recap or 15 years on a straight line with an owner or lease occupied, if you were given a choice on a tax would that take care of the problem? In other words, the taxpayer could decide which schedule they wished to take.

Mr. Stoll. Mr. Chairman.

Senator Symms. Yes?

Mr. Stoll. I believe NARGUS view is that that choice would be acceptable and certainly be an alternative to what is there now.

Senator Symms. How about from FMR's standpoint providing that both taxpayers have that option?

Mr. Sullivan. You won't reach tax equality in that case, but each taxpayer will have had the opportunity to make his own decisions and we think that that would be acceptable.

Mr. Van Dongen. Senator, if I might comment on this and briefly on your previous question as well. I would associate NAW with the views that have been expressed with regard to the option as between the two approaches.

On your previous question, yes, we very strongly support Senator Moynihan's efforts.

Senator Symms. I think you brought it up in your testimony first.

Mr. Van Dongen. Yes, I did sir. I would point out, however, that Senator Mitchell's bill, in addition to addressing the points raised in Senator Moynihan's bill, goes further to the general and systemic reform on inventory valuation procedures per se with one exception and that was the one I eluded to in my testimony and that is to come to grips with both the retroactive and perspective effects of the Thor decision. I would be glad, sir, to provide you with a more detailed analysis on that point.

Senator Symms. I appreciate that very much. Thank you.

Mr. Stoll. Mr. Chairman, I think one of the problems in reference to the LIFO changeover, the inventory evaluation, many small firms of which NARGUS represents a great many, don't have either the funds or the talent within their own organizations to comply with the existing IRS regulations as far as the polling requirements and setting up all these complex indexes and so on.

It appears to NARGUS that some of those procedures could be simplified, that some of the smaller stores could take advantage of what now is almost set aside for the larger more capable firms.

It would be a tremendous advantage to the small independent retailer if they were able to use LIFO valuation method without all the complexities that are now tied to it. It would be a tremendous advantage.

Senator SYMMS. So, I guess that the complication on your inventory is coming from a situation where we have had large amounts of monetary inflation which has brought about these rising prices on inventories that their replacement costs starts throwing them in a cash poor position.

Mr. STOLL. That is correct.

Senator SYMMS. I had one dealer here before the big housing slump hit that told me that it was getting so that he didn't like to sell 2 x 4's and he was running a lumberyard. Every time he sold one he had to pay more money to replace it and he was getting in a situation where he could not afford the inventory replacement because the retail price was hardly keeping up with the wholesale replacement cost. He was having a very difficult time.

I am glad to have all your testimony and I just ask you, Harry, one more question. Do you think there might be the possibility, if the choice were given and there was an accommodation on both sides of this argument, that there may just be some of the retailers in your organization that might make a determination to use the 10-5-3 to be able to start owning property?

Mr. SULLIVAN. I think that all taxpayers would have to run an analysis just as they look at interest rates and a lot of other factors in determining whether to buy or to lease. That very definitely would be one of their considerations. I can't really predict how they would come out—whether they would become owner-occupiers or tend to stay still leasing.

Senator SYMMS. Do you want to comment on that Mr. Stoll?

Mr. STOLL. Yes. In the individual stores that I operate, I am a retail grocer and we operate four supermarkets. We lease all of them. We have a new competitor that opened up and if they would, in fact, own and occupy that building maybe adjacent or in direct competition with one of our units, we then would be at a competitive disadvantage because of the difference in the accelerated as opposed to straight line writeoff methods.

I think as a small business many of us lease our buildings because we don't have the available capital to go out and buy a million dollar structure. It could be a very important point.

Mr. VAN DONGEN. Senator, there is an additional dimension to this that perhaps has not been emphasized the way it should. In the wholesale distribution industry it is prevalent to some extent for the real estate involved to be held separate from the operating corporation notwithstanding the fact that the owners are one and the same.

In many instances, this is a business perpetuation device where from generation to generation the land is placed in the hands of the retiring generation, quite frequently the widow of say the original founder of the business in order to provide her with certain income protection through her lifetime.

To the extent that a circumstance would be created with regard to the difference in depreciation treatment, you may find a disincentive for that type or a barrier for that type of perpetuation device to be utilized to the extent that it is.

Senator SYMMS. Thank you very much. I appreciate it.

Mr. VAN DONGEN. Thank you.

Mr. STOLL. Thank you.

Mr. SULLIVAN. Thank you.

[Statements follow:]

SUMMARY STATEMENT

Dirk Van Dongen, President
National Association of Wholesaler-Distributors
Senate Finance Committee
May 18, 1981

INTRODUCTION

Mr. Chairman, on behalf of NAW's 119 national commodity-line associations and our aggregate 45,000 individual firm members, I would like to commend the efforts of this Committee and the Administration to deal with the serious economic problems facing the American free enterprise system today.

The current economic plight of the predominantly family-owned wholesaler-distributors, brought on by inflation, high interest rates, government spending and government regulation, places a sense of urgency on the need to correct the situation before we pass the "point of no return."

Again, NAW strongly supports the efforts of this Committee to address this issue and the immediacy of its nature.

ADMINISTRATION ECONOMIC RECOVERY PROGRAM

Inflation and Fiscal Responsibility

Business enterprises, including those in wholesale distribution, are undergoing severe strain because of the current continuing high rate of inflation. Interest rates are at an all-time high -- higher not only than those this generation, but several preceding generations have seen. The effect of inflation on wholesale distribution has been the subject of a careful and comprehensive study conducted by the senior faculty at the Graduate School of Business of the University of Michigan. The major conclusion of the study was that nothing would assist in creating an economic climate favorable to capital formation as the halting of the price spiral and the stabilization of the dollar.

High inflation produces significant and, at certain levels, untenable pressures for increased cash flow to support the resultant higher and higher level of investment in inventory and receivables required to maintain the same real level of business activity. Limited access to long-term capital markets, combined with a rapid escalation of interest rates on short-term financing, exacerbate the situation geometrically as the rate of inflation increases.

The effects of inflation on the financial performance of the wholesaler-distributor is a result of a complex process somewhat unique to each firm. Nonetheless, our analysis of the financial performance of

($185). In short, the wholesale distribution industry provides dependable, well-paying jobs throughout the U.S. economy.

Industry sales totaled approximately $955 billion in 1980 and are expected to reach over $1 trillion in 1981, according to United States Commerce Department estimates.

A 1980 profile of the wholesale trade as compiled by the U. S. Department of Commerce from Census Bureau figures shows the following:

SIC CODES: 50-51	
Sales (million $)	955,175
Employment (000)	5,280
Number of establishments (1977)	307,264
Compound annual rate of change, 1975-80:	
Sales (percent)	12.3
Employment (percent)	3.6
Payroll (million $)	72,000

Merchant wholesaler-distributors perform an essential economic function. They make goods and commodities of every description available at the place of need, at the time of need. Wholesaler-distributors purchase goods from producers, inventory these goods, break bulk, sell, deliver, and extend credit to retailers and industrial, commercial, institutional, governmental and contractor business users.

Wholesaler-distributors are essential to the efficient satisfaction of consumer and business needs. Further, by the market coverage which they offer smaller suppliers and the support which they provide to their customers, wholesaler-distributors preserve and enhance competition, the critical safeguard of our economic system. According to an NAW survey, the typical wholesaler-distributor established the market connection between 133 manufacturers and 533 business customers. Many of these manufacturers are themselves small businessmen who must rely on wholesaler-distributors to establish, maintain, and nurture markets for their products. The majority of customers are small businessmen, also, who look to the merchant wholesaler-distributor to provide merchandise availability, credit and other critical services.

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2/ A copy of the full study has been provided to your staff separately as it is too lengthy to be included in the record.

Individual Tax Reductions To Stimulate Savings and Investments

NAW strongly supports legislation that would reduce the tax burden on individuals and would encourage investments and savings. Moreover, we recognize that most small businesses are unincorporated and are thus subject to individual tax rate structure. S 683 would greatly benefit these small businesses. For these reasons, we strongly support the Administration's multiyear 10% tax reduction proposal. Since these small unincorporated businesses form the bulk of a wholesaler-distributor's customer base (retailers) their financial well being as well as that of their suppliers is as important to a wholesaler-distributor as his own.

Regulatory Reform

NAW strongly supports the Administration's efforts to reduce the cost, burden, and intrusion of government regulatory efforts that are unnecessary, duplicative, ineffective, inefficient, or simply not justified on the basis of benefits provided as set forth in President Reagan's Executive Order EO12291 and S 1080, introduced by Senator Paul Laxalt (R-NV) and 75 other co-sponsors.

We also recognize the efforts of the House in this regard and support similar efforts to achieve the same results.

"SECOND-TRACK" ADMINISTRATION TAX REDUCTION BILL

Based on the representations of Administration officials, NAW urges this Committee to maintain the integrity of S 683, the assumption being that a subsequent tax reduction bill will be offered by the Administration which will address the other "priority" capital formation/retention problems facing business.

It is with this in mind that NAW offers the following recommendations for inclusion in the second tax bill:

1. Corporate Rate Reductions
   Because of the asset structure of the wholesaler-distributor, a reduction in the corporate income tax rate would provide the most significant and immediate increase in cash flow and, thus, internally generate working capital. The corporate tax rate should be reduced as reflected in S 360, S 394, HR 2245 or HR 2949.

2. Inventory Valuation Simplification and Reform

   Closely following the above in importance is the need to facilitate and simplify the utilization of LIFO inventory procedures by wholesaler-distributors and to reform the lower of cost or market inventory method for those who use the FIFO inventory method. Rapid inflation results in the overstatement of profits for firms which do not utilize LIFO valuation procedures. This is particularly significant for wholesaler-distributors because over 40% of their investment is in inventory. While a significant and growing proportion of the industry is utilizing LIFO, steps can and should be taken to simplify its utilization by wholesaler-distributors and other small businesses so that procedural complexities do not penalize these companies. In this regard, NAW supports S 578, S 360, S 1180, HR 2319, and HR 3202.

3. Estate Tax Reform

Since most wholesaler-distributor companies are family-owned, estate tax reform is essential for their continued existence and independence. In this regard, NAW strongly supports the repeal of all the estate tax provisions in the Internal Revenue Code. In the alternative, NAW supports an increase in the estate tax exemption, a revision of the estate tax brackets necessitated by inflation, an easing of the stringent payment requirements under the Code, and the passing of a family-owned business to a surviving spouse or children on a tax-free basis. S 404, introduced by Senator Symms, would repeal the estate tax laws; S 360 and S 1140 address the alternate.

4. Rehabilitation Tax Credit for Structures

The investment tax credit should be increased to provide a 25% credit for rehabilitation of 20-year-old structures rather than the current 10%. In so doing, the investment tax credit would be made much more valuable to wholesaler-distributors whose warehouses are typically located in urban areas. S 360, S 317 and S 394 specifically address the issue.

5. Used Machinery Tax Credit

The limitation on the amount of used machinery eligible for the investment tax credit should also be lifted. For wholesaler-distributors and other small businesses, used equipment is often the only equipment they can afford to purchase. Moreover, facilitating the purchase of used machinery by liberalizing the ability to take the investment tax credit against such purchases will facilitate the purchase of new equipment by those who must dispose of used equipment. Should the Congress determine that a dollar limitation on the amount of used machinery eligible for the credit be maintained, we would urge its increase to $300,000 from the present $100,000, and the application of a carryover/carryback approach of some magnitude. S. 360, S 317, S 394, S 1140, and HR 3202 address this issue.

FULL STATEMENT

Mr. Chairman, Members of the Committee, this statement is presented on behalf of the wholesale distribution industry by the National Association of Wholesaler-Distributors. My name is Dirk Van Dongen, President of NAW.

Mr. Chairman, I would like to begin by commending this Committee and the Administration on cooperating to deal with the serious economic problems facing the American free enterprise system today.

The current economic plight of family-owned wholesaler-distributors, brought on by inflation, high interest rates, government spending and government regulation, places a sense of urgency on the need to correct the situation before we pass the "point of no return."

Again, NAW strongly supports the efforts of the Committee to address this issue and the immediacy of its nature.

NAW

The National Association of Wholesaler-Distributors is a federation of 119 national wholesale distribution associations[1] which have an

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[1] Appendix A.

aggregate membership of approximately 45,000 wholesaler-distributors, with 125,000 places of business. The members of our constituent associations are responsible for 60% of the $1 trillion of merchandise which will flow through wholesale channels this year, according to the Commerce Department. They employ a comparable percentage, or 2.5 million, of the 4 million Americans who work in wholesale trade. Thus, although the individual firms which our organization represents are small- to medium-sized businesses individually, their collective economic importance is most significant.

The Industry

The wholesale distribution industry, in contrast to the manufacturing sector of the economy, continues to be dominated by small- to medium-sized, closely held, family-owned businesses. Of the 238,000 merchant wholesaler-distributor corporations filing tax returns in 1977, 99% had assets of $10 million or less. These smaller firms accounted for about 58% of the industry's sales volume. In contrast, in the manufacturing sector, approximately 2% of the firms controlled about 88% of the assets and accounted for approximately 80% of sales.

The wholesale distribution industry provides year-round employment for over 4 million individuals. In 1977, average hourly earnings ($6.78) in wholesale trade exceeded those for all private industry ($5.14), while average weekly earnings ($212) were 15% above those in private industry

($185). In short, the wholesale distribution industry provides dependable, well-paying jobs throughout the U.S. economy.

Industry sales totaled approximately $955 billion in 1980 and are expected to reach over $1 trillion in 1981, according to United States Commerce Department estimates.

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Wholesaler-distributors are essential to the efficient satisfaction of consumer and business needs. Further, by the market coverage which they offer smaller suppliers and the support which they provide to their customers, wholesaler-distributors preserve and enhance competition, the critical safeguard of our economic system. According to an NAW survey, the typical wholesaler-distributor established the market connection between 133 manufacturers and 533 business customers. Many of these manufacturers are themselves small businessmen who must rely on wholesaler-distributors to establish, maintain, and nurture markets for their products. The majority of customers are small businessmen, also, who look to the merchant wholesaler-distributor to provide merchandise availability, credit and other critical services.

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2/ A copy of the full study has been provided to your staff separately as it is too lengthy to be included in the record.

conclusion of the study was that nothing would assist in creating an economic climate favorable to capital formation as the halting of the price spiral and the stabilization of the dollar.

Briefly summarizing the findings, the study shows that a typical wholesale distribution enterprise is engaged in the function of procuring inventory from suppliers, warehousing same, and reselling the merchandise or equipment involved in smaller quantities to retailers, and business, industrial, professional, and institutional customers, typically, extending credit in the process. Because of the nature of his business, 80% of the wholesaler-distributor's assets are, on average, used in support of inventory and accounts receivable, with the balance of the asset base composed of plant and equipment, of which warehouse facilities comprise the major share. As a consequence, wholesaler-distributors "turn" their assets much more frequently than enterprises characterized by heavy investment in fixed assets such a manufacturers and, thus, feel the impact of inflation in an extremely immediate manner.

High inflation produces significant and, at certain levels, untenable pressures for increased cash flow to support the resultant higher and higher level of investment in inventory and receivables required to maintain the same real level of business activity. Limited access to long-term capital markets, combined with a rapid escalation of interest rates on short-term financing, exacerbate the situation geometrically as the rate of inflation increases.

This progressively degenerating situation is readily apparent if one examines the process by which inflation affects the wholesaler-distributor's financial performance. Theoretical support for the results of this process is detailed in the complete study.

Inflation seriously reduces the ability of the wholesaler-distributor to finance current levels of business activity and, in many cases, virtually precludes real growth. The situation is made worse for firms which (1) use FIFO inventory procedures; (2) lag price increases behind cost increases; (3) experience excessive interest rates due to lenders overestimating the inflation rate.

The wholesale distribution industry is characterized by a high degree of competition in the absence of concentration. The largest firms in the industry control relatively small shares of market nationally and regionally. Even in individual metropolitan areas there is marked absence of concentration. As a result of this strongly competitive environment, profitability in wholesale distribution has historically been moderate, capital accumulation has been limited; and the potential damaging effects of inflation, especially on the marginal firm, are severe.

The effects of inflation on the financial performances of the wholesaler-distributor are a result of a complex process somewhat unique to each firm. Nonetheless, our analysis of the financial performance of wholesaler-distributors in an inflationary environment reveals that inflation does affect financial performance with the very real consequence that wholesaler-distributors are suffering capital erosion, reduction of liquidity, overstatement of profit, and overpayment of taxes.

Inflation also results in management decisions contrary to the long-term self-interest of the firm and of the economy in general, but necessitated by immediate circumstance. Wholesaler-distributor investment policy becomes altered in times of high inflation with inflation very clearly tending to reduce the growth orientation of the industry. In times of high inflation, the focus of management in wholesale distribution, and indeed its major preoccupation, becomes the financing of working capital needs to sustain present levels of activity. Growth in real terms is postponed by the consequence of high inflation, resulting in less employment than would otherwise be the case in the industry, and contributing itself to the inflationary process as demand goes unmet because expansion is foregone. The data collected in our study clearly demonstrate that in times of high inflation, a survival strategy rather than a growth strategy is mandated.

No single factor has been the cause of inflation more than deficit spending by the federal government. During the past twenty-five years, we have had a balanced budget in only four years. Therefore, before any changes in taxes or other federal measures are adopted, we believe a balanced federal budget must be made the first priority. In this regard, NAW notes with great interest the purposeful and responsible way in which this Committee is dealing with the tax reductions proposed by the Administration in relation to action on the spending cuts.

Conscientious interface and balance between the two processes is absolutely necessary in order to achieve the ultimate objective of a recapitalized and revitalized economy.

There are only two ways to end federal deficit spending: either increase taxes or decrease spending. We believe that the federal government already consumes too large a portion of the gross national product. Every dollar taken from a wage-earner or a business for government spending is one dollar less that individual or business can spend in a manner that would bring the greatest benefit to that taxpayer. No amount of government spending can achieve prosperity; additional government spending can lead only to increased inflation. Both the Senate and House have already spoken and NAW is confident that these actions will contribute significantly to a reduction in the inflation and interest rates.

NAW strongly supports the Administration's economic recovery proposal as it relates to government spending and balancing the federal budget.

Business Tax Reductions To Stimulate Modernization

Accelerated cost recovery. There is an urgent need for wholesaler-distributors to be able to depreciate their fixed assets on the basis of replacement costs rather than useful life. The current limitation on depreciation means that wholesaler-distributors are overpaying their taxes as the Tax Code fails to recognize the true cost of obsolescence of facilities and equipment. Because of this, NAW strongly supports S 683, the Administration's economic recovery system, particularly as it relates to accelerated depreciation. For the wholesale distribution industry, as well as other sectors of the economy with comparable asset bases, this proposal, allowing the depreciation of owner-used structures over 10 years, is the most applicable and, thus, the most important aspect of the proposal. An illustration of how this proposal impacts on the wholesale distribution industry, particularly in terms of cash flow, is set forth below:

Structures -- 10-year depreciation for owner-used warehouses and industrial buildings.

Assume that a newly acquired warehouse with a depreciable basis of $1,000,000 has an estimated useful life of 60 years and negligible salvage value. The following table shows the annual depreciation allowances under the 10% straight line rate, the 20% double declining balance rate, the sum-of-year's digits method, and the Administration's proposal. The table also shows the increased cash flow resulting from the Reagan proposal.

YEAR	10% straight line	20% declining balance	Sum of the year's digits	Adm proposal	Minimum cash flow increase/yr
1	16,667	33,334	32,787	100,000	+ 66,666
2	16,667	32,223	31.712	180,000	+147,777
3	16,667	31,148	30,672	160,000	+128,852
4	16,667	30,109	29,667	140,000	+109,891
5	16,667	29,106	28,694	120,000	+ 90,894
6	16,667	28,136	27,753	100,000	+ 71,864
7	16,667	27,198	26.843	80,000	+ 52,802
8	16,667	26,291	25.963	60,000	+ 33,709
9	16,667	25,415	25.112	40,000	+ 14,585
10	16.667	24,568	24,288	20,000	+ 4,568
TOTAL	166,670	289,461	283.491	1,000,000	+721,608

Note that under the Administration's proposal, 80% of the structure is written down by year 7.

The 1245 recapture provision under the Administration's proposal does not cause wholesaler-distributors much concern. Historically, wholesaler-distributors tend to retain their warehouses rather than sell them and build replacements. However, they do construct new additional warehouses from time to time to follow the movement of their customer base (primarily retailers) as it concentrates outside the larger metropolitan areas.

In terms of tax savings, S 683 can reduce the taxable income by 98% of a wholesaler-distributor with annual gross sales of $5 million and net taxable income of $150,000 in year 2 of the ACCRS. The percentage will vary to lesser degrees over the 10-year period. However, the average tax savings over the entire 10-year period is 48%!

There has been considerable discussion lately on the pros and cons that any depreciation proposal should be "neutral" in its application; that is, a proposal would not favor owner-occupied over leased, nor long-lived assets over short-lived.

These arguments have been embodied in such proposals as Jorgensen-Auerbach and in those which would use a 15-, 18-, or 20-year straight line depreciation for all industrial and commercial buildings regardless of their owner-occupied or leased status.

Using the same example as set forth above, the following charts detail the impact these proposals would have on cash flow as compared with S 683. Note, as with the President's proposal, component accounting would be eliminated; however, unlike the President's offering, the 15-, 18-, and 20-year proposals do not have an accelerated aspect to them; and thus, the elimination of component accounting, coupled with the straight line method, would decrease the rate of depreciation for those structural components not currently subject to the straight line depreciation rates of structures, but eligible for the double-declining balance or sum-of-the-year's digits methods.

For example, under the component depreciation method, a wholesaler-distributor may allocate the cost of a building to its basic component parts (shell, plumbing, heating, roof, etc.) and then assign separate useful lives to those components. This would have the effect of shortening the depreciation life of the building and increasing the depreciation deduction. This is reflected in current Treasury statistics which give warehouses a 60-year useful life; the average life claimed by a wholesaler-distributor, however, is 37 years.

DEPRECIATION RATES
(Comparison Chart for Warehouses)
($1,000,000 depreciable basis)

RATE	AMOUNT($)	Annual Cash Flow Increases over Current	Total Cash Flow Increases over Current	Cash Flow Difference (±) To Admin. Proposal
Current (SL) (60 years)	16,667	-----	-----	-$554,938
15 years (SL)	66,666	49,999	749,995	- 89,335
18 years (SL)	55,555	38,888	699,994	- 139,336
20 years (SL)	50,000	33,333	666,660	- 172,670
Admin. Proposal*	See Chart Below	See Chart Below	839,330	-----

YEAR	Current (SL) Amount	Administration Proposal*	Annual Cash Flow Increase over Current
1	16,667	100,000	83,333
2	16,667	180,000	163,333
3	16,667	160,000	143,333
4	16,667	140,000	123,333
5	16,667	120,000	103,333
6	16,667	100,000	83,333
7	16,667	86,000	69,333
8	16,667	60,000	43,333
9	16,667	40,000	23,333
10	16,667	20,000	3,333
TOTALS	166,670	1,000,000	839,330

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*It should be noted that the Administration proposal is an accelerated rate as compared with the other rates which are straight-line rates.

Jorgensen-Auerbach
Depreciation Rate
($1,000,000 Warehouse Depreciable Basis)

Asset	First Year Allowance	Year	Depreciation Allowed ($)	Tax Benefit Assuming a 46% Rate
Industrial	.037(No ITC)	1	$370,000	$170,200

Without arguing the merits of these proposals, suffice it to say that NAW supports the President's depreciation proposal (S 683) because it strikes a reasonable balance between all these competing theories. It recognizes the realities of inflation by using replacement value over the obsolete useful life concept. It significantly increases cash flow in the structures area by reducing and accelerating the depreciation life of buildings, thus stimulating moderization, growth and productivity. Further, it distinguishes between owner-occupied (used) and leased structures, a distinction which is of great benefit to the small, family-owned wholesaler-distributor; however, the distinction (5 years) is not significant enough in our minds to have a detrimental impact on those in the industrial, commercial, construction and real estate markets. Finally, it gives flexibility and certainty to the tax and business planning decisions of wholesaler-distributors as opposed to requiring the depreciation to be taken in the 1st year.

In short, we strongly support S 683!

Reduce Federal Regulation of Business

Our members bear a tremendous burden in complying with a multitude of regulations which have very limited benefit to the economy and to the quality of life. Despite all the current discussions about deregulation, government regulatory agencies and executive departments continue their endless stream of detailed regulations covering every minutia of business activity. Owners and managers of many businesses do not have legal departments to monitor the flood of compliance requirements contained in the Federal Register five days a week, every week of the year. We support the President's effort to review these regulations and the reporting requirements that accompany them. We also recommend vigorous congressional action to reduce costly, unnecessary, and burdensome regulations and reporting requirements imposed on business. Specifically, NAW supports cost-benefit (economic) analysis, and the mandatory sunsetting of federal regulations, regulatory agencies, and programs.

Moreover, NAW urges strong congressional oversight to ensure proper and quick implementation of the Regulatory Flexibility and the Paperwork Reduction Acts which were enacted in 1980.

In this regard, we strongly support S 1080, introduced by Senator Paul Laxalt (R-NV) and 75 other co-sponsors.

Individual Tax Rate Reductions To Stimulate Savings and Investments

NAW strongly supports legislation that would reduce the tax burden on individuals and would encourage investments and savings. Moreover, the provisions set forth in S 683 would greatly benefit small business since most small businesses are unincorporated and thus pay taxes on an individual rate basis. This is extremely important to wholesaler-distributors from the standpoint of providing tax relief to their customers (typically unincorporated retail firms). The maintainence of a healthy supplier and customer base is as important to wholesaler-distributors as their own financial well being. For this reason, NAW strongly supports the Administration's multiyear 10% proposal as set forth in S 683.

"SECOND-TRACK" ADMINISTRATION TAX REDUCTION BILL

Based on the representations of Administration officials, NAW urges this Committee to maintain the integrity of S 683, the assumption being that a subsequent tax reduction bill will be offered by the Administration which will address the other "priority" capital formation/retention problems facing the wholesale distribution industry.

It is with this in mind that NAW offers the following recommendations to this Committee for inclusion in that second tax bill:

1. Corporate Rate Reductions

Because of the asset structure of the wholesaler-distributor, a reduction in the corporate income tax rate would provide the most significant and immediate increase in cash flow and, thus, internally generate working capital. The corporate tax rate should be reduced in the manner reflected in S 360, S 394, HR 2245 or HR 2949. An analysis of the impact of the corporate rate reduction in these proposals on the wholesale distribution industry is attached as "Appendix B".

2. Inventory Valuation Simplification and Reform

Closely following the above in importance is the need to facilitate and simplify the utilization of LIFO inventory procedures by wholesaler-distributors and to reform the lower of cost or market inventory method for those who use the FIFO inventory method. Rapid inflation results in the overstatement of profits for firms which do not utilize LIFO valuation procedures. This is particularly significant for wholesaler-distributors because over 40% of their assets is invested in inventory. While a significant and growing proportion of the industry is utilizing LIFO, steps can and should be taken to simplify its utilization by wholesaler-distributors and other small businesses so that procedural complexities do not penalize these companies. In this regard, NAW supports S 578, S 360, S 1180, HR 2319, and HR 3202.

3. Estate Tax Reform

Since most wholesaler-distributor companies are family-owned, estate tax reform is essential for their continued existence and independence. In this regard, NAW supports the repeal of all estate tax provisions in the Internal Revenue Code. In the alternative, NAW supports an increase in the estate tax exemption, a revision of the estate tax brackets necessitated by inflation, an easing of the stringent payment requirements under the Code, and the passing of a family-owned business to a surviving spouse or children on a tax-free basis. S 404 would repeal the estate tax laws, and S 360 and S 1140 would address the alternate.

4. Rehabilitation Tax Credit for Structures

The investment tax credit should be increased to provide a 25% credit for rehabilitation of 20-year-old structures. In so doing, the investment tax credit would be made much more valuable to wholesaler-distributors. S 360, S 317 and S 394 specifically address the issue. Since most wholesaler-distributor warehouses are located in urban areas and are over 20 years old, this would greatly assist in the modernization of those structures.

5. Used Machinery Tax Credit

The limitation on the amount of used machinery eligible for the investment tax credit should also be lifted. For wholesaler-distributors and other businesses, used equipment is often the only equipment they can afford to purchase. Moreover, facilitating the purchase of used machinery by liberalizing the ability to take the investment tax credit against such purchases will facilitate the purchase of new equipment by those who must dispose of used equipment. Should the Congress determine that a dollar limitation on the amount of used machinery eligible for the credit be maintained, we would urge its increase to $300,000 from the present $100,000, and the application of a carryover/carryback approach of some magnitude. S 360, S 317, S 394 HR 2949 and HR 3202 address this issue.

Conclusion

Mr. Chairman, this concludes my statement on behalf of NAW and the wholesale distribution industry. I want to express my appreciation to the Committee for this opportunity to discuss the economic situation in wholesale distribution. I hope that the information which I have presented will contribute to your deliberations in a meaningful way.

I cannot urge you enough to act quickly, but responsibly, to correct the disastrous economic environment that confronts business and individuals today.

The future of our free enterprise system and the entrepreneurial spirit which it embodies are depending upon you.

APPENDIX A

National Wholesaler-Distributor Organizations
Affiliated with the National Association of Wholesaler-Distributors

Air-conditioning & Refrigeration Wholesalers
American Dental Trade Association
American Jewelry Distributors Association
American Machine Tool Distributors' Association
American Supply Association
American Surgical Trade Association
American Traffic Services Association
American Veterinary Distributors Association
Appliance Parts Distributors Association, Inc.
Associated Equipment Distributors
Association of Footwear Distributors
Association of Steel Distributors
Automotive Service Industry Association
Aviation Distributors & Manufacturers Association

Bearing Specialists Association
Beauty & Barber Supply Institute, Inc.
Bicycle Wholesale Distributors Association, Inc.
Biscuit & Cracker Distributors Association

Ceramic Tile Distributors Association
Ceramics Distributors of America
Cooperative Food Distributors of America
Copper & Brass Servicenter Association
Council for Periodical Distributors Association
Council of Wholesale-Distributors
American Institute of Kitchen Dealers

Distributors Council, Inc.
Door & Hardware Institute
Drug Wholesalers Association

Electrical-Electronics Materials Distributors Assn.
Explosive Distributors Association, Inc.

Farm Equipment Wholesalers Association
Flat Glass Marketing Association
Fluid Power Distributors Association, Inc.
Food Industries Suppliers Association
Foodservice Equipment Distributors Association
Foodservice Organization of Distributors

General Merchandise Distributors Council

Hobby Industry Association

International Ceramic Association
The Irrigation Association
Institutional & Service Textile Distributors Association, Inc.

Laundry & Cleaners Allied Trades Association

Machinery Dealers National Association
Mass Merchandising Distributors Association
Material Handling Equipment Distribution Association
Monument Builders of North America-Wholesale Div.
Motorcycle Industry Council
Music Distributors Association

National-American Wholesale Grocers' Association
National Appliance Parts Suppliers Association
National Association of Aluminum Distributors
National Association of Brick Distributors
National Association of Chemical Distributors
National Association of Container Distributors
National Association of Decorative Fabric Distributors
National Association of Electrical Distributors
National Association of Fire Equipment Distributors
National Association of Floor Covering Distributors
National Association of Manufacturing Opticians
National Association of Marine Services, Inc.
National Association of Meat Purveyors
National Association of Plastics Distributors
National Association of Recording Merchandisers, Inc.
National Association of Service Merchandising
National Association of Sporting Goods Wholesalers
National Association of Textile & Apparel Distributors
National Association of Tobacco Distributors
National Association of Writing Instrument Distributors
National Beer Wholesalers Association
National Building Material Distributors Association
National Business Forms Association
National Candy Wholesalers Association
National Commercial Refrigeration Sales Association
National Electronic Distributors Association
National Fastener Distributors Association
National Food Distributors Association
National Frozen Food Association
National Independent Bank Equipment Suppliers Assn.
National Industrial Belting Association
National Industrial Glove Distributors Association
National Lawn & Garden Distributors Association
National Locksmiths' Suppliers Association
National Marine Distributors Association
National Paint Distributors, Inc.
National Paper Trade Association, Inc.
National Plastercraft Association
National Sash & Door Jobbers Association
National School Supply & Equipment Association
National & Southern Industrial Distributors Associations
National Spa and Pool Institute
National Truck Equipment Association
National Welding Supply Association
National Wheel & Rim Association
National Wholesale Druggists' Association
National Wholesale Furniture Association
National Wholesale Hardware Association
Northamerican Heating & Airconditioning Wholesalers
North American Wholesale Lumber Association, Inc.

Optical Laboratories Association

Pet Industry Distributors Association
Petroleum Equipment Institute
Power Transmission Distributors Association, Inc.

Safety Equipment Distributors Association, Inc.
Scaffold Industry Association
Shoe Service Institute of America
Specialty Tools & Fasteners Distributors Association
Steel Service Center Institute

Toy Wholesalers' Association of America

United Pesticide Formulators & Distributors Association

Wallcovering Distributors Association
Warehouse Distributors Association for
Leisure & Mobile Products
Watch Materials & Jewelry Distributors Association
Water and Sewer Distributors Association
Wholesale Florists & Florist Suppliers of America
Wholesale Stationers' Association
Wine & Spirits Wholesalers of America, Inc.
Wood Heating Alliance
Woodworking Machinery Distributors Association

APPENDIX B

ANALYSIS OF IMPACT
OF PROPOSED CORPORATE RATE REDUCTIONS
ON THE WHOLESALE DISTRIBUTION INDUSTRY

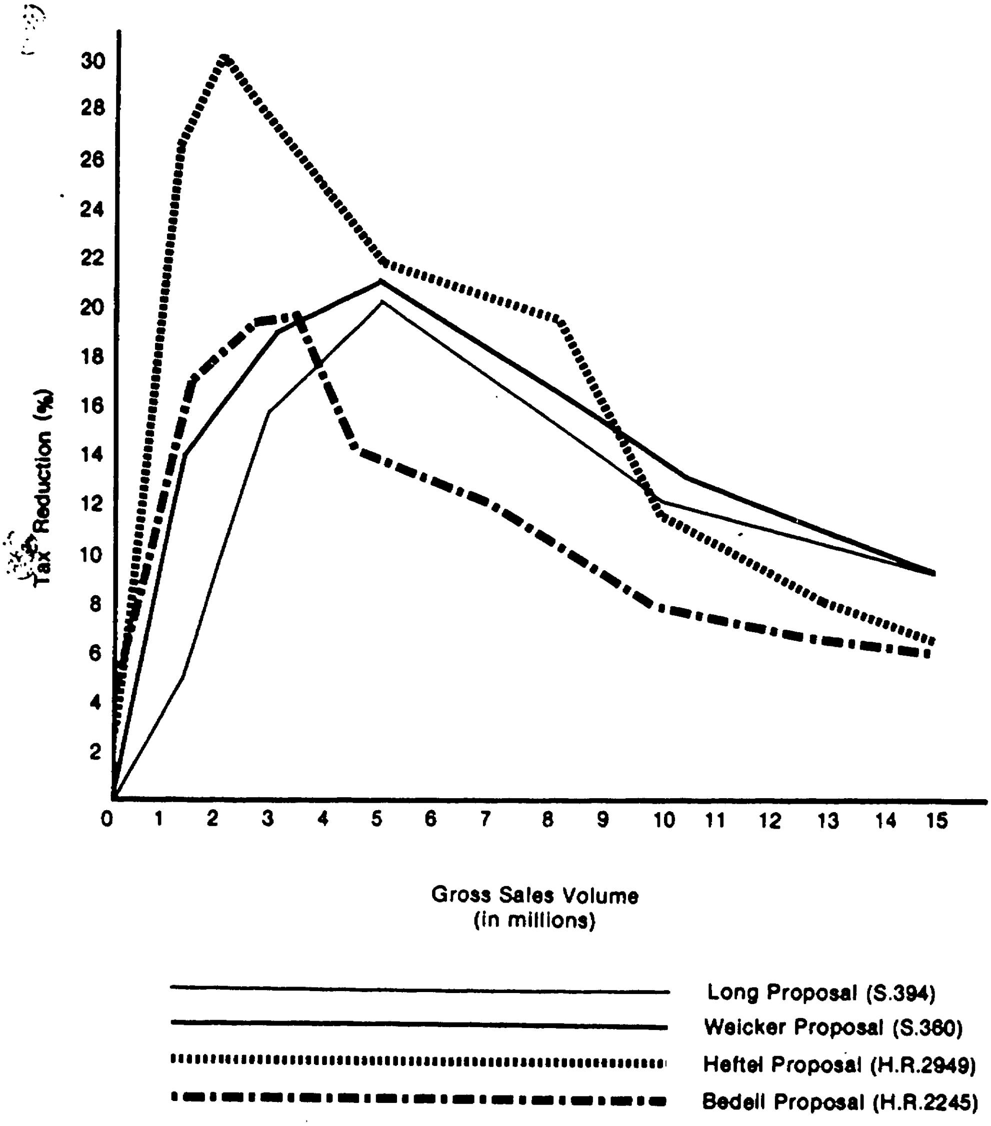
A. INCOME AND RATES

	Taxable Income	Rate (%)
1. Current	$ 0- 25,000	17
	25,000- 50,000	20
	50,000- 75,000	30
	75,000-100,000	40
	over 100,000	46
2. Weicker Proposal (S. 360)	$ 0- 25,000	15
	25,000- 50,000	17
	50,000- 75,000	25
	75,000-100,000	30
	100,000-150,000	35
	150,000 200,000	40
	over 200,000	44
3. Long Proposal (S.394)	$ 0- 25,000	15
	25,000- 50,000	20
	50,000- 75,000	25
	75,000-100,000	30
	100,000-150,000	35
	150,000-200,000	40
	over 200,000	44
4. Heftel Proposal (H.R.2949)	$ 0-25,000	12
	25,000-50,000	15
	50,000-75,000	20
	75,000-100,000	30
	100,000-150,000	40
	150,000-200,000	43
	200,000-250,000	45
	over 250,000	46
5. Bedell Proposal (H.R.2245)	$ 0-25,000	15
	25,000-50,000	18
	50,000-75,000	24
	75,000-100,000	33
	100,000-250,000	43
	250,000-500,000	45
	over 500,000	46

B. COMPARISON CHART

		TAXES					TAX REDUCTION							
							(Dollars)				(%)			
Gross Sales (millions)	Taxable Income	Current	Weicker	Long	Heftel	Bedell	Weicker	Long	Heftel	Bedell	Weicker	Long	Heftel	Bedell
1.5	$ 50,000	$ 9,250	$ 8,000	$ 8,750	$ 6,750	$ 7,750	$ 1,250	$ 500	$ 2,500	$ 1,500	14	5	27	16
	75,000	16,750	14,250	15,000	11,750	13,750	2,500	1,750	5,000	3,000	15	10	30	18
3.0	100,000	26,750	21,750	22,500	19,250	22,000	5,000	4,250	7,500	4,750	19	16	28	18
5.0	150,000	49,750	39,250	40,000	39,250	43,500	10,500	9,750	10,500	6,250	21	20	21	13
	200,000	72,750	59,250	60,000	60,000	65,000	13,500	12,750	12,750	7,750	19	18	19	11
10.0	300,000	118,750	103,250	104,000	106,250	109,000	15,500	14,750	12,500	9,750	13	12	11	8
	400,000	164,750	147,250	148,000	152,250	154,000	17,500	16,750	12,500	10,750	11	10	8	7
15.0	500,000	210,750	191,250	192,000	198,250	199,000	19,500	18,750	12,500	11,750	9	9	6	6

G. GRAPH OF TAX REDUCTION IN TERMS OF GROSS SALES



STATEMENT

ON

S. 683

BY

JAMES A. STOLL, CHAIRMAN-ELECT

NATIONAL ASSOCIATION OF RETAIL GROCERS OF THE UNITED STATES

BEFORE

SENATE FINANCE COMMITTEE

MAY 18, 1981

My name is James A. Stoll. I am Chairman-Elect of the National Association of Retail Grocers of the United States (NARGUS). I am a retail food store operator in New Philadelphia, Ohio. NARGUS is a national trade association representing local operators of grocery stores. The association has approximately 40,000 members.

My plan is to make a few brief remarks on the subject of the need of retail grocers for tax adjustments.

I begin with the general principle that to preserve the free competitive enterprise system in this country, tax reform must be provided in a way that will encourage initiative, reward risk, promote new and small enterprise, and preserve the open economic system.

Capital formation, or the availability of financing, is a major problem for many small businesses today. High interest rates and tight money have a major impact. Capital cost recovery is more important than ever before. The tax system plays an important role in determining the rate of capital formation.

One of the country's major tasks is to promote more capital investment. This will increase productivity and economic growth, and help bring about a higher standard of living for every citizen.

President Reagan, in his tax proposal to Congress, has recognized the need for increasing the tax incentives for investment. The President has recommended an accelerated cost recovery system for commercial buildings, structures, equipment, and machinery that business requires to perform its function. NARGUS supports the principle of this proposal.

Another tax problem independent retail grocers have is changing over to the last in - first out (LIFO) inventory valuation system in order to properly compensate for the effects of inflation. In a period of high inflation, LIFO is necessary to prevent fictitious inflated inventory values falsely appearing to increase profits. LIFO reflects the current cost of goods sold and tends to minimize inflating profits.

Present tax rules allowing small taxpayers to change over to LIFO are much too complicated and too expensive for small concerns. NARGUS has worked with the Internal Revenue Service for several years in a thus far unsuccessful effort to correct this problem. Legislation is needed.

NARGUS supports simplification of inventory pooling requirements, permitting the use of regularly published government price indexes, and repeal of LIFO conformity requirement.

Revision of this country's tax laws to remove barriers against investment is, by general agreement, one of the most basic economic needs today. The President has responded to this need through introduction of S. 683.

Members of Congress have considered the issues of accelerated capital cost recovery for many years. The Congress has devoted considerable energies to investigating, and reviewing measures aimed at dealing with the problem of inadequate capital formation as it relates to small business.

The need for a more adequate capital cost recovery system is made much greater by inflation. In a period of inflation, businesses in general, and small businesses in particular, pay taxes on capital disguised as income to the extent inflation causes an overstatement of business profits. In the case of depreciation, allowances on existing plant and equipment are understated because of the inflation factor.

Another concern of retail grocers is tax simplification. A simpler cost recovery system not based on such concepts as useful life and salvage value would enhance taxpayer understanding. Repeal of the complex Asset Depreciation Range (ADR) system would result in tax simplification, particularly to small businesses.

NARGUS supports the Capital Cost Recovery Act familiarly known as 10-5-3.

The legislation would establish three classes of capital investment as follows:

Class I	ten years - generally applicable to all investment in buildings and structural components of buildings.
Class II	five years - generally applicable to investment in tangible property other than that included in Class I or Class III.

Class III three years - applicable to investment in automobiles and light duty trucks.

The accelerated cost recovery system in S. 683 restricts Class I investment treatment to buildings and structural components used by their owners. Under this proposed system, a 15 year life with straight-line depreciation is applied to leased buildings and structural components. NARGUS believes that owner-occupied and leased buildings should be under Class I ten year life and accelerated depreciation.

For a cost comparison of a 10 year accelerated depreciation owner-occupied building with a 15 year straight-line depreciation leased building consider the following: On a building (approximately 31,250 square feet) costing $1,000,000 and renting for $139,063 per year, assuming a corporate tax rate of 46 percent applies and a 15 percent pre-tax return on investment, the increased cost of a 15 year life leased building over the 10 year life owner-occupied building would be $244,500 total over the 15 year period, or $16,300 per year. This amounts to a substantial tax bias against those businesses occupying property on a leased basis. It would be more equitable if the tax law treated both owner-occupied property and leased property under the 10 year accelerated depreciation class. In this way, the tax reform objectives of equity and fairness can be met.

The second tax area where NARGUS urges action concerns the last-in first-out (LIFO) method of inventory valuation.

NARGUS supports simplified inventory pooling requirements by allowing a LIFO taxpayer to elect to place items of inventory in pools according to customary business or department classifications used in the taxpayer's business. Requiring excessive LIFO inventory pool is unnecessary and costly. Legislation is needed to simplify pooling requirements by allowing a taxpayer to use LIFO inventory pools according to customary business classifications.

A second need is to simplify LIFO tax regulations to allow LIFO taxpayers to use regularly published government price indexes, such as the Consumer Price Index (CPI), or the Producer Prices and Price Indexes (PPI). Current tax regulations have the practical effect of requiring many LIFO taxpayers to develop their own LIFO index for each LIFO inventory pool. Constructing an internal company LIFO index for each LIFO pool is expensive and complicated. Few taxpayers, except the largest, can afford to do so.

The best remedy for this problem is to allow taxpayers on LIFO to use regularly published government price indexes, such as the Consumer Price Index (CPI) or the Producer Prices and Price Indexes (PPI).

Under the last-in first-out (LIFO) method of inventory valuation, the cost of inventory sold is valued at the price of the latest goods added to the same inventory pool. During a period of inflation, using LIFO increases the cost of goods sold and decreases taxable profits. Actual profits remain the same. In the last few years, many businesses have turned to LIFO to value their inventory. However, small taxpayers have difficulty meeting the complicated LIFO tax regulations.

This is why legislation is needed allowing LIFO taxpayers to use either the Consumer Price Index (CPI) or the Producer Prices and Price Increases (PPI) to measure price change for each dollar value LIFO pool, and to use LIFO inventory pools in accordance with customary business classifications followed in the trade or business of the taxpayer.

Statement on
the Administration's Tax Reduction Proposals

by

Harry Sullivan

Senior Vice President and General Counsel

Food Marketing Institute

Mr. Chairman, we appreciate the opportunity to provide you and the Committee with Food Marketing Institute's views on the business tax portion of the President's Program for Economic Recovery.

The Food Marketing Institute (FMI) is a non-profit association that conducts programs in research, education and public affairs on behalf of its 1100 members -- food wholesalers and retailers and their customers in the United States and overseas. FMI's domestic member companies operate over 17,000 retail food stores with a combined annual sales volume of $100 billion -- half of all grocery sales in the United States. More than three-fourths of FMI's membership is comprised of independent supermarket operators or small regional firms.

Food Marketing Institute endorses the President's Program for Economic Recovery including certain specific cuts in spending in which our members have a direct economic interest. They believe that they must bear their fair share of a much needed spending reduction program.

They also believe in a "fair share" in the tax portion of the recovery program. FMI was a supporter of the original 10-5-3 depreciation proposal in the previous Congress. We continue to believe that depreciation reform and capital cost recovery are essential to a healthy economy. We were pleased, therefore, to see most of the original concept included in the administration's business tax proposals. We are particularly concerned, however, with the unequal treatment which the administration proposes for building depreciation based upon whether the occupancy is by an owner or by a tenant. My remarks will center on this inequity.

We believe that depreciation based on occupancy is inequitable, unfair and introduces a new principle in tax treatment that could lead to massive and unproductive re-orientation of the method of doing business. It presents the Committee with a new question on basic tax policy which is -- should <u>like</u> structures used for <u>like</u> purposes be denied and deprived of <u>like</u> treatment for tax purposes. The administration proposes that cars and light trucks be treated equally, irrespective of whether used by a lessee or by an owner. Why then is unequal treatment proposed for buildings based on whether occupancy is by a lessee or by an owner.

Let me illustrate the effect this proposal could have on the occupancy costs of similar situated food retailers. Assume side-by-side stores or across-the-street stores so that location has no bearing. Each operates an identical supermarket of approximately 31,000 square feet with a cost of $1 million. Using a 46% tax bracket for each, and assuming a 15% pre-tax return on investment, the proposed building depreciation would cause the lessee-occupied operator to pay at least an average of $27,298* more a year (over the 15 year period) in occupancy costs than the owner-occupied operator. That is an average -- the per year difference would be much greater in earlier years. This presents a serious competitive disadvantage to the lessee-operator.

Businesses with the financial strength to own will do so, especially with this proposal. Other businesses, including small businesses may not have that option and will be faced with a competitive handicap of $27,298 a year. This does not sound like good tax policy.

One of the objectives of the capital cost recovery program is to simplify depreciation. The proposed treatment, based on occupancy, runs counter to that objective.

*Computed on a present value basis.

FMI represents grocery retailers and wholesalers --- not just retailers and wholesalers who happen to be owner-occupiers. Our members, both owner-operators and tenant-operators believe in equality and ask the Committee to give careful consideration to this provision.

In hearings before the Committee on House Ways & Means in July 1980, another retail association stated, "It would be a mistake to divide the business community in two segments, and to provide increased cost recovery allowances for some businesses and not for others." The witness for that organization perhaps said it best in stating, "these revised depreciation allowances should be available to all businesses -- large and small, manufacturing and retailing, on an equal basis -- to achieve tax neutrality and equality" (emphasis added).

We could not agree more. All retailing, including tenant-occupied facilities and owner-occupied facilities should be treated equally. This is especially important if we are to truly achieve the espoused goal of tax neutrality and equality. Equality starts at home, and retailing must have equality within itself before it can achieve equality with other forms of business.

As a basic tax policy, there should be equality between industries. But, to the extent that there is inequality, it tends to become a little "blurred." That is, the inequality is sometimes hard to pinpoint because of basic differences between the industries. But, within an industry, unequal tax treatment would quickly become intolerable because it would give advantages to one competitor over another competitor in the same business.

Now is not the time to introduce new complexities or inequities; therefore, we urge your support of a 10-year-life for all retail structures irrespective of occupancy.

Thank you, Mr. Chairman.

Senator SYMMS. Now we have our last panel for this morning. Tom Donohue, president of Citizen's Choice, Margaret Cox Sullivan, president of Stockholders of America, Steven Brobeck, Consumer Federation, Robert McIntyre, Federal Tax Policy for Citizens Tax Justice, James Dale Davidson, chairman of the National Taxpayer's Union.

So, we have five witnesses. Welcome to the panel this morning. Mr. Donohue, why don't you go right ahead and start? And let's all do the best you can to come under the 5-minute rule and I think it will work out very well for us.

STATEMENTS OF THOMAS J. DONOHUE, PRESIDENT, CITIZEN'S CHOICE; MARGARET COX SULLIVAN, PRESIDENT, STOCKHOLDERS OF AMERICA, INC.; STEVEN BROBECK, EXECUTIVE DIRECTOR, CONSUMER FEDERATION OF AMERICA; ROBERT S. McINTYRE, DIRECTOR, FEDERAL TAX POLICY, CITIZENS FOR TAX JUSTICE; AND JAMES DALE DAVIDSON, CHAIRMAN, NATIONAL TAXPAYER'S UNION

Mr. DONOHUE. Thank you, Mr. Chairman.

I am Tom Donohue, president of Citizen's Choice, a national grass roots taxpayers lobby with 70,000 members from coast to coast. Our organization has been in existence for little more than 4 years and spends the majority of its efforts and resources in fighting for limited spending and taxing within the Federal Government.

We are pleased to comment on the subject at hand this morning, and we will submit for the record our formal testimony and will make just a few comments for your consideration.

We have chosen this morning not to comment on the detailed economic and tax proposals before the Congress and the various ramifications that would come from it. Instead, we would like to relate for your consideration the conclusions that have come from a long and very intensive study of the attitudes of our citizens toward the tax system and the day-to-day workings of our tax collection system.

In a sentence, what we found, Mr. Chairman (and the message is very clear), is that the American taxpayer is feeling increasingly alienated and frustrated by the pressures of an ever-increasing tax burden.

It has become obvious to us that tax relief is not only an economic necessity, but an absolute must if the Federal Government and the Congress hope to regain the confidence and respect of its citizens and taxpayers.

Now, how did we figure this out and what did we do?

We appointed a National Commission on Taxes and IRS, chaired by the dean and vice president of the Georgetown Law School, and made up of 25 distinguished professionals and business leaders from around the country.

We held hearings in 10 cities throughout the United States. We maintained a toll-free "hot line" and we received testimony or comments from more than 2,500 citizens.

Mr. Chairman, I am very happy to include with our testimony a copy of the final report of the commission for your consideration.

Senator Grassley was at our press conference a few weeks ago, and he commented at the time the report was released.

I think the report says very clearly that there exists in this country a fear of the tax system.

There exists a frustration with the complexity of our tax system. There is a very serious concern with how taxes have become a major portion of the spending budgets of the families in this country.

One of the people who testified, sir, when I was present, gave an analogy of the tax system to OPEC and suggested that the frustration that we, as citizens, have felt with the OPEC countries, our anger, perhaps, when we filled up our gas tanks, was not too different from the feeling we are beginning to feel or express about those who collect our taxes.

The tax system is in effect destroying the American dream, they have said. Taxpayers have lost 6 percent in real after-tax income in the last 24 months alone. And today if you get a 10 percent increase in pay, you are going to pay 16 percent more in taxes.

The thing that really concerns us, I think, is that unlegislated tax increases that are happening without your overt concurrence each year. That is the bracket creep question which will cause $175 billion in increased taxes in the next 3 years, or $800 per man, woman and child.

Obviously, then sir, we would encourage you to reduce the individual tax rate at all costs.

Now there are two political confusions or misleading statements that the American people are not falling for and the first is that the tax cuts are too Draconian, too big and ominous. The fact is that taxes will increase this year $100 billion and we are only talking about a cut in the percentage of that increase.

The second misleading statement is that if the Government has the money and spends it, it won't be inflationary. But, if the people keep the money and spend it, it will.

Now, I know my time is coming to an end, but I would just make two more concluding comments. A recent Gallup Poll revealed that 86 percent of the public believes that if we follow the present economic trends in this country, in terms of taxes, we are going to be in trouble and therefore they favor individual tax relief.

Finally, sir, one of the things that continues to be discussed in the press and on Capitol Hill is that we can reduce the taxes on business and not have to do something so aggressive for taxes on individuals.

I would remind you that 14 million small businesses in this country pay their taxes as individuals or as partnerships and can only benefit if we have a major and sustained reduction in taxes for the individual.

I would finally say that to rejuvenate this economy, we need more than a factual improvement in the tax process and the tax rate. We need a perception that will go out to the markets, to the banks, to the small businesses and to those individuals who invest their capital; a perception that says the tax system will get better over time. A 3-year tax reduction, with a serious commitment for real tax relief is essential.

Thank you very much.

Senator SYMMS. Thank you very much, for a very excellent statement.

Ms. Sullivan.

Ms. SULLIVAN. Yes. Thank you very much for allowing me to testify. I appreciate the opportunity to testify.

Senator SYMMS. Could you speak into the microphone, please, Ms. Sullivan?

Ms. SULLIVAN. Yes.

Senator SYMMS. I am having trouble hearing you.

Ms. SULLIVAN. Yes.

I am here to express the views of our organization on the tax aspects of the President's economic program. I am president of this 9-year-old national, nonprofit, nonpartisan organization, dedicated to representing the interests of the over 29 million stockholders who share in the ownership of the estimated 13,500 publicly held American corporations.

We support the two-edge thrust of the administration's program, embraced in part the Economic Recovery Act of 1981.

We herald the cutting down of personal and business taxes and the paring down of government programs and spending. This is not a new viewpoint for us at Stockholders of America. There is agreement that big government and big government spending have largely caused our present economic condition.

Stockholders believe it is a strong, free enterprise system and not government that creates jobs and increases productivity and economic growth.

We strongly advocate the restructuring of our complex unrealistic and outmoded capital recovery system. The period of capital recovery in the United States is one of the longest of all industrialized nations.

Also, it must be recognized that the United States not only has the longest period of capital recovery, but we have the lowest rate of investment in any industrialized nation. We now rank seventh in productivity and capital investment and economic growth.

Our lagging productivity caused in a large part, we feel, by the lack of investment capital, because that means fewer jobs and fewer products and fewer services and the loss of our competitive edge.

Therefore, we believe that the Economic Recovery Tax Act should include, in addition, provisions to encourage capital investment into our business system.

Our capitalistic system plays a basic role in our national wellbeing and our national economy. It is unique in that.

Over the past century this system has provided the productive capital needed by industry for plant and equipment, research and development, to create new jobs.

It has also allowed millions of its people, the equity investors, the stockholders to share in the ownership in industrial growth.

Our system depends upon a continuous supply of new private capital every year.

Historically, this working capital comes from the millions of individual investors from every walk of life and living all over America. They have been called the "little guys," and rightfully so, for the average portfolio is $4,000, and they are hurting from inflation and heavy tax burden. Family plans, education plans, as well as retirement plans are jeopardized. They need relief.

The tax bias against equity investment must be lifted.

Stockholders of America has long advocated that a basic change in the way capital is treated and is taxed, in the United States, is imperative and it is imperative now.

Capital formation and supply-side economics are not just current buzz words. They stand for sound economic principles.

Capital is the fundamental foundation of all goods and services and any tax on capital is indicative of the misconception of its vital function in a free enterprise system.

Therefore, to deduct from it annually, in the form of taxation is to diminish our national productivity base. There should be no tax on capital gains.

When Congress passed the Revenue Act of 1978, which reduced taxes on capital gains for both individuals and corporations, our capital markets showed marked improvement.

You heard that earlier today.

Another thing that you haven't heard is that the total number of stockholders, nationwide, is now back to more than 29 million, from a low of 25 million, in 1975.

Now stockholders are the backbone of our equity market. The markets won't work without them. The success and strength of our free enterprise system comes from this large and varied ownership base, yet they are heavily and unfairly taxed.

When Stockholders of America was established in 1972, our theme was: "Let's get the country back to business." There was no equity-investment-related bills in the hopper at that time. Times have changed. There are many thoughful, well-drafted bills proposed by members of this committee, to encourage capital investment by different approaches and complement each other.

We support them. S. 75, introduced by Senator Wallop, for himself, and Senators Moynihan and Cranston. I am just finishing.

Then, S. 141, introduced by Senator Bentsen and S. 268, introduced by Senator Johnston.

Again, all of these approaches are not in conflict with any other incentives.

Now stockholders are the little guy, but we obviously still have faith that the future of America lies within its system of people's capitalism. We are putting our money, they are putting their money where their faith is, in business. This should be encouraged.

The President's program, with these bills, will do it, and then the reindustrialization and the revitalization of America will become a reality. Isn't that what we all want to see?

Thank you.

Senator SYMMS. Thank you very much, for a very excellent statement. I do like your sense of optimism. I am heartened to note that the President, yesterday, made that case to the graduating class of 1981, that the future looks better for them than it has any class up to now.

Ms. SULLIVAN. Yes.

Senator SYMMS. If you don't think that, then you don't have much chance to achieve it, that is for sure.

Ms. SULLIVAN. Yes.

Senator SYMMS. Next is Steven Brobeck.

Mr. BROBECK. Thank you, Mr. Chairman.

The Consumer Federation of America welcomes the opportunity to appear before this committee to comment on President Reagan's tax proposals.

These proposals are relevant to consumers, because they intend to increase real income and restrain inflation by increasing productivity. They propose to do this by redistributing income and wealth, away from low- and middle-income families to the affluent and to large corporations.

Such a redistribution would, of course, adversely affect millions of families living on the margin or providing negligible benefits to wealthy individuals and institutions.

However, I do not wish to focus on the means and impact of this redistribution. Other witnesses will be treating the issue in some detail.

What I would rather do is challenge the assumption of the President's plan that the specific tax breaks it proposes, would increase productivity, allowing the expansion of real income and the control of inflation.

The logic of this assumption is that individual tax reductions and accelerated depreciation allowances would stimulate capital investment, thus increasing productivity.

The written testimony I have submitted attempts to show that these tax breaks would not generate much additional capital investment and that this investment would not automatically lead to an increase in productivity.

Let me summarize its most important points.

Reducing marginal tax rates for individuals would not increase business investment by any significant amount. A portion of the tax savings would be used to reduce work effort and other portions, clearly the bulk, would be allocated for consumption, and out of the remainder that would be saved, a large part would be invested in tangible assets, such as land and collectables, and thus, would not be available to business, for investment in capital stock.

The small portion left would, of course, be invested in stocks, bonds, and other financial instruments that supply business with capital, yet the majority of these investments, if the recent past is any predictor of the future, would be short-term, and thus, less useful than long-term stock and bond investments that have been so important to our growth in past decades.

As we know from our experience over the past decade, there has been a massive flow of personal savings out of long-term investments in stocks and bonds, into tangible assets such as real estate and collectables, and into short-term financial investments such as 6-month money market certificates and Treasury bills.

Given the volatility of interest rates and the existence of the mortgage interest deduction and the capital gains exemption applying to most tangible assets, this shift is entirely rational and there is no reason for supposing that reducing marginal tax rates would persuade many investors to return to long-term investments in stocks and bonds.

Similarly, accelerated depreciation allowances would stimulate little productive capital investments.

For decades there has been little decrease in the rate of corporate savings as indicated by the table on page 4 of my written testimony.

Business has had capital to invest and in fact they invested this capital in plant and equipment, at a rate that has varied little for three decades.

As the table on page 6 reveals, they have received the whole range of investment tax incentives in this period, including faster depreciation.

At the present, these incentives are far more generous than in most industrialized countries, including Germany, Japan, and France, that have high capital investment in productivity growth rate.

I raise the question as to whether any kind of accelerated depreciation would increase capital investment appreciably, yet it is quite clear that President Reagan's 10-5-3 plan would do nothing of the sort.

Let me suggest several reasons.

First, this plan would provide the greatest benefits to those industries that need them the least. Oil companies, for example, would benefit as much as any industry, yet they are awash in capital.

Second, 10-5-3 would not help and may harm those industries most in need of capital.

According to economics Prof. Robert Eisner, the proposed 3-year capital recovery would be less advantageous for the auto industry than what is currently available.

Moreover, he adds, the 10-5-3 plan would tend to draw capital away from small businesses, especially high technology, research-related firms.

Third, by expanding incentives to purchase shortlived equipment, accelerated depreciation may reinforce corporations' growing preoccupation with short-term profit maximization, other than long-term growth.

Fourth, the 10-5-3 plan would expand tax shelter opportunities in areas such as equipment leasing and commercial real estate to such an extent, that according to Harvard economist Dale Jorgensen, the shelter business would deserve its own line on the GMP accounts.

Even if though, individual tax cuts and accelerated depreciation were to increase capital investment, these increases would probably not expand productivity.

As the table on page 6 indicates, there is no close association between capital investment and productivity growth rates. Although this lack of association is not fully understood, it reflects in part the counting of certain business expenditures as capital investments.

Much spending for office equipment and company cars, for example, falls into this category.

To expand real income and check inflation, we must restrain energy prices and interest rates, and we must introduce incentives——

Senator Symms. Would you please summarize your statement?

Mr. Brobeck. Yes. Just a few last sentences.

We must restrain energy prices and interest rates, and we must introduce incentives to encourage long-term planning and more productive use of resources.

CFA urges the members of this committee to develop a tax reform package that clearly distinguishes between productive and wasteful, speculative uses of capital.

Thank you.

Senator SYMMS. Thank you very much for being with us this morning.

Now, Robert S. McIntyre, director, Federal tax policy, Citizens for Tax Justice.

Mr. McINTYRE. Thank you, Mr. Chairman.

Citizens for Tax Justice is a coalition of public interest and labor groups which works for tax reform at the Federal, State and local levels. Our interests are in tax equity and in making the tax system to be as economically productive as possible.

Today, I would like to focus on one of the major problems we see in the President's tax program, the business tax cuts.

We have a detailed examination of the individual tax cuts included in our written statement as well.

The President has said that his 10-5-3 depreciation plan is designed to improve productivity, a goal which of course, we all share. If in fact the plan would do that, I think most of us here would be supporting it.

However, there are such serious problems with. 10-5-3, that we think it would actually be a disaster for the economy. We hope the committee will amend it to improve it.

As you have heard from some of the other witnesses at these hearings, 10-5-3 would replace the corporate income tax with a corporate tax subsidy.

In other words, we would have negative tax rates on new investments.

What that means is that we would begin to subsidize investments which would make no sense in the absence of a tax system. We would be encouraging tax shelters and other unproductive kinds of investments.

There is even a worse effect, though, and I refer you to page 7, of my testimony, which illustrates the different kind of subsidies we would provide for different kinds of investments.

Now in general, the largest subsidies would be provided to very short-term investments. In other words, we would be encouraging business to continue the trend which has already been criticized, of purchasing assets which have very fast paybacks, instead of concentrating on the long term and durable assets.

Now that is a disaster for the economy. These distortions would cost us hundreds of billions of dollars a year in lost national income.

We would shift even further away from research and development, for example, which is now favored by the current law, but very disfavored under 10-5-3.

In addition, 10-5-3 would be very sensitive to the rate of inflation. If the inflation rate should go down, as we all hope, the distortions which 10-5-3 creates would go up, and we would have a system whereby we would probably find ourselves with far more short-term assets than we have even now with the current problems in the tax laws and in management philosophy.

We need a system of depreciation which is neutral among assets, if we believe in the free market system.

Now, the chairman of the Ways and Means Committee has announced that his committee will be seeking such a system.

Last fall, this committee passed the 2-4-7-10 plan which was designed to try to achieve more neutrality. There are serious problems with 2-4-7-10, however.

First of all, it remains sensitive to inflation, and second, the neutral corporate tax rate which it attempted to achieve was zero, a rate we think is far too low for a balanced tax system.

This morning, the American Bar Association endorsed the move toward a neutral tax system by endorsing replacement cost depreciation. That is one way to achieve the kind of neutrality we all seek and to avoid the distortions caused by inflation.

Another method has been proposed by Professor Jorgenson of Harvard, which is the first-year recovery system, which has the additional advantage of being far simpler than any other proposal yet made, including 10-5-3.

We urge the committee to study that proposal.

The point is that we should be trying to move to a system which works with the market and not against it, as the President has said he would like to do.

If in fact we need to bail out certain industries, we should target the subsidies to them directly and they should be very limited. But in general, we should be looking for a system which is neutral and which allows the free market to give us the benefits which it is capable of giving.

Thank you.

Senator SYMMS. Thank you very much. All your statements will be included in the record.

Next is Mr. James D. Davidson, chairman, National Taxpayer's Union.

Mr. DAVIDSON. Thank you, Mr. Chairman.

First let me make the obligatory bow to our members who have made it possible for me to be here. There are many of them. I thank you very much for this opportunity.

Before I launch into my prepared remarks, I want to commend the chairman, Senator Symms, for some of the remarks he made earlier. I think if we are thinking clearly, we would like to move toward a system such as that you suggested where we would have a flat proportional rate which would be the same on every income, would simplify the system tremendously. We would not need to have thousands, and tens of thousands, and hundreds of thousands of lawyers, and tax accountants, and other people sitting around helping people to figure out what the tax rate is on a given activity.

The deadweight loss of human ability that goes into this kind of a system is tremendous. I feel that it would be wrong to come here and not appreciate the remarks that you made. So, I associate myself with that very much.

Senator SYMMS. Thank you.

Mr. Davidson. As to the President's proposal for tax cuts, I think, too, that this is a good and noble idea. I don't think that it goes very far or far enough.

The reason I say that is the tables which are with my testimony show that if inflation goes as projected in the President's program, at the end of 4 years, only those people who are making less than $10,000 or more than $100,000 will be in a lower marginal tax bracket than they are today.

Of course, if inflation is higher than expected, we may end up with no tax cuts. That certainly will not have a startling incentive effect.

I think the primary reason, which we must recognize again, and again for these growing taxes is that we need lots and lots of money to pay for the fantastic growth of Government spending. It is not new. Everybody knows that Government spending is out of control, in spite of the Herculean efforts which are being made to draw it into control.

This is one reason why we would all be better off if we had a constitutional amendment which would help you and the other Members in the House of Representatives to effectively control Federal spending.

A constitutional amendment would also make today's tax cuts have a greater incentive effect in stimulating investment, because they would help individual businesses and others know that the Federal budget would be balanced in the future and that any reductions in tax rates today would not likely be washed away by bracket creep and by other factors in the future.

It has been said many times, and I believe it is true, that the Federal income tax is a tremendous disincentive to productive effort.

In some respects, the tax resembles the counterproductive laws of the Middle Ages which reduced output by reducing the profitability of additional effort.

I quote from one medieval stint law: "It was ordered that whosoever shall hereafter ship more than his respective stint, he shall pay double imposition, and double imprest for all that he shall soe ship."

The tax laws today are not quite as bald a counterproductive obstacle as that, but they are very similar in effect.

I think that the solutions are clear. We have to provide real incentives for investment. We need to take the President's program, but we have to go further.

I suggest that we index the tax laws now, to be sure that tax reductions stick; that we reduce or eliminate the taxes on capital gains; that we provide an exemption for savings income of up to $10,000, which would put us back on track, so that we could compete with the Japanese who now save five times as much money as we do, partly because they have a tax provision that enables them to get up to $6,000 or the equivalent thereof tax free.

Those are my remarks. Thank you.

Senator Symms. Thank you very much. I thank all the panel. Senator Matsunaga.

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

Senator SYMMS. We are glad to have you here this morning.

I have several questions I would like to ask and notice that I am very short on time.

Mr. Davidson, of the NTU, those recommendations you made, you do that in addition to the President's tax bill; is that not correct?

Mr. DAVIDSON. I think so. I put this forward because I think the President's tax program is fine, but I think we have to recognize that we can't expect startling incentive effects from a program which basically does not change marginal rates very much under the most optimistic assumptions.

I think, if you are going to expect a great spurt of investment and activity, you have to provide some real incentives. They have to be directed toward people who have the money.

Under the progressive system today, the top 50 percent of the income earners are paying 94 percent of the taxes.

So, obviously, if we are going to reduce rates, we have to reduce them at the top.

I say, let's immediately shrink the differential between earned and unearned income.

Senator SYMMS. Do that immediately?

Mr. DAVIDSON. Yes; let's do something—more than this trivial $200 exemption which probably does not increase savings very much. It just——

Senator SYMMS. Most people do not know about it.

Mr. DAVIDSON. Right. But, if you had a $10,000 exemption, you could bet your bippy that people would be out saving money and investing. That would be something that would also benefit new growing businesses and not merely the ones that were profitable already.

Senator SYMMS. Well, I had one more question I wanted to direct to you and that is, if the President is taking the most optimistic point of view that the President would be successful in passing his tax package, plus some corrections in unearned income and savings incentive, looking down the road, 2, to 3, to 5 years, because you can't unscramble this egg overnight that has taken 40 years to get to the condition it is of high tax levels and high spending levels that are built into the system.

But, if the Federal Reserve System continues to expand the money supply as they have recently, what impact will this have on a Congress that is making a concerted effort to try to restrain the growth of spending, and a Congress that is trying to restrain the growth of increased taxation.

You make the point that we are really not cutting spending. We are not cutting taxes. We are slowing down the rate of increase in taxes and slowing down the rate of increase in spending growth.

But, that is at least starting the horse in the right direction so he doesn't run off the cliff on the left side of the road.

What will be the effect if the Fed continues to either miss their targets, or for whatever reason keep expanding the money supplies?

Mr. DAVIDSON. Well, Senator, you raised the several-trillion-dollar question. I think the basic answer is we are like people cruising down a mountain highway, in an 18 wheeler. We have taken our foot off the accelerator, but we don't have very much in the way of brakes and this whole process is just pushing ahead on its own momentum.

It is very possible for the Fed, through either its inability or unwillingness to meet the money growth targets, to completely undo any incentive effects which would be achieved by reduced marginal rates, because as long as we have a progressive system which can boost people up into a higher tax bracket, the gentlemen down at the Federal Reserve Board can unilaterally, without a vote of Congress, raise everybody's taxes simply by turning on the high speed printing press which grinds out 384,000 green backs an hour.

Now I think what we need to do is to have some kind of control, substantial controls on the activities of the Fed.

It has been suggested by Professor Melcher and the people at the Shaddow Open Market Committee, that the Fed be more accountable to Congress and to the public by announcing in advance what its money targets would be and then being required to submit the resignation and we will bring somebody in here who can meet these targets, along with some explanation.

If the President thought that the explanations were sufficiently extenuating, then he could say, OK you can remain on the Board, but if you do not achieve these goals, then we will accept your resignation and we will bring somebody in here who by damn can achieve these goals.

That is what we need in this country. If we are going to have the Government, the Congress, the Senate going through political tribulations, and also exacting tremendous costs to attempt to bring Federal spending under control, while on the other end of the street, the Federal Reserve is, in essence, printing money, then all of this good work will be undone. And if it were true, in fact, that it had no incentive effects when they increase the money supply, we might as well dispense with taxation all together and just let the Government be run by the printing press, because the effect is the same.

So, we have to admit that at some point there is an interaction between the money supply and the tax policy in terms of incentives.

If we let the interest rates go to 25 percent, you are not going to get much investment.

So, we need to put this money supply under control and in the long run, we have to get back to real money. We have to have a quarter or a dollar in your pocket that is worth something, not because the Congress says so, but because you can go down to the money exchange or the COMEX and you can melt the thing down and get out some silver or gold or something that is useful.

That is my opinion.

Senator SYMMS. Thank you very much. I happen to share that opinion.

Ms. Sullivan, you made the point and I just would reemphasize it, but supply side economics is nothing new, that is really what America was built on. Is that really what you were saying?

Ms. SULLIVAN. That is what I am saying; yes.

Senator SYMMS. There isn't anything new to this at all, it is just that we have gotten away from it and that is where we are getting into a problem. Now it is treated by some people as though this is something new.

I did have, and I appreciate your testimony. I did have one question for you, Mr. Brobeck.

You did make quite a criticism of the administration's taxing proposal, but I wasn't sure that I—did you just want to continue what it was we are doing now, not change the code, just go ahead the same way and let them go ahead and confiscate your earnings of the producers and give it to the nonproducers so we just have everybody just quit working?

Mr. BROBECK. I think the problem is that this is not being targeted. The administration is saying we have a capital shortage. We would dispute that. We presented data, concrete data, that suggests there is not a capital shortage. We believe that is a myth.

Then, in addition, clearly if Congress passes the administration's tax proposal, there is going to be an increase in capital for corporations.

It is not clear to us at all. We have severe doubts that that capital is going to be used to increase productivity. That is really the point we are making.

Senator SYMMS. Well, don't corporations hire people?

Mr. BROBECK. Yes; they do.

Senator SYMMS. Essentially wouldn't that help lower unemployment numbers?

Mr. BROBECK. Well, there are many ways to increase employment. You can just, the Fed just increases the money supply, that is, at least in the short term, going to increase employment, but in the long run, it is going to have disastrous kind of impact.

What we need to increase employment in the long run is to increase the rate of productivity to rechannel resources that are currently being wasted into more productive areas.

I think that has to be our long-term goal. If we don't keep our eye on that mark, we are headed for an awful lot of trouble down the line.

Senator SYMMS. Is there any way you can be as critical of the administration's plan without really repudiating the market, free market system?

Mr. BROBECK. No; that is not what we are saying at all. There are incentives and disincentives within the market. I think we all accept that idea. The question is what should be the nature of those incentives and disincentives.

We are arguing that the set of incentives and disincentives proposed by the administration, are not going to accomplish the goals which I think we all share, increased productivity, and more prosperity down the line.

Senator SYMMS. Yes, Mr. Donohue.

Mr. DONOHUE. Mr. Chairman, I take some issue, as you might imagine, with my fellow panelist. Some of the comments he made I think refute his logic. Obviously there is capital available. Our question is: How do we get capital invested in long-term projects; in productive creation of jobs, equipment, plant, and opportunity.

The reason that capital has not been forthcoming, the Litmus test of why we have not had that capital, is that Government policy, over a long period of time, too long, has disuaded people from putting their capital into these markets.

They have, as he has suggested, put them instead in short-term securities and in real estate, the two places they could be assured of some return in a radically adjusting and changing market situation where inflation was going up very quickly.

What we need to do is focus on two or three items and get on with it. No. 1 is that corporations do not, per se, pay income tax. What they do is collect income tax for whichever Government agency happens to need the money.

You know politically, it is a lot easier to say: "Let's get the money from General Motors," than it is to say: "Let's get it from its employees." But we all know the tax must be passed on in prices and other ways.

Second of all, to recognize that it is absolutely essential for us to create a system that encourages individuals, those 10 percent of the people that pay 50 percent of the taxes, to get individuals to invest their capital in the long term. The only way to do that is to come up with a tax package much like the administration suggests where we have a 3-year assurance of where we are going, where we give a perception of which direction the Government is going, and tie with that the reductions in spending you are planning.

I think you will end up with a situation which takes money out of places that are not as productive, out of shelters that are not in the best interests of this country, and puts it in productive investment.

Senator SYMMS. I thank you very much. I thank all of the members of all of the panels that testified this morning.

I note that the distinguished chairman of our committee, Senator Dole, has now arrived.

Would you care to make a comment or ask questions?

The CHAIRMAN. I have no questions. I apologize for not being here earlier, but we had two other subcommittees meeting. I appreciate Senator Matsunaga giving all the hard questions to the witnesses. [Laughter.]

We hope to meet, we are trying to work out some tax, I'll say "compromise," that is a bad word, but some program that will have the unanimous support of Congress. It may take a few hours to do that. [Laughter.]

Thank you.

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

The CHAIRMAN. We meet again at 2 o'clock.

Senator MATSUNAGA. Mr. Chairman, I just wish to join my colleagues in thanking the panels for taking the time out to be here.

As you can see, Monday is a bad day. Many go back to their districts and return in the afternoon.

You can rest assured that your written testimonies will be read and decisions will be based on what testimony you have presented.

Thank you, all of you.

Senator SYMMS. The committee is in recess until 2:00 o'clock this afternoon.

[Statements of the preceding panel follow:]

STATEMENT BY
MARGARET COX SULLIVAN
PRESIDENT
STOCKHOLDERS OF AMERICA, INC.

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I APPRECIATE THE OPPORTUNITY TO APPEAR AGAIN BEFORE THIS DISTINGUISHED COMMITTEE ON BEHALF OF STOCKHOLDERS OF AMERICA, INC. TO EXPRESS THE VIEWS OF THE ORGANIZATION ON THE TAX ASPECTS OF THE PRESIDENT'S PROGRAM. MY NAME IS MARGARET COX SULLIVAN AND I AM PRESIDENT OF THIS NINE YEAR OLD NATIONAL, NON-PROFIT, NON-PARTISAN ORGANIZATION DEDICATED TO REPRESENTING THE INTERESTS OF THE OVER 29 MILLION STOCKHOLDERS WHO SHARE IN THE OWNERSHIP OF AN ESTIMATED 13,500 PUBLICLY HELD AMERICAN CORPORATIONS.

WE SUPPORT THE TWO-EDGED THRUST OF THE ADMINISTRATION'S PROGRAM EMBRACED IN PART IN THE ECONOMIC RECOVERY TAX ACT OF 1981 (S. 683). WE WELCOME THIS APPROACH AND ARE GRATEFUL IT IS NOW SPELLED OUT IN THE PROPOSED LEGISLATION.

UNDER EXISTING LAW, STOCKHOLDERS, AS TAXPAYERS, WILL PAY MORE IN FEDERAL INCOME TAXES THIS YEAR THAN EVER BEFORE. AS SENATOR BAKER STATED IN INTRODUCING THIS LEGISLATION FOR CHAIRMAN DOLE, "THE FEDERAL TAXATION BURDEN ... INCREASES MORE THIS YEAR THAN DURING ANY PREVIOUS YEAR IN OUR HISTORY".

THE SITUATION IS OUT OF HAND - WE HAVE REACHED THE LIMITS.

PERSONAL INCOME TAXES CANNOT BE REDUCED UNLESS GOVERNMENT SPENDING IS REDUCED - THE GOVERNMENT SPENDING OF THE PEOPLE'S MONEY. THIS MUST BE DONE. THAT IS WHY WE HERALD THE TWO-EDGED SWORD APPROACH IN THE PRESIDENT'S PROGRAM - THE CUTTING DOWN OF PERSONAL AND BUSINESS TAXES AND THE PARING DOWN OF GOVERNMENT PROGRAMS AND SPENDING.

WE WOULD LIKE TO STATE THIS IS NOT A NEW VIEWPOINT FOR US AT STOCKHOLDERS OF AMERICA. OUR SURVEYS HAVE CONSISTENTLY SHOWN THAT STOCKHOLDERS BELIEVE THE FEDERAL GOVERNMENT IS TRYING TO DO MORE THAN ITS RESOURCES WILL PERMIT; IT IS TRYING TO DO MANY THINGS THAT IT CANNOT DO VERY WELL; AND ENDEAVORING TO DO SOME THINGS THAT IT SHOULDN'T DO AT ALL. THERE IS AGREEMENT THAT BIG GOVERNMENT AND BIG GOVERNMENT SPENDING HAVE LARGELY CAUSED OUR PRESENT ECONOMIC CONDITION.

STOCKHOLDERS WANT LESS GOVERNMENT AND LOWER TAXES SO THAT THEY CAN MANAGE THEIR OWN LIVES AND HANDLE THEIR OWN MONEY, RATHER THAN HAVE THE GOVERNMENT SPEND IT FOR THEM. THEY BELIEVE IT IS A STRONG FREE ENTERPRISE SYSTEM, NOT GOVERNMENT, THAT CREATES JOBS, INCREASES PRODUCTIVITY AND ECONOMIC GROWTH.

STOCKHOLDERS, AS OWNERS AND INVESTORS IN THE AMERICAN BUSINESS SYSTEM, STRONGLY ADVOCATE THE RESTRUCTURING OF OUR COMPLEX, UNREALISTIC AND OUTMODED CAPITAL RECOVERY SYSTEM. THERE MUST BE FASTER WRITE-OFFS FOR BUSINESS INVESTMENT IN PLANT AND EQUIPMENT. THE PERIOD OF CAPITAL RECOVERY IN THE UNITED STATES IS ONE OF THE LONGEST OF ALL THE INDUSTRIALIZED NATIONS.

WE THEREFORE ADVOCATE THE CONCEPT OF ACCELERATED DEPRECIATION IN THE PRESIDENT'S PROGRAM AS OUTLINED IN THE ECONOMIC RECOVERY TAX ACT WHICH EMBRACES A MODIFIED VERSION OF THE CAPITAL COST RECOVERY ACT WHICH WE SUPPORTED.

THE CAPITAL INVESTED IN PLANT, EQUIPMENT AND REAL PROPERTY MUST BE RECOVERED IN A SHORTER SPAN OF TIME - FREED - MADE MOBILE - IN ORDER TO BE REINVESTED IN NEW EQUIPMENT TO IMPROVE PRODUCTIVITY, TO EXPAND

OPERATIONS AND TO HELP THE UNITED STATES REGAIN THE NUMBER ONE POSITION IN THE INTERNATIONAL MARKET PLACE. IT IS AN ACCEPTED FACT THAT ANYTHING THAT HELPS OR HINDERS THE MOBILITY OF CAPITAL, HELPS OR HINDERS ECONOMIC GROWTH.

IT IS NO SECRET THAT THE UNITED STATES HAS LOST SOME OF ITS COMMANDING ECONOMIC POSITION IN THE WORLD. STRONG AND CLEAR SIGNALS WERE SENT UP IN THE 1980 REPORT OF THE CONGRESSIONAL JOINT ECONOMIC COMMITTEE DOCUMENTING THE DECLINE; THE UNITED STATES NOW RANKS 7TH IN PRODUCTIVITY, CAPITAL INVESTMENT AND ECONOMIC GROWTH. OUR LAGGING PRODUCTIVITY CAUSED, IN LARGE PART, BY THE LACK OF INVESTMENT CAPITAL FOR NEW PLANT AND EQUIPMENT. THAT MEANS FEWER JOBS, FEWER PRODUCTS, FEWER SERVICES AND THE LOSS OF OUR COMPETITIVE EDGE IN THE INTERNATIONAL MARKETS.

IT MUST BE RECOGNIZED THAT THE UNITED STATES NOT ONLY HAS THE LONGEST PERIOD OF CAPITAL RECOVERY, BUT WE HAVE THE LOWEST RATE OF INVESTMENT OF ANY INDUSTRIALIZED NATION IN THE WORLD.

THEREFORE, WE BELIEVE THAT THE ECONOMIC RECOVERY TAX ACT OF 1981 (S. 683) SHOULD INCLUDE IN ADDITION, MEASURES TO ENCOURAGE CAPITAL INVESTMENT INTO OUR BUSINESS SYSTEM: THE SYSTEM SOMETIMES CALLED FREE ENTERPRISE, THE CAPITALISTIC SYSTEM OR PEOPLE'S CAPITALISM.

OUR CAPITALISTIC SYSTEM PLAYS A BASIC ROLE IN OUR NATIONAL WELL-BEING AND OUR NATIONAL ECONOMY. IT IS UNIQUE IN THAT. FOR IT IS THIS SYSTEM WHICH HAS ALLOWED THE PEOPLE TO BUILD OUT OF A WILDERNESS A GREAT INDUSTRIALIZED NATION. OVER THE PAST CENTURY, THIS SYSTEM HAS PROVIDED THE <u>PRODUCTIVE CAPITAL</u> NEEDED BY INDUSTRY AND ALLOWED MILLIONS

OF ITS PEOPLE TO SHARE IN THE OWNERSHIP AND INDUSTRIAL GROWTH.

OUR CAPITALISTIC SYSTEM DEPENDS ON A CONTINUOUS SUPPLY OF NEW PRIVATE CAPITAL EVERY YEAR. HISTORICALLY THIS WORKING CAPITAL COMES FROM THE MILLIONS OF INDIVIDUAL INVESTORS FROM EVERY WALK OF LIFE, LIVING ALL OVER AMERICA. THEY HAVE BEEN CALLED THE "LITTLE GUYS" - AND RIGHTFULLY SO - FOR THE AVERAGE PORTFOLIO IS $4,000 (NYSE SURVEY) AND THEY ARE HURTING FROM INFLATION AND A HEAVY TAX BURDEN. FAMILY PLANS, EDUCATION PLANS,AS WELL AS RETIREMENT PLANS ARE JEOPARDIZED. THEY NEED RELIEF. THE TAX BIAS AGAINST EQUITY INVESTMENT MUST BE LIFTED.

STOCKHOLDERS OF AMERICA HAS LONG ADVOCATED THAT A BASIC CHANGE IN THE WAY CAPITAL IS TREATED AND IS TAXED IN THE UNITED STATES IS IMPERATIVE - AND IT'S IMPERATIVE NOW. WE NO LONGER HAVE THE LUXURY OF TIME.

CAPITAL FORMATION AND SUPPLY-SIDE ECONOMICS ARE NOT JUST CURRENT BUZZ WORDS - THEY STAND FOR SOUND ECONOMIC PRINCIPLES. CAPITAL IS THE FUNDAMENTAL FOUNDATION OF ALL GOODS AND SERVICES. ANY TAX ON CAPITAL IS INDICATIVE OF A MISCONCEPTION OF ITS VITAL FUNCTION IN A FREE ENTERPRISE SYSTEM. THEREFORE, TO DEDUCT FROM IT ANNUALLY IN THE FORM OF TAXATION IS TO DIMINISH OUR NATIONAL PRODUCTIVITY BASE. THERE SHOULD BE NO TAX ON CAPITAL GAINS. TO CONFIRM THIS POINT, SOME OF OUR INTERNATIONAL COMPETITORS HAVE NEVER TAXED CAPITAL GAINS AT ALL, OTHERS ONLY NOMINALLY.

IT MUST NOT BE OVERLOOKED THAT WHEN CONGRESS PASSED THE REVENUE ACT OF 1978, WHICH REDUCED TAXES ON CAPITAL GAINS FOR BOTH INDIVIDUALS AND CORPORATIONS, OUR CAPITAL MARKETS SHOWED MARKED IMPROVEMENTS.

NEW CAPITAL RAISED THROUGH INITIAL PUBLIC STOCK OFFERINGS WAS $2.5 BILLION MORE FOR 1978-79 THAN FOR 1976-77. THIS AMOUNT OF MONEY HAS THE POTENTIAL TO CREATE 160,000 NEW JOBS. INVESTORS RETURNED TO THE MARKET. (TREASURY REVENUE FROM CAPITAL GAINS INCREASED BY $1.8 BILLION FOR 1979.)

AFTER THE CAPITAL GAINS TAX CUT TOOK EFFECT ON JANUARY 1, 1979, 130,000 NEW INVESTORS ENTERED THE STOCK MARKET IN AN AVERAGE MONTH COMPARED WITH A PREVIOUS MONTHLY FIGURE OF 86,000. THE TOTAL NUMBER OF STOCKHOLDERS NATIONWIDE IS NOW BACK TO MORE THAN 29 MILLION FROM A LOW OF 25 MILLION IN 1975, ACCORDING TO A RECENT NEW YORK STOCK EXCHANGE SURVEY.

HOWEVER, IT MUST BE CONSIDERED THAT IN 1970, WHEN STOCKHOLDERS NUMBERED 32 MILLION, IT WAS PREDICTED WE SHOULD HAVE 50 MILLION INDIVIDUAL STOCKHOLDERS BY 1980 - A NUMBER CONSIDERED NECESSARY TO MEET CAPITAL NEEDS FOR A GROWING WORK FORCE, TO MAINTAIN INDUSTRIAL LEADERSHIP IN THE WORLD, TO KEEP OUR COUNTRY STRONG, AND TO SUSTAIN OUR STANDARD OF LIVING. THESE FIGURES CLEARLY SHOW THE LINKAGE BETWEEN THE LOW RATE OF CAPITAL INVESTMENT AND THE LAGGING ECONOMY. FURTHER, IT MUST BE NOTED THAT WHEN THE NUMBER OF INDIVIDUAL STOCKHOLDERS WAS GROWING, WE, AS A COUNTRY, WERE ENJOYING RAPID, PROSPEROUS ECONOMIC EXPANSION.

INDIVIDUAL STOCKHOLDERS ARE THE BACKBONE OF OUR EQUITY MARKETS. THEIR ROLE IS VITAL. THE MARKETS WON'T WORK WITHOUT THEM. THEY MAKE THE MARKETS. THE MILLIONS OF DIFFERING INDIVIDUAL DECISIONS MADE DAILY IN DIVERSIFIED MARKET TRANSACTIONS ARE NEEDED FOR LIQUIDITY, FOR A TRUE AUCTION, AND A MORE REALISTIC VALUE OF STOCKS. FURTHER, AN INDIVIDUAL HAS A DIFFERENT PATTERN OF INVESTING THAN THE LARGE FINANCIAL

INSTITUTIONS. FUND MANAGERS, EITHER BECAUSE OF REGULATION OR FIDUCIARY RESPONSIBILITIES, INVEST PRIMARILY IN THE WELL-ESTABLISHED COMPANIES AND FOR THE MOST PART IN A FAVORED FEW. THE INDIVIDUAL, IN HIS OWN FRAME OF INTEREST AND JUDGMENT, WITH HIS OWN CAPITAL MAY MAKE INVESTMENTS IN THE SMALLER OFTEN MORE VENTURESOME HIGH RISK NEW COMPANIES AND SHARE IN THE OWNERSHIP AND GROWTH OF THEM. THE SUCCESS AND STRENGTH OF OUR FREE ENTERPRISE SYSTEM COMES FROM THIS LARGE AND VARIED OWNERSHIP BASE, YET THEY ARE HEAVILY AND UNFAIRLY TAXED. THAT IS WHY WE SO STRONGLY URGE THAT LEGISLATIVE MEASURES TO ATTRACT EQUITY CAPITAL INVESTMENT INTO OUR BUSINESS SYSTEM BE INCLUDED IN THE ECONOMIC RECOVERY TAX ACT OF 1981.

WHEN STOCKHOLDERS OF AMERICA WAS ESTABLISHED IN 1972, OUR THEME WAS "LET'S GET THE COUNTRY BACK TO BUSINESS". THERE WERE NO EQUITY INVESTMENT RELATED BILLS IN THE HOPPER AT THAT TIME. TIMES HAVE CHANGED, THERE ARE NOW MANY THOUGHTFUL, WELL-DRAFTED BILLS PROPOSED BY MEMBERS OF THIS COMMITTEE WHICH WOULD ENCOURAGE EQUITY INVESTING BY DIFFERENT APPROACHES. WE CERTAINLY SALUTE THEIR CONCERN WITH OUR PROBLEMS.

S. 75 INTRODUCED BY SENATOR WALLOP FOR HIMSELF AND SENATORS MOYNIHAN AND CRANSTON WOULD INCREASE THE EXCLUSION RATE ON CAPITAL GAINS TO 75% THEREBY REDUCING THE TAX TO 17.5% FOR BOTH INDIVIDUALS AND CORPORATIONS. IT HAS LARGE BI-PARTISAN SUPPORT. WE HERALD THE 17.5% FIGURE.

S. 141 INTRODUCED BY SENATOR BENTSEN WOULD ALLOW DIVIDENDS REINVESTED IN ORIGINAL STOCK UNDER A QUALIFIED REINVESTMENT PLAN TO BE

. . . 7.

EXEMPT FROM THE INDIVIDUAL'S FEDERAL INCOME TAX WITH CERTAIN LIMITATIONS. THIS BILL ENCOURAGES THE INVESTOR TO SAVE AND TO INCREASE HIS INVESTMENT AND THE CORPORATION TO HAVE IMMEDIATE USE OF THE CAPITAL. IT IS AN UNIQUE APPROACH AND DOES NOT COMPETE WITH OTHER INVESTING INCENTIVES. ECONOMISTS SAY THE LOSS IN REVENUE TO THE TREASURY IS NOT LARGE THE FIRST YEAR, A WASH THE SECOND, AND A GAIN IN REVENUE FROM THE THIRD YEAR AND AFTER. THIS HAS WIDE SUPPORT FROM OUR MEMBERSHIP.

S. 268 INTRODUCED BY SENATOR JOHNSTON PROVIDES LIMITED INCOME TAX CREDITS FOR NEW INVESTMENTS IN U.S. CORPORATIONS. THIS METHOD HAS BEEN SUCCESSFUL IN OTHER COUNTRIES IN ATTRACTING NEW AND YOUNGER INVESTORS. AGAIN AN APPROACH NOT IN CONFLICT WITH ANY OTHER INCENTIVES.

STOCKHOLDERS, THE "LITTLE GUYS" IN THEIR RETURN TO THE MARKET, OBVIOUSLY STILL HAVE FAITH THAT THE FUTURE OF AMERICA LIES WITHIN ITS SYSTEM OF PEOPLE'S CAPITALISM AND THEY ARE PUTTING THEIR MONEY WHERE THEIR FAITH IS - IN BUSINESS. THIS SHOULD BE ENCOURAGED. THE PRESIDENT'S PROGRAM WITH THESE ADDITIONAL BILLS WILL DO IT. THEN THE "REINDUSTRIALIZATION" AND THE "REVITALIZATION" OF AMERICA WILL BECOME A REALITY. ISN'T THAT WHAT WE ALL WANT TO SEE?

AGAIN, THANK YOU.

STATEMENT ON
TAX CUT PROPOSALS OF THE
ADMINISTRATION'S PROGRAM FOR ECONOMIC RECOVERY

Mr. Chairman, I am Thomas J. Donohue, President of Citizen's Choice, a national grassroots taxpayers' organization. Citizen's Choice presently has 70,000 individual members nationwide. Our members are all individual taxpayers and come from all walks of life.

I am pleased to have this opportunity to appear before the Senate Finance Committee to comment on behalf of our membership on the tax cut proposals in the Administration's Program for Economic Recovery. Citizen's Choice has a keen interest in the President's tax cut proposals because reducing the tax burden is the one issue of primary concern to all of our members, as I believe it is to all Americans.

I am not going to comment today on all the economic ramifications of the Reagan tax cut proposals -- the members of the Committee will hear from enough people who will do that -- and I don't come here today with any fancy econometric models that will predict the future rate of inflation or where interest rates will be one year from now. What I am here to do is pass on to the Committee the message Citizen's Choice heard from its members and the American people as a result of its 18-month investigation into taxes and taxpayer attitudes toward their government.

Frankly, what we have learned from our investigation does not bode well for our nation unless changes are made soon. In a sentence, the message was clear -- The American taxpayer is feeling increasingly alienated and frustrated by the pressures of an ever-increasing tax burden. It became obvious to us that tax relief is not only an economic necessity but an absolute must if the federal government hopes to regain the confidence and respect of its citizens and taxpayers.

Let me explain how Citizen's Choice came to this conclusion.

Citizen's Choice commenced its investigation into these tax matters in October of 1979 when we established the Citizen's Choice National Commission on Taxes and the I.R.S. (Some of you are aware that just a few weeks ago our Tax Commission issued its final report. I am submitting a copy of this final report for the record.)

This Commission was made up of 25 prominent Americans from the fields of academia, business and the professions. The Commission on Taxes and the I.R.S. was chaired by David McCarthy, Dean and Executive Vice President of the Georgetown University Law Center.

During the subsequent 14 months, members of this Commission and the Citizen's Choice staff criss-crossed the nation, and logged tens of thousands of miles, holding public hearings in ten metropolitan regions across the nation, from Seattle to Tampa and Hartford to San Jose. Thousands of citizens attended these hearings and along with the staff and commissioners heard testimony from citizens representing all sectors of our society. Witnesses spoke about taxes, their concerns about the rising tax burden and the way taxes are collected in this nation.

In addition to these public hearings, Citizen's Choice set up a toll-free "Tax-Line" over which we heard from several hundred additional taxpayers and we noted their concerns. We also received hundreds of pages of written testimony, court documents and letters from taxpayers all over this country.

Frankly, the depth of concern, the magnitude of the frustration and the level of anger and alienation which we found, suprised all of us. Perhaps because Citizen's Choice went out to the people to hold our hearings, instead of holding them in Washington, and perhaps because we did not listen as a government agency but as a private taxpayers' organization, the public let us know exactly what was on their mind.

It became quickly apparent that the state of taxpayer-government relations is not well.

Although the purpose of our public hearings was to examine the relationship between the taxpayer and the I.R.S., it was obvious that the IRS was serving as a "lightening rod" for the taxpayers' overall frustration with higher taxes, even though the IRS as an agency has little control over the rate or level of taxation.

However it is precisely this ever-increasing tax level that has the taxpayer mad.

Let me briefly use OPEC for an analogy. Much has been made of the unscrupulous price hikes which the OPEC nations have made us bear. We are all familiar with the feelings of anger and even hatred which the word "OPEC" can conjure up in the minds of the public. Think of your own feelings of frustration when you pay to fill up your gas tank. Now consider this fact: between 1976 and 1980 during a time of numerous OPEC price increases, federal income and social security taxes went up 18% faster than the cost of transportation! Is it any wonder that the federal government fares no better in the eyes of the taxpayer than the OPEC oil sheiks?

And as inflation increases and automatic tax increases occur through bracket creep and regular Social Security tax hikes, this feeling of anger toward the government only heightens in intensity. This leads to a profound sense of impotence on the part of the taxpayer. A sense of hopelessness and cynicism has developed among many taxpayers. And an even more ominous trend -- as the debilitating effects of inflation and higher taxes take their toll, many formerly patriotic taxpayers are losing their respect for their government. This concerns me a great deal as it must you as well.

By squeezing the middle class's standard of living, this combination of inflation and ever-rising taxes has all but destroyed the traditional American dream that if you work hard, you will get ahead. In the past two years real after-tax incomes have actually declined about six percent! And families who never thought of themselves as well-to-do are shocked to find their rising incomes pushing them into tax brackets once reserved only for the very wealthy. In fact, today for the average American worker, a 10 percent increase in wages translates into a 16 percent increase in taxes!

Now where is all of this taking us? Well, the economics are pretty simple. If nothing is done to cut individual income tax rates, unlegislated tax hikes will continue at an even quicker pace. Bracket creep alone will increase taxes by over $175 billion over the next three years! That works out to $800 for every man, woman and child in the U.S.

That means that unless tax relief comes and comes quickly, taxpayers are going to continue to see their incomes rise only to be gobbled up by even higher marginal tax rates. And if that is the problem then the solution to me appears equally obvious. We must reduce individual tax rates for all income groups. Even the Reagan tax cut program would not keep the average family's tax bill from rising in the years ahead and yet legislators are pontificating all over this town that his program is too "draconian," and all of a sudden these legislators believe that allowing the taxpayers to keep their own hard-earned money is inflationary!

The taxpayers of this country don't fall for that stuff anymore! They aren't falling for the old political lie that Congress is really giving them a tax cut. If the taxpayers were getting a real tax cut then why has their tax burden doubled in the last decade even though several so-called "tax cuts" have been passed? And why is it not inflationary for the congress to spend the taxpayers' money, but if the taxpayer spends his own money it suddenly is labeled inflationary?

In fact, the taxpayers are way ahead of their elected legislators on this issue. A very recent Gallup Poll indicates this as well. An incredible 86 percent of the public believe that if previous policies continue to be followed, our economic problems in the future are likely to be severe.

I am confident that all the members of the Committee are already aware of the serious economic condition we find ourselves in. You are familiar with the statistics on our dismal savings rate, the low level of investment and spending on Research and Development. I'm sure you have heard, as we did at our public hearings, about the difficulties small businesses and citizens are having in coping with interest rates in the upper 'teens.

The members of Citizen's Choice and the vast majority of the American people believe that the Reagan tax cut program would go a long way toward solving these serious economic problems.

President Reagan campaigned on a promise for a three-year tax cut program and the people elected him on that promise. The taxpayer has witnessed almost annual or biannual so-called tax cuts for the past decade. In order to regain their confidence in the integrity of our tax system the government must move ahead with a multi-year tax relief program.

Only a multi-year tax cut will improve the taxpayer's perception of the tax system which they now believe is unduly restrictive and unfair. And only such a program will renew the taxpayer's long-term faith in a tax system which they now realize has many built-in tax increases which produce "windfall benefits" for the federal government.

I would also like to note that throughout our public hearings, one group we heard a lot from was small independent non-incorporated business owners. These small business people realize that what is needed is an income tax rate cut because as non-incorporated businesses thay pay taxes on the individual income tax rate schedule. In fact, over 14 million businesses in this country would benefit from the Administration's income tax reductions. This represents nearly 90 percent of all the businesses in the United States.

Citizen's Choice believes that the need for prompt enactment of the Administration's tax program is clear. The members of Citizen's Choice stand firmly behind the President's tax cut program and they join me in urging you to act quickly to enact much needed tax relief

Indeed, I would go further than that. Having spent a great part of the past two years travelling around the country listening to hundreds of taxpayers, I have come the belief that federal tax relief is an absolute must if the government wants to improve what has become an increasingly adversary relationship between the taxpayer and the government.

This is not a healthy relationship and could well lead to dire consequences if the government fails to respond to this upswelling of sentiment. As Citizen's Choice held its hearings we noticed a number of significant side effects our tax system has caused. They include:

-- A serious rise in the number of individuals and organizations who are actively resisting the collection of income taxes. (Apparently many citizens believe that the tax system is so patently unfair that their evasion of it is consistent with the finest traditions of American independence and free thinking.)

-- A growing number of people are choosing not to report their full income to the IRS. This "underground economy" may well be so large today that as much as one dollar out of every five taxable dollars in America may be escaping the IRS.

-- These "do-it-yourself tax cuts" may cost the U.S. Government as much as $26 billion this year in uncollected taxes!

-- Tax avoidance is rising as "acceptable behavior" in recent opinion polls.

Without wanting to sound like an alarmist, I would warn Committee members that such tax evasion, increased tax resistance and downright cheating will only increase unless you and your colleagues enact tax relief promptly.

The taxpayer's faith and respect in the nation's tax system is already in jeopardy if not completely lost.

Citizen's Choice believes the adoption of the President's tax cut program, followed by additional tax reform in the upcoming two years, would go a long way toward finding a solution to these pressing problems and regaining the faith of the American taxpayer.

The American people sent some very clear signals to Washington in 1980. You have no obligations to Citizen's Choice, but you do have to respond to the American taxpayer, and they expect you to act. If serious tax relief is not forthcoming, it is not unreasonable for the taxpayer to react again in 1982 as they did in 1980. This is not just another issue for the taxpayer, it is The Issue.

Citizen's Choice encourages you to move ahead quickly and favorably on the President's tax cut program and we offer our assistance to you toward fulfillment of this goal.

EFFECT OF TAX POLICY ON THE CONSUMER INTEREST

by

Stephen Brobeck, Executive Director
Consumer Federation of America*

Statement Before the Senate Finance Committee
May 18, 1981

The Consumer Federation of America welcomes the opportunity to appear before this committee to discuss our assessment of President Reagan's tax proposals. CFA wholeheartedly concurs with the President that tax policy profoundly affects the consumer interest through its impact on income and inflation. Also, we commend the President's intent as expressed by Secretary Regan in his testimony before this Committee, "to expand incentives and opportunities for socially productive efforts and saving for all taxpayers."

CFA agrees that increases in productivity are necessary to expand real wages and restrain inflation. However, we are persuaded that President Reagan's specific tax proposals would do little to stimulate "socially productive efforts" and may even retard them. The specific assumptions of the President's program we question are these:

1. A significant portion of savings resulting from individual tax cuts would be allocated to capital investment.
2. 10-5-3 would stimulate a significant amount of productive capital investment.
3. Additional capital investment would automatically lead to an increase in productivity.

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*Consumer Federation of America is a twelve-year-old federation of over 200 national, state, and local consumer groups; cooperatives and credit union leagues; trade unions; senior citizens organizations; and farm groups. Collectively, CFA affiliates represent in excess of thirty million people.

I

Reducing marginal tax rates for individuals would not increase business investment considerably. A portion of the tax savings would be used, by those with discretionary income, to reduce their work effort. Another portion, certainly the bulk, would be allocated for consumption. Out of the remainder which would be saved, a large part would be invested in tangible assets such as land and collectibles and thus would not be available to business for investment in capital stock. The small portion left would, of course, be invested in stocks, bonds, and other financial instruments that supply business with capital. Yet the large majority of these investments would be short-term, and thus less useful than long-term stock and bond investments that have been so important to our growth in past decades.

Some economists suggest that there is no evidence at all that a personal tax cut will stimulate business investment. A Congressional Budget Office study of 1978 concurs. And even Treasury, which is as optimistic as anyone, predicts a savings increase from 5.5% in the late seventies to only 6% in 1980 and 7.9% in 1986. This compares to 14% in West Germany and 20% in Japan. Yet both Germany and Japan have higher marginal tax rates than we do.

MARGINAL FEDERAL TAX RATES, 1979

	Personal Income	Capital Gains
U.S.	50-70%*	28%
Japan	75	38
Germany	56	56
France	60	15

*50% on earned income, 70% on unearned income.
Source: Deloitte, Haskins, and Sells, International Tax Service.

Clearly, then, other factors are far more important than marginal tax rates in determining the rate of business investment.

II

The specific 10-5-3 proposal for accelerating depreciation would not stimulate capital investment. Contrary to popular opinion, personal and corporate savings rates have not been declining. As indicated by the table below, the personal savings rate computed from national income statistics reveals no long-term decline.

SAVINGS AS A PERCENT OF DISPOSABLE PERSONAL INCOME

1955-59	6.3
1960-64	5.3
1965-69	6.5
1970-74	7.3
1975-79	5.5

Source: The National Income and Product Accounts of the U.S., 1929-74.
Survey of Current Business, July Issues, 1976-80.

Even so, these statistics measure savings very imperfectly. As disposable personal income includes the income of unincorporated businesses and non-profit organizations, and savings excludes income from capital gains and depreciation reserves of unincorporated businesses, the savings figures are on the low side. As suggested by the far more rapid increase in individual financial assets than in income, as shown in the table below, savings as a percent of disposable income underestimates the personal savings rate. This is particularly true for the past decade.

NET INCOME IN FINANCIAL ASSETS AS A PERCENTAGE OF DISPOSABLE INCOME*

1955-59	7.5
1960-64	7.8
1965-69	8.3
1970-74	10.6
1975-79	13.2

*Financial assets include currency, demand deposits, savings accounts, government and corporate securities, insurance and pension reserves, commercial paper, and miscellaneous financial assets. Estimates of related debt increases were subtracted from disposable income.

Source: Economic Report of the President, January 1980.

More importantly, for several decades there has been no decrease in the rate of corporate savings. The following table traces undistributed profits and depreciation reserves as a percentage of gross domestic corporate product for the period 1955 through 1979.

CORPORATE SAVINGS RATE

1955-59	13.6
1960-64	13.3
1965-69	13.9
1970-74	13.3
1975-79	14.3

Source: The National Income and Product Accounts of the U.S., 1929-74.
Survey of Current Business, July issues, 1976-80.

Clearly, then, any decline in productivity does not reflect a decline in personal or corporate savings.

The abundance of savings would seem to suggest that any additional corporate savings produced by further acceleration of depreciation allowances would not stimulate needed business investment. But even if savings were not abundant, the implementation of the President's tax plan would not generate productive investments.

First, the 10-5-3 plan would provide the greatest benefits to those industries that need them the least. Oil companies, for example, would benefit as much as any industry, yet they are awash in capital. Because of the decontrol of crude oil prices, oil company profits, as a proportion of all manufacturing profits, have grown from 18 to 40% over the past three years. Much of this increase in profit has been used to finance the acquisition of other companies--coal, copper, and solar firms seem to be among the most favored target companies. Given the limited opportunities for expanded oil production, we can expect a flurry of new acquisitions to result from any acceleration of depreciation allowances.

Second, 10-5-3 would not help and may harm those industries most in need of capital. According to Economic Professor Robert Eisner, the proposed three-year capital recovery would be less advantageous for the auto industry than what is currently available. Moreover, he adds, the 10-5-3 plan would tend to draw capital away from small businesses, specially high technology, research-oriented firms.

Third, by expanding incentives to purchase short-lived equipment, accelerated depreciation may reinforce corporations' growing preoccupational with short-term profit-maximization rather than long-term growth.

Fourth, the 10-5-3 plan would expand tax shelter opportunities in areas such as equipment leasing and commercial real estate to such an extent that, according to Harvard economist Dale Jorgenson, the shelter business would "deserve its own line on the GNP accounts."

Fifth, the plan's three-year phase-in would encourage a delay in any new investment until 1985, at which time it would be subject to the most favorable tax treatment.

Fortunately, the past experience of our country and that of others can instruct us on this issue. In the early 1970s, a whole range of investment tax incentives, including faster depreciation, was enacted. In addition to costing the U.S. Treasury tens of billions of dollars, these changes made U.S. business tax breaks more generous than those in most other industrialized countries with higher capital investment and productivity growth rates than our's. In fact, an International Monetary Fund study found that the U.S. actually subsidized nonresidential fixed investment, while Germany, Japan, and France taxed this investment. Yet our capital investment rates remain well below those of these three countries.

III

Even if individual tax cuts and accelerated depreciation were to increase capital investment, these increases would not expand productivity significantly. As the table below suggests, there is not a close correlation between the two.

AVERAGE ANNUAL CAPITAL INVESTMENT AND PRODUCTIVITY GROWTH RATES

	Nonresidential fixed investment as a % of GNP (72 dollars)	Annual % change in output per hour of all persons in private business sector
1950-54	9.0	3.7
1955-59	9.2	2.4
1960-64	9.1	3.6
1965-69	10.6	2.5
1970-74	10.5	1.7
1975-79	10.2	1.4

Source: Economic Report of the President, 1981.

Though the independence of investment and productivity rates is not fully understood, it reflects, in part, the counting of certain nonproductive business expenditures as capital investments. This is certainly the case, for instance, with much of the spending for the construction of new buildings and for the purchase of many company cars. It is also noteworthy that while capital investments related to the production of military hardware may expand productivity, as it is currently measured, they do not allow for the expansion of real income because these products are not available for consumption.

IV

In summary, President Reagan's tax proposal, if enacted, would do little to check declining productivity, stagnating real wages, or double digit inflation rates. This is because it fails to come to grips with the most basic causes of our economic crisis, which are as follows.

First, rising energy prices have redistributed wealth away from all individual and industrial energy users to the oil industry and to oil-producing countries.

Second, high, volatile interest rates have discouraged long-term productivity increases and have placed tens of thousands of small farmers and other small businessmen in jeopardy. These rates were driven up by the rising inflation rate, but are now being reinforced by the Federal Reserve and large banks who discriminate in favor of big corporations at the expense of individuals, farmers, and small businessmen through their two-tier interest rate policy.

Third, myopic corporate planning is increasingly obsessed with the maximization of short-term profits. Reinforced by fluctuating prices and interest rates, these short-sighted decisions have already crippled the steel, auto, and tire industries, and now threaten machine tools firms.

Fourth, wasteful, speculative investment is expanding the money supply without increasing the supply of goods and services that money is supposed to represent. The increasing capital spent on corporate mergers - estimated by W.P. Grimes and Company at $44.3 billion - least year-- and speculation in real estate, currency, precious metals, and collectibles has diverted capital from much more productive uses.

To increase what Secretary Regan called "socially productive efforts," we must restrain energy prices and interest rates, and we also need to introduce incentives to encourage long-term planning and more productive use of resources.

CFA encourages the members of this committee to develop a tax reform package that only rewards socially useful investments and penalizes wasteful, speculative ones. Until very recently, our society was self-sufficient enough to tolerate waste and inefficiency without reducing living standards. Now that we have become extremely dependent on foreign producers, our national security, as well as our prosperity, requires more productive resource allocations. A Federal tax policy is an important tool for accomplishing such a re-allocation.

Statement of

Robert S. McIntyre
Director, Federal Tax Policy
Citizens for Tax Justice

Mr. Chairman, members of the Committee. I am Robert S. McIntyre, Director of Federal Tax Policy for Citizens for Tax Justice, a coalition of public interest and labor groups working to improve the fairness and efficiency of the tax laws at the federal, state, and local levels. The members of our coalition represent the interests of tens of millions of Americans. Since this is our first appearance before this Committee, I have attached to my testimony a copy of the statement of principles which we adopted last December in connection with our becoming involved in federal tax reform.

Introduction

In the 1980 presidential campaign, the winning candidate promised the voters a 30% cut in taxes, tax reforms designed to enhance productivity, sharp cutbacks in wasteful federal spending, and a general reliance on the free market, rather than government, to guide our economy. The centerpiece of President Reagan's economic program, the tax package, is now before this Committee. If the President's tax proposals had any significant relation to his campaign rhetoric or with the slogans now being used to defend them, our only major concern would be with their responsibility in fiscal and budgetary terms. Unfortunately, however, the President's tax package has virtually no connection with the principles upon which it is supposedly based. We must therefore urge this Committee to reject the President's proposals and instead to design a tax program which will in fact serve the goals which the President has articulated.

In his economic message to the Congress on February 18, the President stated:

> "The taxing power of the government must be used to provide revenues for legitimate government purposes. It must not be used to regulate the economy or bring about social change. We've tried that and surely we must be able to see it doesn't work."

We agree, but how can these brave words be uttered in support of a tax program which would add some $50 billion in tax subsidies purportedly designed to encourage business investment on top of the $36 billion in such subsidies which were enacted in the 70s?

On page 21 of the budget reform plan submitted as part of the economic recovery program by the administration to Congress on the day of the President's speech, it is stated:

> "The past decade of deteriorating national economic performance has been accompanied by a rapid build-up of Federal...subsidies designed to alleviate the effects of that deterioration on specific segments of the population and the economy. Federal programs have thus been created and expended in the name of stimulating growth, jobs, exports, and new technologies; and to assist declining industries and firms and in other ways to alter and fine-tune the level and composition of national economic activity."
>
> "Many of these programs, however, have served to distort the market economy and have thereby contributed as much to the problems they were intended to address as to their solution. Such subsidy policy commitments have largely resulted from... an absence of hard economic analysis and from failure to use limited tax resources on a cost-effective basis."

Again, we agree, but how can this statement be made in light of the complete failure of the administration to attack the tens of billions in tax expenditures enacted in the 70s "in the name of stimulating growth, jobs, exports" and so on, which have clearly "served to distort the market economy" to the detriment of us all? Where is the administration's "hard economic analysis" when it comes to tax subsidies?

Where is its commitment "to use limited tax resources on a cost-effective basis" when the tax boondoggles of entrenched interests are at stake?

The President has sold his Kemp-Roth individual tax cut as "across-the-board." But how can this label be applied to a tax "cut" which will allow the taxes of most Americans to go up, and provides 85% of its real tax reductions to the top 5% of all taxpayers?

The President has defended his 10-5-3 depreciation plan as a program to increase productivity and create jobs. But how can such a justification be offered for a plan which will create terrible distortions in investment decisionmaking, which will encourage replacement of workers with equipment even when the machines are less efficient, and will shower its largest benefits on the companies who need it least, such as oil companies and utilities?

We are convinced that enactment of the President's tax program would be a disaster for our economy and for the vast majority of American taxpayers. The President has asked those who are unwilling to accept his plan to offer "an alternative which offers a greater chance of balancing the budget, reducing and eliminating inflation, stimulating the creation of jobs, and reducing the tax burden." That is exactly what we would like to offer this Committee today.

I. CHANGES IN THE TAXATION OF BUSINESS.

The most far-reaching element in the President's tax package is the proposed "10-5-3" depreciation plan. Costing over a half trillion dollars over this decade, the program would reduce the corporate tax burden by 40% in five years and would eventually eliminate the corporate income tax entirely.

10-5-3 has been touted as a "new" approach to depreciation which will add to the share of the GNP going into productive investment, improve productivity growth, curb inflation, add billions to the national income, provide jobs, improve our international competitiveness, and in general lead us to the promised land. However, our analysis indicates that 10-5-3, far from achieving its purported goals, would actually do very serious damage to the performance of our economy. In fact, the plan is so poorly designed that it is hard to believe that its creators have any purpose other than to shift the corporate tax burden onto wage earners. We do believe, however, that major improvements can be made in depreciation and in other areas of business taxation, and that these changes could yield tremendous economic benefits, while at the same time improving the fairness of our tax system. In Part A we explain the overwhelming drawbacks we find in the 10-5-3 plan; in Part B we offer our proposals for business tax reform.

A. What's Wrong With 10-5-3?

One might think that the record of the 1970s would have curbed the enthusiasm for business tax breaks as a solution to our economic problems. After all, the 70s saw a decline in the growth rate, a stagnation of productivity, and a spiralling inflation, in spite of the enactment of huge supposed "incentives" for productive investment which now cost some $36 billion a year. And despite the massive tax breaks, the share of the GNP going into business investment was exactly the same in 1980 as it was in 1969.

In spite of this experience, many people still have difficulty believing that providing investment "incentives" will not have positive effects. We would like to explain in detail, therefore, why 10-5-3 is not likely to add significantly to investment levels and, even more important, why it is likely to lead to lower growth in national income and productivity.

First of all, a firm does not have to increase its investment spending in order to benefit from 10-5-3's tax subsidies. Most of the tax breaks will be gained even if no change at all is made in the level of investment. Nor is a firm required to reinvest the additional cash flow it gains from 10-5-3 in new productive investments. The tax savings may be reinvested productively, but they may also be used to finance dividend payments, corporate takeovers, advertising campaigns, or foreign investments.

Between 1970 and 1979, the after-tax profits of non-financial corporations jumped by 315%, due in large part to the huge investment "incentives" enacted in 1971 and later years. But investment by these companies in physical assets increased by only 176% over that period, and the share of their investment funds going into physical assets dropped from 84% to only 69%. The share of investment funds going toward increased holdings of financial assets, on the other hand, jumped by 530%.

Economist Robert Eisner has surveyed a large number of companies to try to ascertain the "incentive" effects of the investment tax credit. His finding: "While business welcomes the tax reduction ..., queries as to its effect in stimulating investment draw overwhelmingly negative responses... (W)e are told firms buy little or no additional equipment as a consequence of the tax credit." A recent econometric study by Professor Eisner, in conjunction with Robert S. Chirinko, for the Treasury's Office of Tax Analysis found that only 40% of corporate investment tax subsidies ended up in added investment, and even that figure is suspect, the authors note, since "one can get almost any answer one wants as to the effects of tax incentives for investment by making sure that the chosen model has the specification appropriates to one's purpose."

If the additional investment induced by 10-5-3 is likely to be modest compared to its cost, this does not mean that the plan will have no economic effects. Unfortunately, those effects will be overwhelmingly harmful. 10-5-3's "negative tax rates," its favoritism for some kinds of investment over others, and its extreme sensitivity to the level of inflation are likely to affect investment decisions in ways which undermine productivity growth.

Negative tax rates. To say that an investment has a "negative tax rate" means that, instead of taxing the income from the investment, the government actually supplements it. Because the value of 10-5-3's fast write-offs in conjunction with the investment tax credit is worth more than taking an immediate deduction for the entire cost of an asset, 10-5-3 would result in the replacement of the corporate income tax with a 16% tax subsidy for new investments. At first, these tax subsidies could be used to shelter income from previous investments and non-depreciable assets, such as land and financial assets. In the longer-run, the corporate income tax would essentially be eliminated. The current lobbying for refundable tax credits is in part explained by the desire of the business community for continued subsidies even after companies have reduced their taxable incomes to zero.

These negative tax rates would be likely to lead to a new proliferation of tax shelters -- investments entered into primarily or entirely for their tax saving potential. The plan would expand tax shelter opportunities in areas like equipment leasing so substantially that, in the words of Harvard economist Dale Jorgenson, the shelter business would "deserve its own line in the GNP accounts."

Distortions. Present law already has harmful effects on the quality of investment decisions, encouraging the purchase of mid-lived machines over both short- and long-lived assets. These distortions are clearly counterproductive and costly, but the distortions which 10-5-3 would create are positively frightening. The accompanying chart shows the range of effective tax rates for a representative sample of new

EFFECTIVE CORPORATE TAX RATES*
ON THE INCOME FROM VARIOUS INVESTMENTS
UNDER 10-5-3 AND CURRENT LAW

Asset Category	Effective Tax Rates Under 10-5-3	Effective Tax Rates Under Current Law
Computing and accounting machines	-47%	+28%
Trucks, buses, and trailers	-43%	+19%
Automobiles	-32%	+16%
Aircraft	-31%	+ 8%
Construction machinery	-29%	+16%
Scientific and other instruments	-25%	+17%
General industrial equipment	-21%	+13%
Furniture and fixtures	-20%	+12%
Engines and turbines	-15%	+24%
Mining exploration shafts and wells	-13%	+23%
Research and development expenses	0%	0%
Industrial buildings	+20%	+40%
Residential buildings	+35%	+38%
Commercial buildings	+36%	+43%
WEIGHTED AVERAGE FOR ALL ASSETS	-16%	+25%

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* The term "effective tax rate" means the average amount the corporate income tax will reduce (or increase if the rate is negative) the annual pre-tax income generated by particular kinds of investments. The figures assume inflation at current levels. Lower inflation would reduce effective tax rates under both 10-5-3 and current law, and would lead to wider discrepancies in effective rates for different assets.

SOURCE: Dale Jorgenson and Martin Sullivan, "Inflation and Capital Recovery in the United States," Harvard Institute of Economic Research, March 1981. See also Staff of the Joint Committee on Taxation, "Analysis of Proposals for Depreciation and Investment Tax Credit Revisions, Part I," May 6, 1981.

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assets, under 10-5-3 and current law. As can be observed, under 10-5-3 machines with the shortest lives will be heavily favored over more durable assets. This will encourage purchases of short-lived equipment in some cases when the pre-tax return from a sturdier machine is higher. For example, investments in long-lived equipment such as turbines would need a 30% higher pre-tax return to compete with investments in short-lived equipment due to 10-5-3. Research and development expenses, which are favored by the current tax system and which are probably one of the keys to productivity growth, would lose their relative tax advantage if 10-5-3 were enacted, and in fact would become one of the least favored kinds of investment. For example, under 10-5-3 r&d investments would need almost a 50% higher pre-tax return to compete with some short-lived investments.

Individual businesses may show a higher after-tax return in the short run if 10-5-3 is enacted, but the economy as a whole will be worse off. The distortions would inevitably lead to a change in investment patterns and a consequent reduction in national income, just as have the current investment "incentives," but on a much larger scale. The cost in reduced national income could well be in the hundreds of billions of dollars a year. It is hard to conceive of an investment policy more likely to lead to economic decline.

Inflation sensitivity. One of the most serious criticisms of the current depreciation system is that it is very sensitive to the level of inflation. For example, the average effective corporate tax rate on investments in plant and equipment increased from 14% in 1977 to 25% last year due to a higher rate of inflation If the inflation rate were to drop to 1973 levels, the current depreciation system would produce a tax rate of only 8%.

Instead of solving this problem, however, 10-5-3 only makes it worse. Both the average effective tax rate and the range of effective tax rates under 10-5-3 are extremely sensitive to the level of inflation. If the inflation rate were to decline to its 1973 level of under 6%, for example, the overall negative rate under 10-5-3 would jump to minus 44%, and the size of the distortions would double. The cost to both the economy and the Treasury would be even more astronomical than at the current inflation level.

In sum, 10-5-3 would tremendously aggravate the investment distortions already present under current law. Independent economists like Professor Jorgenson have found that its adoption would be a "serious blow to productivity." Fortune magazine -- no enemy of business -- agrees, criticizing "the false logic of 10-5-3," and condemning "business's dismal record of putting its parochial interest above the general good (as) the darkest cloud over Washington's new approach to taxes."

B. What Should Be Done About Business Taxes?

There is no doubt that the U.S. economy has many problems. Inflation, interest rates, and unemployment all are far too high. Economic growth and productivity gains are much too low.

But the answer is not simply to repeat the tax policy mistakes of the 70s, as President Reagan proposes. Huge business tax cuts over the past 10 years did not help improve our productivity growth rate or curb inflation. Quite the contrary. The business "incentives" encouraged speculation in things like gold and real estate (by lowering the capital gains rate), and distorted business decisionmaking as to which investments made the most economic sense. By doing so, they contributed to a dramatic reduction in the output from new capital investments, Thus, while our level of total capital investment has remained high, its productivity has been steadily declining.

BUSINESS FIXED INVESTMENT AND PRODUCTIVITY GROWTH
1950--1980

Year(s)	Non-residential fixed investment (billions of 1972 dollars)	NRFI as a percent of GNP (1972 dollars)	Annual Productivity Growth Rate (private business sector)
1950-59 average:	$ 58.2	9.1%	3.1%
1960-69 average:	90.1	9.9%	3.1%
1970-79 average:	132.3	10.4%	1.4%
1960	66.9	9.1%	3.1%
1961	66.7	8.8%	3.3%
1962	72.0	9.0%	3.8%
1963	75.1	9.0%	3.7%
1964	82.7	9.4%	4.3%
1965	97.4	10.5%	3.5%
1966	108.0	11.0%	3.1%
1967	105.6	10.4%	2.2%
1968	109.5	10.3%	3.3%
1969	116.8	10.7%	0.2%
1970	113.8	10.5%	0.9%
1971	112.2	10.0%	3.6%
1972	121.0	10.2%	3.5%
1973	138.1	11.0%	2.7%
1974	135.7	10.9%	-2.3%
1975	119.3	9.7%	2.3%
1976	125.6	9.7%	3.3%
1977	140.6	10.3%	2.1%
1978	153.4	10.7%	-0.2%
1979	163.3	11.0%	-0.4%
1980	157.7	10.7%	-0.1%

SOURCE: Economic Report of the President, Jan. 1981.

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Tax changes alone will not solve all of our problems. But basic improvements can be made in our tax laws which will contribute significantly to the reindustrialization of our economy and improve the fairness of our tax system at the same time. We suggest reforms in three basic areas: Removing roadblocks to productive investment, carefully targeting any investment incentives, and offsetting a portion of employer payroll taxes.

1. Removing roadblocks to productive investment.

Nowhere is waste and inefficiency more prevalent in government than in the tax system. Yet the corporate lobbyists who are clammering so loudly for new tax subsidies for themselves and budget cuts for workers, consumers, and the needy are silent when it comes to rooting out waste and inefficiency in the tax code.

But unless tax subsidies for unproductive investments are repealed, other efforts to use the tax system to encourage productive investment will fail. American industry is not suffering from a lack of capital, but from the inefficient use of the capital it has.

Our current depreciation laws distort investment decisions and divert capital away from its best uses. Tax shelters, speculation, mergers and acquisitions, runaway plants, and the export of American jobs overseas all are encouraged by provisions of our current tax system. Restructuring depreciation and repealing the wasteful subsidies which divert resources away from productive uses in the American economy will contribute more to increased productivity than all the billions of dollars in new tax subsidies offered by the Reagan tax program. It will also enhance the effectiveness of incentives for productive investment with which they will no longer be competing. Such changes will improve the fairness of our tax laws and produce additional revenues to provide more tax relief for average taxpayers and/or reduce fiscal pressures on the federal government.

a. Restructuring depreciation.

The current depreciation system is a mess. It results in different effective tax rates on different kinds of assets, shifts investment capital away from its best uses, is far too sensitive to the rate of inflation, and undercuts the effectiveness of the corporate income tax. 10-5-3 and similar proposals would simply make things worse. We suggest that the existing accelerated depreciation program and the investment tax credit be replaced with a system which will base depreciation write-offs on the actual ways plant and equipment wear out.

A great deal of analytical work has been done in recent years in calculating how to measure real economic depreciation. In addition, a number of proposals have been made as to how to put this new knowledge into action. Essentially, all of these concepts are based on replacement cost depreciation. Perhaps the simplest proposal in this area is the First Year Recovery System, introduced in the House by a number of members of the Ways and Means Committee. We believe that these bills, as well as other approaches based on real economic depreciation, should be carefully studied by the Committee.

The basic thrust of tax depreciation systems based on replacement cost is to allow true economic forces, rather than tax factors, to determine investment allocations. In other words, the basic goal is to eliminate distortions caused by tax subsidies and inflation.

A distortion-free depreciation system would provide encouragement for investments in assets which offer the highest economic return. This is is sharp contrast to 10-5-3, which would increase the premium for basing investment decisions on tax considerations.

The improvements in the efficiency of our capital investment from a distortion-free system could be startingly large. Professor Dale

Jorgenson estimates, for example, that the return to the economy on the investments made in 1977 alone could have been increased by some 25% if the distortions in current law had not been present. This is equivalent to adding $60 billion to the total amount of investment made in that year.

By shifting investments away from tax shelters and toward their most productive uses, a distortion-free depreciation system has the potential to improve economic growth and productivity enormously. The benefits of such a system would redound to all of us, businesses and consumers alike. As Professor Jorgenson reminds us, "what we're after is productivity, not capital spending."

The Chairman of the House Ways and Means Committee has announced his intention to seek depreciation restructuring which is as neutral as possible in its treatment of various investments. Last fall, this Committee approved the 2-4-7-10 plan for depreciation, which also was designed to improve neutrality. Obviously, many members of the two tax-writing committees are now becoming increasingly sensitive to the crucial importance of the distortion issue -- a development which we applaud.

Although 2-4-7-10 represents a major advance over 10-5-3, we cannot endorse it because of two major drawbacks. First of all, its neutrality is achieved at the price of essentially eliminating the corporate income tax on new equipment investments. In other words, the "neutral effective tax rate" it would establish is close to zero. Second, 2-4-7-10 remains sensitive to the level of inflation. If the inflation rate declines, 2-4-7-10 would produce <u>negative</u> tax rates, and serious distortions would reappear.

We therefore urge the Committee to undertake a serious examination of depreciation restructuring proposals which reduce investment distortions without being sensitive to inflation and without moving toward elimination of the corporate income tax. Adoption of such an approach could make a major contribution to productivity growth, enhance tax fairness, and be consistent with fiscal responsibility.

b. Repealing counterproductive tax subsidies.

Both fiscal responsibility and the need to improve the allocation of capital suggest that attention also be paid to existing tax subsidies which are costly to the Treasury and counterproductive in their effects on the economy. We urge that reforms in the following five areas be considered by the Committee:

(1) Tax breaks for foreign investment and multinational corporations.

At a time when priority must be given to encouraging investment in the American economy, tax provisions encouraging overseas investment and granting huge tax subsidies to multinational corporations can no longer be tolerated. We recommend the following steps in this area:

- The maze of tax treaties and IRS regulations which allows foreign tax havens to flourish must be completely overhauled and IRS enforcement activities expanded.
- The Reagan budget proposal calls for $410 million in reduced outlays by the Export-Import Bank in fiscal 1982, but completely ignores the wasteful and inefficient DISC tax shelter for exporters. Repeal of DISC would save taxpayers $1.8 billion in fiscal 1982, without the slightest effect on exports.
- The tax credit for corporations investing in U.S. possessions has been used primarily as a tax shelter device for drug companies investing in Puerto Rico. Repeal would save taxpayers $1.1 billion in fiscal 1982.
- Deferral of taxes on overseas income shelters profits made in foreign tax havens and encourages American multinationals to retain earnings abroad instead of bringing them home to invest

in the American economy. Repeal of deferral would add at least one half billion dollars in revenues in fiscal 1982.

(2) Tax subsidies for the oil and gas industries.

As a result of the enormous windfall profits generated by decontrol, the oil industry now controls 40% of all manufacturing profits in the U.S., compared to just 18% three years ago. Continuation of huge multi-billion dollar tax subsidies to the oil industry can no longer be justified. Percentage depletion and the expensing of intangible drilling costs should be repealed and abuses of the foreign tax credit should be ended. These changes would generate more than $5 billion in fiscal 1982.

(3) Capital gains exclusion for unproductive investments.

The provision allowing taxpayers to exclude 60% of the income they receive as capital gains overwhelmingly benefits the highest income taxpayers. In addition, it provides the impetus for many tax shelters designed to convert ordinary income (which is fully taxed) into income from capital gains (which is not). Moreover, the capital gains tax break is available not just for investments in productive assets (e.g., venture capital stock), but also for gains from gold, silver, stamps, coins, antiques, jewelry, and art.

Representative Shannon has proposed a bill to deny the capital gains exclusion to non-productive investments. Some estimates indicate that such as approach could cut the capital gains loophole by as much as one-third, or $6 billion. In addition, it would significantly reduce the scope unproductive tax shelter schemes and enhance tax equity. The same would be true of any provision which narrows the gap between the tax treatment of income from capital gains and income from employment.

(4) Commodity tax straddles.

Commodity tax straddles are a perfect example of a tax shelter abuse which diverts resources away from productive uses. No one has even attempted to offer an economic justification for these tax avoidance devices, which are estimated to cost the government between $1 and $3 billion a year. At a recent hearing before the House Ways and Means Committee, there was general agreement that commodity straddle abuses should be curtailed at once. Senator Moynihan has introduced legislation (S. 626) which, with a few amendments, would achieve this result. The Reagan administration has also endorsed comprehensive reforms in this area.

(5) Industrial Development Bonds

The use of tax exempt bonds to provide interest subsidies to private industry is a wasteful expenditure of federal funds and a boondoggle for the wealthy. Although proponents of these bonds like to argue that they encourate industrial development, the two largest users of tax-exempt financing last year were McDonald's and K-Mart. In fact, McDonald's has managed to finance hundreds of new restaurants around the country with tax exempts, causing one observer to rename them "Burger Bonds." Whether one calls them "IDBs" or "BBs", however, the abuse of tax-exempt financing has clearly gotten out of control. The reason, of course, is a simple one. Local governments make the decisions, but the federal government picks up the tab. There is a growing consensus that the use of tax-exempt bonds for non-governmnetal purposes should be curtailed. Such action could yield as much as $2 billion in added federal revenues.

2. Targeting investment incentives.

If the Committee adopts changes which reduce or eliminate the investment distortions caused by current law, it will have taken a giant step toward rekindling the growth of productivity in this country. In addition, the Committee may decide that particular areas or industries need additional government assistance, perhaps to deal with short-run economic problems. If the Committee does reach such a conclusion, we urge that it target its added subsidies to areas of need in a careful and rational manner.

Whatever the rhetoric used to justify them, all subsidies, routed through the tax system or otherwise, are targeted. Despite the "across-the-board" label its backers apply to the Reagan 10-5-3 plan, it is in fact a targeted tax reduction directing huge tax subsidies to the oil industry, the petrochemical industry, and others who have no need of such subsidies to meet their investment needs.

When economic circumstances suggest the need for investment subsidies, it is simply common sense that they ought to be directed to the areas of demonstrated need and that businesses benefitting from such public assistance be held accountable for its productive use.

One such approach has been proposed by Congressman Frank Guarini with the support of the AFL-CIO. HR 3218 calls for the creation of a new Reconstruction Finance Corporation (RFC) under the direction of a national tripartite Reindustrialization Board. The RFC would have authority to approve narrowly focused grants, loans, loan guarantees, and tax subsidies in order to direct capital to areas of need as established within the framework of a national industrial policy. Such an approach could target capital resources where they would do the most to stimulate economic recovery and growth, while avoiding the economic distortions and counterproductive misallocations of capital which the Reagan approach would create. We urge the Committee to examine seriously proposals for targeted subsidies, as the most cost-effective way of providing aid to truly needy industries.

3. Payroll tax reductions.

If productivity is in fact our objective, current tax policies are counterproductive for another reason. By reducing the cost of capital through a variety of tax subsidies while adding to the cost of labor by increasing payroll taxes, the current system encourages wasteful and inefficient uses of capital relative to labor. The Reagan tax program will only make matters worse. It ignores the 1981 increases in social security taxes and grants huge new tax subsidies to capital.

One way to reduce this distortion is to reduce the employer payroll tax burden by offsetting all or part of the 1981 social security tax increase. The AFL-CIO advocates a 5% credit, which would provide $3.1 billion in payroll tax reductions. A 10% credit would cost $6.2 billion. Such a credit would not only reduce the tax system's bias against employment, it would also be of substantial assistance to labor-intensive small businesses. And by reducing employer costs, it would exert some downward pressure on inflation.

II. INDIVIDUAL TAX CUTS

A. What's Wrong With the Reagan Administration's Proposal.

President Reagan has proposed a slightly altered version of the the Kemp-Roth plan, which will reduce statutory tax rates by 30% over the next three years. It is not a 30% cut in the taxes most people actually pay, because it adjusts only the statutory rates, while ignoring other important factors which also affect tax bills. In fact, the main result of the Kemp-Roth plan would be to shift a significant portion of the individual tax burden away from the top 5% of taxpayers and onto the bottom 60%.

1. How the Reagan Tax Cuts Would be Distributed

The effects of the Reagan plan would include the following:

-- Because of inflation-caused "bracket creep" and the 1981 hikes in social security taxes, most individuals earning under $20,000 a year would actually pay higher tax rates in 1984 than they did in 1980, even after enactment of Kemp-Roth. Eighty-five percent of the real reductions in taxes would go to the 5% of individuals with incomes over $50,000 a year.

-- Taxpayers earning under $10,000 would end up with a 28% real increase in taxes under the Reagan plan. The 2/10th of one percent of individuals with incomes exceeding $200,000 on the other hand, would receive real tax cuts averaging almost $21,000 each, even after subtracting the effects of bracket creep and rising social security taxes.

-- Middle-income taxpayers with incomes between $20,000 and $50,000 would get real tax cuts in 1984 averaging only $44, or less than 1% of their current income and payroll tax liabilities.

Thus, for 95% of the taxpayers, Kemp-Roth offers virtually nothing in tax reductions, and for 60% it allows tax rates to go up. How does a 30% "across-the-board" tax cut turn out to be distributed so unfairly?

THE NOMINAL AND THE REAL DISTRIBUTION OF THE REAGAN TAX CUTS IN 1984 (1981 Income Levels)

Expanded Income ($ -000)	Distribution of		Percent Change in Tax Liability[c]	
	Nominal Cuts[a]	Real Cuts[a]	Nominal[a]	Real[b]
Less than $10	3.1%	TAX INCREASE	- 18.6%	+ 27.8%
$10-15	6.2%	TAX INCREASE	- 20.6%	+ 7.1%
$15-20	8.5%	TAX INCREASE	- 21.0%	+ 1.4%
$20-30	21.0%	1.8%	- 21.2%	- 0.2%
$30-50	30.2%	12.1%	- 22.5%	- 1.1%
$50-100	18.0%	23.5%	- 25.4%	- 4.1%
$100-200	7.5%	27.1%	- 24.1%	- 10.6%
$200 and over	5.4%	37.3%	- 19.9%	- 17.0%
TOTALS (Averages)	100.0%	100.0%	- 22.2%	- 1.1%

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[a] Nominal cuts are those announced by the Reagan administration, and are based on the assumption that the inflation rate will be zero over the next four years.

[b] Real cuts are nominal cuts net of inflation-caused "bracket creep" and the 1981-82 payroll tax hikes. The tax increases in the under $20,000 income class were not included in calculating the distribution of the real tax cuts.

[c] Change as a percentage of the 1981 income and payroll tax liability, not including increases in '81 due to inflation and increased payroll taxes.

SOURCE:
Based on data from the Joint Committee on Taxation, April 13 and April 27, 1981.

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1984

1984 IMPACTS PER TAXPAYER[a]
OF THE REAGAN INDIVIDUAL TAX CUTS
AND THE TAX INCREASES DUE TO INFLATION-CAUSED "BRACKET CREEP" AND THE 1981-82 HIKES IN SOCIAL SECURITY PAYROLL TAXES
(1981 Income Levels)

Expanded Income ($-000)	Average Tax Cut Under Reagan Plan	Average Tax Increase Due to "Bracket Creep" and Payroll Tax Hikes[b]	Average Net Change In Tax Liability	% Change in Tax[c] Liability	% of All Taxpayers[d]
Under $10	$ 81	$ 204	$ + 123	+ 27.8%	34.2%
$10-15	367	487	+ 120	+ 7.1%	14.7%
$15-20	616	656	+ 40	+ 1.4%	12.1%
$20-30	978	967	- 10	- 0.2%	18.9%
$30-50	1,742	1,655	- 86	- 1.1%	15.2%
$50-100	3,930	3,298	- 632	- 4.1%	4.0%
$100-200	9,393	5,258	- 4,136	- 10.6%	0.7%
$200 and over	28,720	6,738	-21,982	- 17.0%	0.2%
AVERAGES (Totals)	$ 883	$ 838	$ - 45	- 1.1%	100.0%

[a] Averages for all individuals subject to income and/or social security payroll taxes.

[b] "Bracket Creep" means the effect of taxpayers being pushed into higher tax rate brackets even though their real incomes have not increased. The tax increase shown here is the revenue cost of avoiding this result. In 1981 the payroll tax rate was raised from 6.13% to 6.65% and the maximum amount of income to which the tax applies was increased in excess of an inflation adjustment. In 1982, the rate will go to 6.70%. These payroll tax increases average $99 per taxpayer. Also, in 1981, a $200/400 exemption for interest and dividends was instituted. The figures shown are net of the tax reduction resulting from this change.

[c] Total income and payroll tax liability.

[d] Individuals subject to income and/or payroll taxes.

SOURCE:
Based on data from the Joint Committee on Taxation, April 13 and 27, 1981.

Citizens for Tax Justice
May 7, 1981

1981

1981 IMPACTS PER TAXPAYER[a]
OF THE REAGAN INDIVIDUAL TAX CUTS
AND THE TAX INCREASES DUE TO INFLATION-CAUSED "BRACKET CREEP"
AND THE 1981 HIKES IN SOCIAL SECURITY PAYROLL TAXES
(1981 Income Levels)

Expanded Income ($-000)	Average Tax Cut Under Reagan Plan	Average Tax Increase Due to "Bracket Creep" and 1981 Payroll Tax Hikes[b]	Average Net Change In Tax Liability	% Change in Tax[c] Liability	% of All Taxpayers[d]
Under $10	$ 16	$ 65	$ + 49	+ 11.0%	34.2%
$10-15	71	144	+ 73	+ 4.1%	14.7%
$15-20	117	206	+ 90	+ 3.1%	12.1%
$20-30	184	306	+ 122	+ 2.6%	18.9%
$30-50	327	522	+ 195	+ 2.5	15.2%
$50-100	725	924	+ 199	+ 1.3%	4.0%
$100-200	1,561	1,316	- 197	- 0.5%	0.7%
$200 and over	4,677	1,683	-2,999	- 2.3%	0.2%
AVERAGES (Totals)	$ 163	$ 255	$ + 92	+ 2.3%	100.0%

[a] Averages for all individuals subject to income and/or social security payroll taxes.

[b] "Bracket Creep" means the effect of taxpayers being pushed into higher tax rate brackets even though their real incomes have not increased. The tax increase shown here is the revenue cost of avoiding this result. In 1981 the payroll tax rate was raised from 6.13% to 6.65% and the maximum amount of income to which the tax applies was increased in excess of an inflation adjustment. The 1981 payroll tax increase averaged $91 per taxpayer. Also, in 1981, a $200/400 exemption for interest and dividends was instituted. The figures shown are net of the tax reduction resulting from this change.

[c] Total income and payroll tax liability.

[d] Individuals subject to income and/or payroll taxes.

SOURCE:
Based on data from the Joint Committee on Taxation, April 13 and 27, 1981.

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There are two reasons: the 1981 hikes in social security taxes and, most important, inflation's effect on tax rates. The Reagan-Kemp-Roth plan allows the personal exemption, the zero-bracket-amount, the size of the tax brackets and the earned income credit all to be eroded by rising prices. For example, by 1984, the $1,000 personal exemption will be worth only about $700 in 1980 dollars. Just to keep the exemption's value constant would require an increase by 1984 to about $1,400.

The effects of this inflation-caused bracket creep and the 1981 payroll tax increases are felt most heavily by middle and lower income taxpayers. For example, in 1981 alone, bracket creep will add 29% to the income tax bill of families earning under $10,000, 7% to the rate paid by those in the $15-30,000 range, but only 1% to the taxes paid by those with incomes in excess of $200,000. Similarly, in 1981 the payroll tax hikes will add 6% to the total tax bills of individuals earning under $10,000 but only 0.2% to the taxes of those with incomes over $200,000.

2. The Treatment of "Earned" and "Unearned" Income.

In addition to its terribly unfair distribution by income classes, the Reagan plan would also increase the disparity between the treatment of "earned" and "unearned" income. Contrary to the administration's rhetoric, current law already taxes "earned" income -- primarily wages -- much more heavily than "unearned" income -- which includes such things as capital gains, dividends, interest, and so on. A recent Treasury study documents the tremendous disparity. The title of the study asks the question, "Is Income From Capital Subject to Individual Income Taxation?" The study concludes that, even after generous adjustments are made for inflation, the answer is generally "no."

The primary reason for the light taxation of "unearned" income is that some 80% of individually-held capital assets are in a form for

PERCENT TAX INCREASES DUE TO "BRACKET CREEP" IN 1981
(1981 Income Levels)

Expanded Income ($-000)	% Tax Increase Due to "Bracket Creep"*
Less than $10	29.0%
$10-15	9.1%
$15-20	7.3%
$20-30	6.8%
$30-50	6.5%
$50-100	5.7%
$100-200	3.3%
$200 and over	1.2%
AVERAGE	6.3%

*The percent increase in income taxes which would result from the failure to adjust the zero-bracket-amount, the personal exemption, the earned-income-credit, and the bracket widths for 9.2% inflation.

SOURCE:
Based on data from the Joint Committee on Taxation
April 13 and 27, 1981.

Citizens for Tax Justice
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PERCENT TAX INCREASES
DUE TO 1981 HIKES
IN PAYROLL TAXES

Expanded Income ($-000)	% Increase In Total Tax Liability*
Less than $10	5.6%
$10-15	3.1%
$15-20	2.8%
$20-30	2.6%
$30-50	2.6%
$50-100	1.7%
$100-200	0.7%
$200 and over	0.2%
AVERAGE	2.3%

*Change in combined income and payroll tax liability

SOURCE:
Based on data from the Joint Committee on Taxation, April 13 and 27, 1981

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which a tax preference is available to shelter all or part of the income generated. In addition, there is a much lower rate of compliance by taxpayers in reporting capital income than in reporting wages (which, unlike capital income, are subject to withholding).

Although the Reagan administration says it wants to reduce the disparity in the taxation of "earned" and "unearned" income, all its actual program does is widen the gap. By cutting the top theoretical tax rate on "unearned" income from the current 70% to 50% -- the same as the top rate on "earned" income -- the maximum rate on capital gains would drop to only 20%, or less than the marginal income and social security tax rate paid on wages by a family earning $15,000 a year. Meanwhile, the maximum rate on wages would remain at 50%, and most "unearned" income would still be exempt from taxation.

Furthermore, the lowered capital gains rate would add to the attractiveness of real estate tax shelters, and would make investments in non-productive assets, like gold and collectibles, even more lucrative. In addition, the Reagan 10-5-3 depreciation plan would create outright tax subsidies (or negative tax rates) for investments in depreciable equipment. Some studies have suggested that this could lead to complete exemption from taxation for high bracket taxpayers, who enjoy most of the "unearned" income.

In sum, the goal of equalizing the tax treatment of "earned" and "unearned" income is a worthy one, but the Reagan program would increase rather than decrease the current, already huge disparity. If the President were serious about "equalizing the treatment of earned and unearned income," he would be proposing to curtail some of the many tax preferences and shelters which favor unearned income. At the very least he should be seeking a reduction in the capital gains exclusion along with his rate cuts, to reduce this preference which discriminates against income earned from wages. In conjunction with reforms such as those listed in section I of our testimony, an equalization of the top rate on earned and unearned income would make a great deal of sense. Without those reforms, a cut in the top rate will only increase the discrimination against wage income.

3. The Economic Effects of Kemp-Roth

When all the rhetoric about "across-the-board" and "equalizing earned and unearned income" is stripped away, the only remaining defense of the Reagan administration's individual tax cut plan is that its beneficial economic effects would outweigh its unfairness. While some supply-side heroes like George Gilder */ would relegate tax changes to a third-order priority, behind stifling feminism and curtailing welfare, and while the movement's economic guru Arthur Laffer has retreated from his previous claim that the tax cuts would be self-financing, there remain those in the administration who have consulted their entrails and predict massive additions in work effort and investment and a dramatic shift away from tax shelters as a result of Kemp-Roth's cuts in marginal tax rates.

Unfortunately, there are too many holes in this theory for it to be credible.

First of all, for most taxpayers, marginal tax rates will not be reduced at all. Inflation will push them into higher brackets even as the Reagan program attempts to move them into lower ones. Thus, for the vast majority the only "incentive" offered by the Reagan plan is the "incentive" of higher taxes and lower real disposable incomes.

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*/ Wealth and Poverty (1980).

KEMP-ROTH AND "MARGINAL TAX RATES"[a)]
(Four-person, Two-earner Families)

1980 INCOME	MARGINAL TAX RATES IN 1980 ON			MARGINAL TAX RATES IN 1984 ON SAME REAL INCOME[b)] UNDER KEMP-ROTH ON			CHANGE IN EFFECTIVE TAX RATES[c)] 1980-1984 UNDER KEMP-ROTH
	WAGES	DIVIDENDS[d)]	CAPITAL GAINS	WAGES	DIVIDENDS[d)]	CAPITAL GAINS	
$ 10,000	22%	16%	6%	20%	13%	5%	+ 25%
15,000	24%	18%	7%	25%	18%	7%	+ 3%
20,000	27%	21%	8%	28%	21%	8%	0%
30,000	34%	28%	11%	34%	27%	11%	- 1%
40,000	43%	37%	15%	39%	32%	13%	- 2%
50,000	49%	43%	17%	43%	36%	14%	- 4%
100,000	50%	54%	22%	43%	43%	17%	- 9%
200,000	50%	64%	26%	49%	49%	20%	- 13%
1,000,000	50%	70%	28%	50%	50%	20%	- 26%

[a)] Income tax and, where applicable, social security tax rate which would be paid on one additional dollar of income.

[b)] Income levels are adjusted for 9.2% annual inflation.

[c)] Change in the percentage of income paid in income and social security taxes.

[d)] Assumes that $400 interest and dividend exclusion does not apply.

Citizens for Tax Justice
March 18, 1981

Second, even for the relatively small number of taxpayers who would experience lower marginal rates under Kemp-Roth, the effects on work effort and productive investment are likely to be minimal because the Reagan program fails to take the necessary steps to assure a beneficial response.

Under Kemp-Roth, the top 5% of taxpayers will in fact receive substantial real reductions in both taxes and in marginal tax rates, primarily on their "unearned" income. For these individuals, the Reagan plan does offer real incentives, but for what? For more work and investment to grow even richer or for more leisure and consumption to enjoy the fruits of lower taxes? Most economic studies agree with the common-sense conclusion: the two factors would just about balance each other out.

Even if investment is increased, will it go to productive investment in new technologies, plants, and equipment, or will it go to real estate speculation, gold, silver, commodity tax straddles, art, coins, stamps, foreign tax havens, antiques, and other non-productive investments -- as has been the pattern in recent years? One impact seems certain: by reducing the maximum rate on capital gains to only 20%, the Reagan plan will encourage the continued proliferation of uneconomic tax shelter schemes designed to convert ordinary income into capital gains.

The only economic response which the administration spokesmen have made to the charge that their program is undercut by its failure to attack tax loopholes is that such steps are unnecessary, because high-income investors will "automatically" move out of tax shelters in response to lower rates. The obvious counter-response is to ask, if this is true, why is the administration so reluctant to attack the shelters head-on? Why should we risk getting no benefit from the rate cuts when we could obtain a real test of supply-side economics by curbing shelters at the same time?

Lowering marginal tax rates could produce some real economic benefits -- as tax reformers have argued for years. But the benefits will ensue only if the tax subsidies and shelters which distort investment patterns and encourage waste are eliminated at the same time. The Reagan program's failure to take such steps stands in stark contrast to its alleged goals, and suggests that its real purpose is to shift more income to the well-off rather than to improve the economy.

4. Capital Gains

As was noted, the Reagan rate cuts would have the effect of lowering the maximum capital gains rate to only 20% -- the same as the marginal rate paid on wages by a family of four earning $15,000. Others have suggested even larger reductions in capital gains taxes, by increasing the exclusion to as much as 75%. The support for lower capital gains taxes on the part of high-income individuals is understandable, since they manage to style over a third of their income in this form. The enthusiasm for lower capital gains taxes in some quarters of Congress, however, can be explained only as a misinterpretation of the results of the 1978 reduction. We would like, therefore, to set the record straight.

The stated purpose of the '78 capital gains cut was to help the economy, primarily by boosting the stock market and encouraging venture capital. Promises were made about 40% increases in the Dow-Jones average and a return of the number of venture capital issues to their halcyon days of the late 60s and early 70s. Now, obviously, the economy has not been an amazing success since the capital gains taxes were reduced. From the fourth quarter of 1978 through the end of 1980, real growth totalled a mere 1%, the price level increased 18%, unemployment went from 6% to 7.4%, and productivity growth was negative.

THE CAPITAL GAINS EXCLUSION

DISTRIBUTION AND TAX SAVINGS PER RETURN
(1981 Income Levels)

Expanded Income ($-000)	Share Of Total Benefits	Percent Of Taxable Returns In Class With Cap. Gains	Tax Savings Per Return With Capital Gains	Tax Savings Per Taxable Return	% Of Returns In Class
Under $10	0.5%	3.5%	$ 172	$ 6	22.6%
$10-15	0.9%	5.4%	277	15	17.3%
$15-20	1.1%	5.6%	400	22	14.2%
$20-30	3.8%	7.3%	670	49	22.2%
$30-50	10.7%	13.1%	1,291	169	17.9%
$50-100	18.1%	28.4%	3,830	1,086	4.7%
$100-200	18.9%	49.1%	13,058	6,415	0.8%
$200 and over	46.0%	65.9%	91,713	60,396	0.2%
TOTALS	100.0%				100.0%
(Averages)		8.4%	$ 3,386	$ 283	
ADDENDUM:					
Under $30	6.3%	5.4%	434	23	76.3%
Over $50	83.0%	32.8%	12,434	4,073	5.8%
Over $100	64.9%	52.6%	33,332	17,523	1.0%

SOURCE: Based on data from the Staff of the Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 1981-86, March 16, 1981, page 19.

Citizens for Tax Justice
May 1, 1981

DISTRIBUTION OF THE TAX SAVINGS FROM INCREASING THE CAPITAL GAINS EXCLUSION TO 70% (AS APPROVED BY THE FINANCE COMMITTEE IN SEPT. 1980) (1981 Income Levels)

Expanded Income ($-000)	Amount of Tax Cut (millions)	Percent of Total Cut	Average Cut Per Taxable Return ($-actual)
Less than $10	$ 10	0.4%	58 cents
$10-15	20	0.9%	$ 2
$15-20	29	1.2%	3
$20-30	108	4.6%	5
$30-50	280	12.0%	21
$50-100	480	20.5%	134
$100-200	434	18.6%	686
$200 and over	975	41.7%	5,945
TOTALS	$2,336	100.0%	$ 31
ADDENDUM:			
Less than $20	$ 59	2.5%	$ 1
$20-50	388	16.6%	13
$50 and over	1,889	80.9%	431
$100 and over	1,409	60.3%	1,768

SOURCE: Data from the Joint Committee on Taxation, 1/30/81

Citizens for Tax Justice
February 12, 1981

The failure of the capital gains tax cut to improve the economy is understandable in light of its failure to help even the stock market. In fact, following Senate approval of the reduction, the market collapsed. As of May 13, 1981, the Dow-Jones average had still lost substantial ground to inflation, and the Standard & Poor's 500 and the broad-based New York Stock Exchange Composite were barely holding their own. Small venture capital stock issues were still over 80% below the level they attained in the late 60s and early 70s.

Although a few of the advocates of lower capital gains taxes have continued to maintain that their plan would improve the economy, most of the supporters realize that the hoped-for economic effects of the '78 cut did not pan out. They have therefore shifted their focus, and are now trumpeting the fact that preliminary Treasury data for 1979 indicate that the cost of the '78 cut was minimal, due to increased capital gains realizations. Now, in fact, even opponents of the '78 cut conceded that in the short run the revenue losses were likely to be reduced by the "unlocking effect" of increased selling. But this effect is likely to be short-term in nature.

Furthermore, a significant portion of the increased capital gains realizations may be due to the proliferation in the use of commodity tax straddles in the last few years. Since this device is largely employed to convert ordinary income into capital gains, it would naturally have resulted in a surge in capital gains realizations, even in the absence of the '78 changes.

The '78 capital gains cut has clearly failed to perform the economic feats predicted by its supporters. Its only sure effect has been to lower the effective tax rate for those earning over $200,000 a year by five full percentage points. Further cuts in capital gains taxes are simply unwarranted.

PERFORMANCE OF THE STOCK MARKET SINCE 1978 CAPITAL GAINS TAX REDUCTIONS

	10/11/78*	5/13/81	% Change	Inflation (Change in GNP Deflator)	Net Change
Dow-Jones Industrial Average	901.4	967.8	+ 7.4	25%	- 14.1%
Standard & Poor's 500	105.4	130.6	+ 23.9	25%	- 0.9%
New York Stock Exch. Composite	58.8	75.6	+ 28.6	25%	+ 2.9%

*The day the Senate approved its capital gains cut, thereby guaranteeing that a large reduction in capital gains taxes would be enacted.

SOURCE:
Stock market data from The Wall Street Journal, October 12, 1978 and May 14, 1981.

Citizens for Tax Justice
May 14, 1981

STOCK ISSUED BY COMPANIES WITH NET WORTH OF LESS THAN $5 MILLION 1968-1980

Year	No. of Issues	Amount (millions of 1972 dollars)	% of 1968 No.	% of 1968 $$$
1968	358	$ 928	100%	100%
1969	698	1,575	195%	170%
1970	198	410	55%	44%
1971	248	573	69%	62%
1972	409	896	114%	97%
1973	69	151	19%	16%
1974	9	14	3%	2%
1975	4	13	1%	1%
1976	29	110	8%	12%
1977	30	84	8%	9%
1978	21	86	6%	9%
1979	46	112	13%	12%
2nd ½ 1979 - 1st ½ 1980	60	170	17%	18%

SOURCE:
Based on data from People and Taxes, January 1980, p.5; Congressional Budget Office, "The Productivity Problem: Alternatives for Action", January 1981, p.78.

Citizens for Tax Justice
March 6, 1981

B. What Should Be Done About Individual Taxes?

The size of the individual tax change this year must be determined as a matter of fiscal and budgetary policy. It will be dependent upon the scope of congressional spending reductions, the amount of the business tax cuts, and the choice as to the size of the deficit. The advice which we offer here, therefore, is concerned first with the distribution of whatever amount of individual tax reductions the Committee decides to be appropriate, and second with tax changes which could provide substantial economic benefits and at the same time help finance the cuts. Most of our suggestions are already implicit in our criticisms of the Reagan plan in part A above.

1. How the Individual Tax Cuts Should Be Distributed

There are several factors which we urge the Committee to keep in mind in deciding upon the distribution of individual tax changes.

First of all, a tax "cut" of some $23 billion is needed in calendar 1981 just to offset the tax increases caused by this year's inflation and payroll tax hikes. The distribution of such a "cut" -- which could be accomplished by adjusting the brackets, exemptions and the earned income credit for inflation and providing a 10% payroll tax credit -- would be approximately as follows:

Expanded Income ($-000)	Percentage of Tax "Cut"
Under $10	8.8%
$10 - 15	8.3%
$15 - 20	9.8%
$20 - 30	22.8%
$30 - 50	31.3%
$50 -100	14.2%
$100-200	3.7%
$200 and over	1.2%
TOTAL	100.0%

Such a distribution is in sharp contrast to the Reagan-Kemp-Roth tax "cuts," which would be distributed as follows:

Expanded Income ($-000)	Percentage of Kemp-Roth Tax "Cut"
Under $10	3.1%
$10 - 15	6.2%
$15 - 20	8.5%
$20 - 30	21.0%
$30 - 50	30.2%
$50 -100	18.0%
$100-200	7.5%
$200 and over	5.4%
TOTAL	100.0%

Second, when Congress passed the windfall profits tax, it promised to mitigate some of the burdens of higher energy prices by reducing individual taxes. In fact, 60% of the revenues from the windfall tax were earmarked for such tax reductions. If an additional 10% payroll tax credit were provided -- an approach which would assign tax relief in roughly the manner in which higher energy cost burdens are being borne -- the distribution of the overall tax cuts (including those discussed above) would be approximately as follows:

Expanded Income ($-000)	Percentage of total Tax "Cut"
Under $10	8.9%
$10 - 15	8.5%
$15 - 20	10.1%
$20 - 30	23.3%
$30 - 50	31.8%
$50 -100	13.2%
$100-200	3.2%
$200 and over	1.0%
TOTAL	100.0%

We suggest that, whatever the size of the individual tax adjustment approved by the Committee, it ought to be distributed in about the manner shown in the last table.

Third, if the Committee decides to provide substantial tax reductions on business income, those changes will affect both corporate and individual tax liabilities. And insofar as they affect individuals, most of the benefits will inevitably go to taxpayers in the higher brackets. We urge the Committee to take note of this fact in calculating the distribution of any individual tax changes it approves.

2. Cutting Back on Wasteful and Counterproductive Tax Subsidies

The administration has shown great enthusiasm in its attacks on waste and inefficiency in direct federal spending, in many cases proposing cutbacks even in programs which have been successfully fulfilling important purposes. At the same time, the administration has failed to identify even one of the many costly federal programs administered through the tax system as a target for retrenchment. Yet nowhere is waste in the federal budget more prevalent than in the tax code.

We believe that this Committee has the duty to take on the burden -- which has been shirked by the Reagan administration -- to examine carefully the tax subsidies in current law and to repeal those which are unnecessary, counterproductive, non-cost-effective, or otherwise undesirable. At a time when financial markets are reacting nervously to the prospect of enlarged federal deficits, a focus on tax preferences is clearly a necessity.

In our analysis of the business tax cuts above, we included a list of tax subsidies which we believe should be eliminated. Some of them primarily affect corporations; others, individuals.

If the changes we suggest are made, then it may be possible to adjust individual tax rates more significantly. For example, disallowing capital gains treatment for non-productive assets and restraining the use of industrial development bonds could make a reduction in the top tax rate to 50% acceptable from an equity point of view, and at the same time help improve the productive allocation of capital. Further changes could allow general rate reductions while reducing other counter-productive incentives. In fact, our proposed reforms could actually make a real test of "supply-side" economics possible.

3. Savings Incentives

Finally, we urge the Committee to avoid the temptation to enact new tax expenditures whose purpose is to encourage personal savings. We have studied the various proposals in this area, and have found that they all have two major drawbacks: First, they are unlikely to add significantly to personal savings, and are even less likely to add to the nation's total store of savings. Second, they tend to make the tax system less fair.

Most of the proposed savings incentives are based on exempting a certain amount of savings or interest from taxation. As such, they obviously will have no "incentive" effect for those whose savings or interest already exceed the limits. Thus, most of the revenue loss will merely reduce government savings, without any corresponding increase on the individual side.

In addition, the proposals all share the defect that taxpayers can take advantage of them without any actual increase in net savings. First of all, it seems clear that most added investments in tax-favored areas will be undertaken simply by shifting funds away from less-favored investments. In other words, investments in IRAs will be at the expense of reduced investments in stocks or savings accounts, not at the expense of reduced consumption.

Second, most of the so-called "incentives" are extremely vulnerable to arbitrage. For example, a taxpayer with zero savings could utilize a $1,000 interest exemption by borrowing, say, $10,000 and depositing the proceeds in an interest-bearing account. The profits would be the tax savings from the interest deduction on the loan. Other proposals offer similar, albeit more complex, arbitrage possibilities. An illustration is provided by a solicitation letter recently circulated by the Chase Manhattan Bank (a copy of which is attached to this testimony). In this letter, Chase offers to lend potential customers up to $7,500 to finance a Keough account, and explains in detail the tax advantages of borrowing to "save" in a tax-sheltered account.

Neither shifting nor arbitrage adds a nickel to net personal savings -- and the loss to the government means a net reduction in total societal savings. Such is the usual effect of well-intentioned but misguided efforts to stimulate personal savings through tax incentives.

Finally, because of progressive tax rates, most tax incentives for savings provide their largest dollar benefits to high income individuals. For example, the $200/400 interest exemption enacted in 1980 is worth a maximum of only $36 to a family earning $15,000, but it saves a very high income family as much as $280. Thus, most "small savers" bills tend to provide their most generous "incentives" to big savers, who do not even have to change their behavior to gain the benefits.

We believe that the best way for this Committee to increase the stock of productive savings in this country would be to adopt our proposals to curtail tax subsidies which divert savings away from their most productive uses. These steps could add more to growth and productivity than all of the savings "incentives" which have been suggested.

CHASE

August J. Byllott
Second Vice President
The Chase Manhattan Bank, N.A.
Retail Banking Center
New Hyde Park, New York 11042

March 19, 1981

Dear Mr.

The enclosed certificate can be good for $7,500 if you want it to be.

Chase is now embarked on a program to establish and expand relations with individuals like you, professionals of proven achievement and excellent credit worthiness.

We believe an appropriate "get acquainted" step is to provide you with the opportunity to obtain funds you may need right now. Many professionals tell us that at this time of year their cash flow often makes it difficult for them to make the appropriate contribution to their Keogh or PC pension accounts. The idea is to offer you money to help with these or any other contingencies.

All you need do, is complete the short form on the back of the Request Certificate, sign and mail it to me within 60 days. Our goal is to send you the money by return mail on verification of your good credit standing. (Should you require less money, simply cross out the $7,500 and write in the amount you wish — minimum $3,500.)

That's it. In effect, the money can be yours just this simply. We think that's the way it <u>should</u> be.

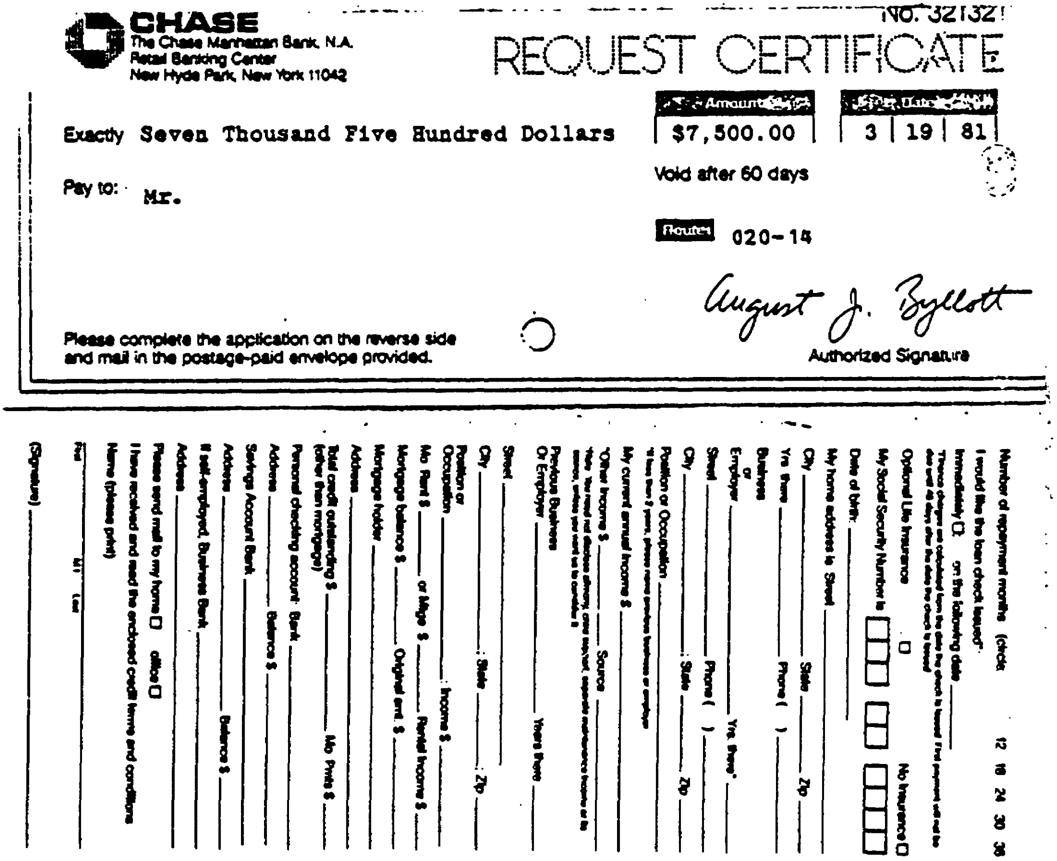
Sincerely,

August J. Byllott

August J. Byllott
Second Vice President

AJB:aa

P.S. As you probably know, you can make a contribution to your pension plan anytime before you file your tax return. Failure to shelter the maximum allowable portion of your income can have profound consequences over and above the impact of the immediate tax liability. As the enclosed chart demonstrates, skipping a $7,500 retirement plan contribution can, at today's interest rates, reduce your pension "nest egg" by more than $25,000 fifteen years from now. And your benefit, even in the first year, can be as much as $2,512.48, which would otherwise be lost forever.



NO. 32132

CHASE
The Chase Manhattan Bank, N.A.
Retail Banking Center
New Hyde Park, New York 11042

REQUEST CERTIFICATE

Exactly Seven Thousand Five Hundred Dollars

Amount	Date
$7,500.00	3 | 19 | 81

Void after 60 days

Pay to: Mr.

Routes 020-14

August J. Byllott
Authorized Signature

Please complete the application on the reverse side and mail in the postage-paid envelope provided.

Number of repayment months (circle 12 18 24 30 36

I would like the loan check issued*

Immediately ☐ on the following date ______

*Finance charges are calculated from the date the check is issued. First payment will not be due until 45 days after the date the check is issued

Optional Life Insurance ☐ No Insurance ☐

My Social Security Number is ☐☐☐ ☐☐ ☐☐☐☐

Date of birth: ______

My home address is Street ______

City ______ State ______ Zip ______

Yrs there ______ Phone ( ) ______

Business or Employer ______ Yrs. there* ______

Street ______ Phone ( ) ______

City ______; State ______ Zip ______

Position or Occupation ______

*If less than 2 years, please name previous business or employer

My current annual income $ ______

*Other Income $ ______ Source ______

*Note: You need not disclose alimony, child support, separate maintenance income or its source, unless you want us to consider it

Previous Business Or Employer ______ Years there ______

Street ______

City ______; State ______; Zip ______

Position or Occupation ______; Income $ ______

Mo Rent $ ______ or Mtge $ ______ Rental Income $ ______

Mortgage balance $ ______ Original amt. $ ______

Mortgage holder ______

Address ______

Total credit outstanding $ ______ Mo Pmts $ ______ (other than mortgage)

Personal checking account: Bank ______

Address ______ Balance $ ______

Savings Account Bank ______

Address ______ Balance $ ______

If self-employed, Business Bank ______

Address ______

Please send mail to my home ☐ office ☐

I have received and read the enclosed credit terms and conditions

Name (please print)

______
First M.I. Last

(Signature) ______

BENEFITS OF PENSION CONTRIBUTION FINANCING TERMS, OPTIONS AND CONDITIONS

CHASE

Member FDIC

Short Term Tax Benefits of a Pension Contribution	**12 Mo. Loan After One Year**	**24 Mo. Loan After Two Years**	**36 Mo. Loan After Three Years**
Value of income tax deduction for interest paid on loan*	$ 325.01	$ 625.38	$ 945.72
Value of income tax deferment for retirement plan contribution*	3000.00	3000.00	3000.00
Less interest paid on a $7500 Chase loan (with life insurance)	(812.53)	(1563.44)	(2364.31)
Total short term tax benefit*	$2512.48	$2061.94	$1581.41

*Assuming a 40% tax bracket

How Your Pension Contribution Grows

At 8% per year compounded daily (8.45% effective rate) a $7500 deposit grows to the following amounts:

1 yr.	2 yrs.	3 yrs.	5 yrs.	10 yrs.	15 yrs.	20 yrs.	25 yrs.	30 yrs.	35 yrs.
$8,133	$8,821	$9,566	$11,251	$16,879	$25,322	$37,988	$56,990	$85,496	$128,261

N.B. No taxes are due on Retirement Plan Principal or Interest until withdrawn.

Financing Terms, Options and Conditions

The examples shown below will help you to compare the financial details of a $7500 loan with or without credit life insurance for various terms. They are calculated with the first payment due 45 days after the date of the loan. Please note, there is no prepayment penalty.

	Term in Months	Life Insurance	Amount Financed	FINANCE CHARGE	Total of Payments	Monthly Payments	ANNUAL PERCENTAGE RATE
With insurance	12	$ 39.59	$7539.59	$ 812.53	$8352.12	$696.01	
No insurance		0	7500.00	808.20	8308.20	692.35	17.97%
Difference			39.59	4.33	43.92	3.66	
With insurance	18	58.68	7558.68	1181.94	8740.62	485.59	
No insurance		0	7500.00	1172.76	8672.76	481.82	17.97%
Difference			58.68	9.18	67.86	3.77	
With insurance	24	79.12	7579.12	1563.44	9142.56	380.94	
No insurance		0	7500.00	1547.04	9047.04	376.94	17.97%
Difference			79.12	16.40	95.52	4.00	
With insurance	30	100.96	7600.96	1957.64	9558.60	318.62	
No insurance		0	7500.00	1931.70	9431.70	314.39	17.97%
Difference			100.96	25.94	126.90	4.23	
With insurance	36	124.25	7624.25	2364.31	9988.56	277.46	
No insurance		0	7500.00	2325.84	9825.84	272.94	17.97%
Difference			124.25	38.47	162.72	4.52	

NOTICE: A consumer credit report or reports may be requested from one or more consumer reporting agencies (credit bureaus) in connection with this application. Subsequent consumer credit reports may be requested or used in connection with any update, renewal or extension of the credit requested by this application. If you request, you will be informed whether any consumer credit report was requested and, if so, of the name and address of the consumer reporting agency which furnished the report.

We may request and use the credit reports described above and we, or anyone we ask, or anyone who asks us, may exchange credit information about you in connection with this application or any debt established as a result of this application.

If you have any questions please telephone our Loan Information Group at [illegible] (within N.Y. State [illegible]).

CITIZENS FOR TAX JUSTICE

STATEMENT OF PRINCIPLES FOR FEDERAL TAX REFORM

Citizens for Tax Justice supports the federal income tax as the fairest means of raising the funds necessary to pay for the programs of the federal government. CTJ will work to improve the current tax laws and to avoid the adoption of provisions which further reduce their fairness, based on the following principles:

- Taxes should be based on the ability to pay them -- equally-situated taxpayers should be treated equally, and effective tax rates should increase as incomes increase, with no tax imposed on individuals whose incomes are below the subsistence level.
- The tax system should be as easy to deal with as possible for average taxpayers.

CTJ supports a system based upon these principles which equitably distributes the burden of supporting government programs. CTJ will oppose proposals which unfairly shift taxes onto middle and low income taxpayers.

CTJ will oppose special tax preferences designed not to measure income but to provide benefits or incentives to particular taxpayers, whenever they:

- result in equally-situated taxpayers being treated differently;
- undermine the ability to pay principle by providing tax shelters which allow high income individuals to avoid their fair share of taxes;
- shift more and more of the tax burden onto middle and low income wage earners;
- divert productive resources into wasteful tax avoidance activities;
- add complexity to the tax system making our tax laws more difficult to enforce; and/or

- erode public confidence in the fairness of our laws and the government by which they are made and enforced;and
- they cannot be clearly shown to have benefits which substantially outweigh these drawbacks.

CTJ will support efforts to improve the administration of the tax system and will oppose changes which will interfere with efficient and fair administration. A tax system which is difficult to administer is subject to abuses which result in inequities and undercut public support and trust.

CTJ will oppose efforts to undermine the corporate income tax, and will work to strengthen this tax. As representatives of their shareholders and as entities in their own right, corporations should bear a share of the tax burden commensurate with both ability to pay and the benefits which society grants them.

STATEMENT OF JAMES DALE DAVIDSON
CHAIRMAN, NATIONAL TAXPAYERS UNION
before the
COMMITTEE ON FINANCE
UNITED STATES SENATE
MAY 18, 1981

Mr. Chairman and distinguished Members of the Committee, thank you for the opportunity to discuss the tax aspects of the President's economic program.

I appear representing the 450,000 family members of the National Taxpayers Union in all 50 states.

President Reagan's proposal for personal income tax cuts is fine as far as it goes, but it doesn't go far enough.

Before I comment on the proposed tax reductions, I would like to put the current tax picture into perspective. We must realize the proposed tax cuts will only barely cut taxes in the next four years. In fact, much of the effect of the tax cut will depend on the actual inflation rate in the future. Steeper inflation rates could push people into higher tax brackets faster than legislated cuts can reduce marginal tax rates.

We should not forget that over $50 billion in new taxes will be collected in fiscal year 1981. This includes an income tax increase caused by bracket creep, a social security tax increase which was effective January 1, 1981, and the first full year of tax collections for the oil excise ("Windfall Profit") tax.

Federal Spending Must Be Controlled

The primary reason for the unprecedented level of taxation is the need to finance the unprecedented level of federal spending. In 1975 federal spending amounted to 19.9% of GNP. For fiscal year 1980, federal spending amounted to

22.6% of GNP. The growth of federal spending must be controlled if we are to reduce tax rates and keep them lower.

That's why it is crucial to institute real controls on federal spending through a constitutional amendment which would help Congress to resist pressures to expand federal spending. Such an amendment would also help increase the investment response to current tax rate reductions by assuring that future deficits will be avoided.

The Federal Income Tax Is An Obstacle to Economic Growth

The federal income tax resembles the counter-productive laws of the middle ages which reduced output by reducing the profitability of additional effort. I quote from one fourteenth century "stint" law:

> It was ordered that whosoever shall hereafter shipp more than his respective stint, he shall pay doble imposicions and doble imprest for all that he shall soe shipp.

High taxes may not be as bald an obstacle to productivity as the medieval "stint" rolls, but their effect is similar. They discourage output, raise prices and invite economic subterfuge. The higher the tax rates, the greater the premium on leisure, and the higher incentive to burrow into the "underground economy." There the marginal tax rate is zero, but economic efficiency suffers because of the need to remain inconspicuous. Significantly lower rates will lure hidden billions in out of the moonlight.

More Tax Reduction Needed

The biggest problem with the President's program of rate reductions is that it doesn't go far enough to insure significant incentive effects. In fact, if the program is enacted as proposed, and inflation follows the Administration's projections, by 1984 only taxpayers earning more than $100,000, or less than $10,000 would be in lower brackets than in 1965. (This calculation is based on constant real income of taxpayers filing jointly.) If inflation runs at a higher rate than projected by the Administration, then the tax rate reductions could disappear entirely for most taxpayers as bracket creep escalates people into higher brackets. If Congress wants to really reduce marginal tax rates, it should index tax rates first, then cut rates across the board for guaranteed tax rate reduction.

We hope that Congress will choose to index and reduce tax rates rather than make yearly discretionary tax cuts. The concept of multi-year tax rate reductions is sound. If the hoped for incentive effects are to materialize, real marginal rate reductions must be guaranteed. Otherwise, people will respond rationally by reducing work effort, savings and investment. Without indexing, any of the benefits gained by the reduction of marginal tax rates could be quickly washed away.

Indexing also has several other salutary benefits. It would help slow the growth of government spending. The current unindexed tax system is biased towards ever greater government spending. By removing government's ability to raise taxes without an explicit vote by Congress, indexing would make it easier to control spending.

Indexing would also increase government accountability. Taxes are now raised automatically each year with no legislative action or public debate. This amounts to taxation without representation.

Finally, indexing the personal income tax is simple. The Advisory Commission on Intergovernmental Relations says "Indexing the personal income tax is not a complex process, and it will not make it more difficult for individual taxpayers to complete their tax forms."

We strongly feel that any tax relief bill passed by Congress this year should include a provision for indexing similar to S. 1 as proposed by Senator Robert Dole.

The tables indicate the dramatic rise of tax rates since 1965. We include social security taxes, but they only apply to earned income of those that work in the private sector. But these tax rates should not be ignored because they also reduce incentives to work.

Tax Rates on Same Real
Taxable Income
for 1984, 1980, 1965

Joint Returns

1980 Taxable Income	Marginal Tax Rates			Marginal Tax Rates (including Social Security)		
	1984	1980	1965	1984	1980	1965
5,000	11%	14%	16.5%	17.7%	20.13%	20.125%
7,500	13	16	17.5	19.7	22.13	21.125
10,000	15	18	18	21.7	24.13	21.625
12,500	18	21	20	24.7	27.13	23.625
15,000	18	21	20	24.7	27.13	20
17,500	21	24	20	27.7	30.13	20
20,000	23	24	20	29.7	30.13	20
22,500	27	28	23.5	33.7	34.13	23.5
25,000	27	32	23.5	33.7	38.13	23.5
30,000	32	37	23.5	32	37	23.5
35,000	36	37	27	36	37	27
42,500	36	43	30.5	36	43	30.5
50,000	40	49	30.5	40	49	30.5
75,000	43	54	41	43	54	41
100,000	47	59	47.5	47	59	47.5
150,000	49	64	56	49	64	56
200,000	50	68	61	50	68	61

Single Returns

1980 Taxable Income	Marginal Tax Rates			Marginal Tax Rates (including Social Security)		
	1984	1980	1965	1984	1980	1965
5,000	13%	18%	18%	19.7%	24.13%	21.625%
7,500	16	19	20	22.7	25.13	23.625
10,000	19	21	20	25.7	27.13	23.625
12,500	21	24	23.5	27.7	30.13	27.125
15,000	25	26	23.5	31.7	32.13	23.5
17,500	28	30	27	34.7	36.13	27
20,000	28	34	27	34.7	40.13	27
22,500	32	34	30.5	38.7	40.13	30.5
25,000	32	39	30.5	38.7	45.13	30.5
30,000	36	44	34	36	44	34
35,000	40	49	37.5	40	49	37.5
42,500	46	55	44.5	46	55	44.5

Single Returns (Cont'd.)

1980 Taxable Income	Marginal Tax Rates 1984	1980	1965	Marginal Tax Rates (including Social Security) 1984	1980	1965
50,000	46%	55%	47.5%	46%	55%	47.5%
75,000	49	63	56	49	63	56
100,000	50	68	61	50	68	61
150,000	50	70	66	50	70	66
200,000	50	70	71	50	70	71

Estimates for 1984 are based on the economic assumptions and tax rate reductions contained in the FY 1982 Budget Revisions.

One item that is very difficult to quantify, but should not be ignored, is the effect of marginal tax rates from income taxes imposed by state and local governments. Since 1965, 8 states (Michigan, Nebraska, Illinois, Maine, Ohio, Pennsylvania, Rhode Island, and New Jersey) have instituted an income tax. In addition, a total of 76 income tax rate increases have been passed by 34 states and the District of Columbia since 1959. Inflation has also moved taxpayers into higher brackets in all states with progressive income taxes. We estimate that the typical taxpayer faces at least a 6% marginal income tax rate on the state and local level. That means that in most states, a median American family of four with one wage earner faces a combined marginal tax rate of 40% on earned income. In some states, marginal state and local income tax rates exceed 12%.

The Tax Laws Favor Consumption

Today the tax laws are not neutral. They favor consumption. This bias is accentuated by steeply progressive rates which discourage risk taking and work effort by placing an especially high penalty on the income from savings. The rates on savings income go as high as 70%, 40% higher than the rates on so-called "earned" income. The effect is to make the tax laws an engine of forced consumption.

If there is to be any distinction at all between "earned" and "unearned" income,the distinction should go the other way. The problem in the American economy today is not too much savings, but too little. We need massive new additions to the savings stock to finance a re-tooling of American industry, to provide mortgage money for the millions of would-be home owners and to lower the carrying charges on our massive federal debt. The Japanese, who save five times as much of their income as we do, have tax provisions which allow savers to receive the equivalent of almost $6,000 tax-free. We need a provision to enable us to catch up with the Japanese, a provision which would unambiguously encourage savings and investment. We propose that Congress exclude the first $10,000 of interest and dividend income from taxation. This would enable Americans to earn a positive real rate of return from their savings. Under current tax laws, saving more than a minimal cash reserve is not a rational act for many taxpayers.

There are several other ways to reduce the tax bias against personal savings which we support.

One way would be to tax savings income separately, starting in the lowest tax bracket, just like earned income. Currently, earned income and savings income are lumped together. The first dollar of savings income is usually taxed at the taxpayer's top tax rate. By taxing saving income separately from earned income, we could drastically reduce the tax rates on savings.

We would also support excluding a certain percentage of interest and dividend income from tax, much the way capital gains today is partially exempted from tax. This would also lower marginal tax rates on savings.

Alternatively, a tax-free rollover of dividend and interest income would also address the problem.

The American economy today is suffering from avoidance of risk by investors. This is altogether sensible. Why take extreme risks when assured rates of return are widely available on Treasury bills and bonds or money market funds?

To alleviate this problem, capital gains taxes should be further reduced or abolished altogether. A good interim step would be to increase the exclusion on capital gains income to 70%. Capital gains taxes fall heavily on new emerging enterprises, which are risky, rather than the established dominant corporations. A drastic reduction of capital gains taxation would reduce the disincentives to taking risks.

This has important implications for increased employment. From 1969 to 1976, 81.5% of the net new jobs created were created in firms of 100 employees or fewer.

Gains from capital are now measured as the difference between the original price of an asset and the nominal price at which it is sold. The problem is that the "gain" may have been partly, if not wholly, due to inflation and not an increase in purchasing power.

This problem can be alleviated by further reducing capital gains taxes or extending a rollover provision -- such as that which applies for housing. It should completely exempt all gains from taxation so long as they are reinvested. At the same time, the distinction between short and long term gains should be eliminated. The effect of this provision is to lock capital into current uses and hinder the efficient operation of markets. Why would the Congress want to create incentives to immobilize capital? That is what the current laws do.

President Reagan has pointed the way toward economic recovery by advocating a slash in taxes. For his plan to work, however, we must have the courage to give real tax reductions a fair test. Minor reductions in overall marginal rates cannot be expected to have startling incentive effects. It is up to Congress to turn the promise of the President's proposal into reality by enacting truly significant cuts which will encourage savings, investment and work effort.

[Whereupon, at 11:50 a.m., the hearing recessed, to reconvene at 2: p.m., the same day.]

AFTERNOON SESSION

Senator HEINZ [acting chairman, presiding]. This afternoon the Finance Committee continues its public hearings on tax reduction proposals. We have a panel of distinguished representatives consisting of Frederick J. Napolitano, Jack Carlson, Stanley Taube, Howard Ruby and Alan Aronsohn.

Gentlemen, before we start, let me ask my friend, the distinguished Senator from Virginia, if he has any remarks he would care to make at this time.

Senator BYRD. Thank you, Senator Heinz.

I don't believe so. I am prepared to welcome my fellow Virginian, first vice president of the National Association of Home Builders, who leads this panel, I assume. I welcome all of you, for that matter, but especially for my fellow Virginian.

Senator HEINZ. Gentlemen, we are glad to have you here. Let me ask Mr. Napolitano to be our initial witness.

STATEMENTS OF FREDERICK J. NAPOLITANO, FIRST VICE PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS; JACK CARLSON, EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF REALTORS; STANLEY TAUBE, PRESIDENT, NATIONAL APARTMENT ASSOCIATION, HOWARD RUBY, DIRECTOR, NATIONAL MULTI HOUSING COUNCIL; AND ALAN J. B. ARONSOHN, TAX COUNSEL, NATIONAL REALTY COMMITTEE

Mr. NAPOLITANO. Thank you, Mr. Chairman. Thank you, Senator Byrd.

First, let me ask if we can submit our full statement for the record.

Senator HEINZ. Without objection, so ordered.

Mr. NAPOLITANO. Mr. Chairman, and members of the committee, my name is Frederick J. Napolitano, and I am a home builder from Virginia Beach, Va.

I am testifying today on behalf of the more than 123,000 members of the National Association of Home Builders, of which I am first vice president.

I might add, I will summarize my full statement, Mr. Chairman.

NAHB is a trade association of our Nation's home building industry. Accompanying me today is Jim Skylow, our legislative counsel, for governmental affairs.

We appreciate this opportunity to present our views on the administration's tax reduction proposal and other tax related issues affecting the home building industry, the potential home buyer and our financial institutions.

Mr. Chairman, let me begin by saying that I do not envy this committee's task. There has been considerable disagreement about the tax portion of the economic recovery program and it seems evident that the significant segments of the financial markets and Wall Street community, along with the Federal Reserve Board, have shown an uneasiness and skepticism about the program which has reflected in soaring interest rates over the past few weeks.

That is bad news for an interest rate sensitive industry like housing which is still reeling from the effects of Fed policy and record high interest rates which began in October 1979.

Mr. Chairman, I would be the first to say that we do not have the answer to the real dilemma facing your committee, whether "Reaganomics" or "Volckernomics" or "Kaufmanonomics" will open the door to a lasting recovery.

But, I think I can present you with a judicious and balanced approach from our perspective, which hopefully will lead our country back to work, increase productivity and savings and reduce the underlying rate of inflation.

The short-term outlook for housing as described in detail in my statement, is in a word "DISMAL." Those are all capital letters.

However, housing demand is quite strong and will continue to grow substantially during this decade.

First-time home buyers have been hardest hit by inflation and have been priced out of the housing market today.

The revolutionary changes due to deregulation of the financial institutions, along with the phenomenal growth of the money market funds, have decimated our traditional supply of mortgage credit for housing.

As you are aware, rental housing vacancy rates are at record low levels and new privately constructed multifamily housing at rents people can afford has all but dried up.

Something dramatic needs to be done if we are to meet our national commitment to provide housing for the American people.

Now, what is our approach to deal with the scenario I have just outlined?

First, we strongly support major reductions in Federal spending and immediate movement toward a balanced budget as embodied in the administration's budget reduction program.

Second, we support an individual income tax reduction program with principal emphasis directed toward stimulating savings and investment including a tax incentive for savers targeted at housing.

Third, we believe that tax relief should be provided only to the extent that comparable net reductions in Federal spending are made.

Fourth, we believe that any change in business capital cost recovery should maintain the historical and traditional relationship of favorable tax incentives for multifamily rental housing of low income and other than low income as regards other nonresidential investment including favorable depreciation schedules, repeal of section 189 of the Internal Revenue Code to allow current deductibility of construction period interest and taxes, and inclusion of investment tax credit benefits for equipment and machinery installed in rental housing.

Mr. Chairman, we are pleased that the White House and the Treasury Department have recognized the inequity in the administration's proposal and have indicated that review is underway in order to insure that residential real estate is treated equitably as regards industrial and commercial investment.

Fifth, we share the view expressed to us by HUD Secretary Pierce that tax-exempt revenue bonds are an important source of financing for single family and multifamily housing. We urge that all needed legislative changes be made to this program to be fully implemented.

Sixth, as a short-term remedy to reduce the substantially unsold inventory and allow our builders to begin building new homes, we support a limited 5 percent up to $5,000 credit to the purchaser of a home which was constructed prior to 1 year.

Seventh, we believe the private and public pension and retirement funds have become the largest growing source of long-term investment in the country.

We urge the enactment of legislation to require pension and retirement funds in order to maintain the tax-free status on earnings to invest a substantial portion of their assets in residential mortgages and housing securities.

Eighth, we believe that homeowner's deductions for mortgage interest and property taxes are a prerequisite to homeownership for millions of Americans.

We would vigorously oppose any attempt to limit the deduction for mortgage interest and property taxes.

Ninth, it is universally accepted that the housing component of the Consumer Price Index substantially overstates inflation. The use of inflationary CPI in computing index programs only builds inflationary pressures.

We would support rapid legislation and/or regulatory changes in the weighting and computation of the housing components of the index.

Mr. Chairman, the plate is full this year when it comes to issues of tax reduction of interest to the hard-pressed housing industry.

We wish you well as you begin your deliberations and we appreciate the opportunity to appear before you today to present our views. We would be happy to answer any questions you might have.

Senator HEINZ. Mr. Napolitano, thank you very much. Mr. Carlson.

Mr. CARLSON. On behalf of the realtors, we compliment the Congress and the President for taking the first steps toward wise economic policy to fight inflation, achieve lower interest rates, and assure improvement in food, clothing and shelter for all Americans.

However, we as well as the financial markets are concerned that the $695 billion spending limit in the first concurrent budget resolution will likely be broken in the months ahead and exceed $715 billion which would result in a higher inflationary deficit in 1982 and beyond.

We strongly recommend that the first concurrent budget resolution spending ceiling be enforced in all authorization and appropriation actions. We strongly recommend that tax relief be significantly smaller than likely spending reductions—$25 to $35 billion in 1982.

We strongly recommend that personal income tax cuts be delayed until at least January 1, 1982 and be limited to 5 percent across the board in 1982 and 5 percent each year thereafter until 30 percent is achieved.

We strongly recommend that one-half of any tax relief be used directly to stimulate both savings and investment. This should include broad encouragement of savings such as raising the limit on dividends and interest excludable from Federal taxation.

This should include raising the ceilings on annual contributions to individual retirement accounts. This should include encouragement directly for housing such as tax-exempt certificates of deposit dedicated for home financing.

Even though the need for housing is high, investment as a percent of the gross national product and loanable funds is down and has declined for 30 years; this is creating and will continue to create a shortage of housing and future inflation.

The currently high inflation and high and fluctuating interest rates are causing a dismantlement of housing institutions and incentives and without substitutes could result in only the rich owning homes in the future.

Less than 10 percent of American households who do not already own their homes can qualify to finance their own home.

The nonrich may be forced to live in rental housing owned by their employers in a national financial institution through Government. This undermines the American democracy built on private home ownership and privacy and would lead to the inferior pattern of housing patterns found in the 1920's and in other countries in terms of the next generation of Americans.

Investment should be encouraged by lowering the depreciation allowed to at least 15 years straight line for commercial, industrial, and rental housing structures in 1982 and lowering the economic life of machinery to 5 years phased in during the next 3 years.

Construction should be encouraged by allowing current expensing of interest and taxes incurred during construction and remove the unfair $10,000 investment interest limitations on individuals which is not imposed upon corporations.

The administration's personal income tax cuts of 10 percent for each of the next 3 years and mandatory depreciation schedules of 18-15, 10-5-3 will not fight inflation or reduce interest rates or improve housing.

The improvement in business investment would not improve productivity enough to offset inflation caused by the larger deficit.

Moreover, if only about one-half of the spending reductions are achieved, which I believe will occur, which would be equivalent to $750 billion outlays in 1982, then inflation and interest rates would be higher through excessive stimulation of the economy.

In sharp contrast, our recommendations would reduce prices by about 2 percent, lower mortgage interest rates by 2 percent, increase commercial and industrial investment substantially, provide nearly 1.5 million more housing units between now and 1984, create nearly 700,000 jobs, and increase average household by more than $1,000 in the year 1984.

These benefits would occur in every State and would offset any losses from lower Federal spending. The economy would be much healthier than the current forecast.

Senator HEINZ. Mr. Carlson, thank you very much. Mr. Taube.

Mr. TAUBE. Mr. Chairman and members of the committee, my name is Stanley Taube. I am an apartment owner and developer from Minneapolis, Minn. I am president of the National Apartment Association which is the oldest and the largest trade association representing the rental housing industry in the country.

We represent about 45,000 owners and managers and developers of rental housing and as the Senator from Minnesota, Senator Durenberger knows, in my State of Minnesota there is literally no construction of rental housing.

I am here today to speak on behalf of the National Apartment Association because I am concerned, as I know you are, about the millions of young people entering the job market, millions of young families and the elderly who are trying to find a place to rent an apartment, a rental home, and it is becoming a more and more difficult task.

I am concerned about the statistics that show that we need approximately 600,000 rental units a year to meet the demand of the 1980's and in fact, we are producing about 300,000. Of those 300,000, about 60 percent last year were subsidized and the number of rental units each year that are subsidized is increasing and the number of rental units we are building through conventional financing is decreasing.

I would like to share with you an answer to the problem that I posed to some of the largest developers in the country about 6 months ago at a meeting in Houston, Tex.

I asked them what is the answer to getting rental housing back on the market. The answer was a fairly simple one and the answer is that we need more money for housing, more construction money at a reasonable price.

There simply is not any mortgage money available. There simply is very little equity money available under the current tax structure.

There are traditionally four sources of money for our industry. The first is the life insurance industry and I am sorry to report to you that the life insurance industry, although it has the way to make money and funds available for our industry, does not have the desire.

A few months ago, across my desk appeared something that I have seen very seldom in our industry and that is a report from City Corp indicating the money that is available for the real estate industry. There was money available for the office construction. There was money available for shopping centers albeit at a high rate of interest.

But clearly, stamped across the face of that document for rental housing were the words not available, not available, not available.

You know fully well the current status of the savings and loan industry which is our second source of money. The savings and loan industry may have the desire, but they don't have the way.

The third source of money for us is the Federal Government, subsidies. You know that as a matter of necessity, the subsidies are being cut back and in any event, subsidized housing is an expensive and inflationary way. It is not the final answer.

Subsidized housing must be available for those people who cannot help themselves, for the truly poor and for the elderly.

Finally, I submit to you that the source of money, the fourth source, the only source that our industry can possibly look to today is private equity capital.

Private equity capital will not and is not finding its way into the rental housing industry under the current tax structure.

The administration has posed a tax structure which supposedly and hopefully would attract private capital, but I submit to you that under its current form it will not do that.

The administration's tax proposal would allow a faster depreciation schedule, for example, for office buildings than they would for rental housing.

I ask you what are the priorities in this country? We do not have sufficient rental housing and we will have a crisis in future years.

Traditionally, rental housing has received more favorable treatment than any other form of real estate investment. We must continue to have that favored benefit if we are going to build the rental housing that is so desperately needed.

Very briefly, our association is submitting to you the following proposals. First of all, a 10-year straight line depreciation for new rental housing construction.

Second, a 15-year straight line depreciation for existing rental housing.

Third, a 5-year writeoff for rehab properties. We have demonstrated time and time again that the fastest, least expensive way to get more rental housing on the market is to take the existing stock and to rehabilitate that.

We advocate an immediate deduction of construction period interest and taxes, repealing section 189. We are in favor of expansion of eligibility for individual retirement accounts and an increase in IRA contributions limits to funnel more money back into the savings and loan industry and finally, an expansion of the interest and dividend exclusion.

In closing, we certainly support the administration's so-called reindustrialization of America. The National Apartment Association supports those goals. We are in favor of increased productivity. We are in favor of reduced inflation, but in order to answer that productivity we must provide rental housing for millions of Americans.

Thank you for the opportunity to represent the views of the National Apartment Association.

Senator HEINZ. Mr. Taube, thank you very much. Mr. Howard Ruby.

Mr. RUBY. My name is Howard Ruby, Mr. Chairman and members of the committee. I am chairman of R. & B. Enterprises based in Los Angeles which operates over 20,000 apartment units throughout the United States and I have been in business for 21 years. I am chairman of the California Housing Council and a founding member of the board of directors of the National Multi Housing Council.

I have a longer statement which I ask be submitted for the record. I will take just a few minutes now and summarize those remarks, if I may.

Senator HEINZ. Without objection, your entire statement will be part of the record.

Mr. RUBY. Today, I am speaking to you as a former major apartment developer. In the early 1970's, we were one of the largest apartment builders in the country developing as many as 5,000 units in 1 year.

Last year my company built no apartments. This year we will be able to build no apartments. Next year and in ensuing years it will most likely be the same due to lack of money.

In 1973, just a few short years ago in California, Virginia, and Texas where our projects were located, we were experiencing a huge oversupply of apartments. Our vacancy rates exceeded 20 percent even after significant rent reductions.

Today, just 8 years later, national vacancy rental rates are approaching 5 percent and stand at their lowest point in 25 years. In many metropolitan areas, vacancy rates are 1 percent.

The production of unsubsidized rental housing has declined dramatically since the passage of the Tax Reform Act of 1976. In 1977, there were approximately 185,000 unsubsidized rental units started. That dropped precipitously to the current 43,000 units in 1980. Those are unsubsidized, noncondominium, nonfederally funded units.

Why this lack of money for apartment construction? There is no lack of money for commercial real estate investment. The scarcity is merely in money that is available for investment in risk-ridden conventionally financed apartments in today's unfavorable tax and investment climate.

You probably saw the $2 billion requirement for the World Trade Center and there were a half dozen bidders willing to put up the $2 billion, enough to build 50,000 apartment units. There were plenty of bidders for that, but no one wants to build apartments.

Let's go back to 1969 when the 1969 act emerged from this committee. The rental housing industry stood to benefit from the special tax incentives that you put in the code. Within 2 years, apartment construction shot up to 500,000 units in 1 year.

These tax benefits, however, became the villain and tax shelter quickly became a dirty word. Congress, in its haste to plug these loopholes, changed the tax laws in 1976. Most of the tax incentives for investing in apartment construction vanished.

Based on current projections, it appears that no more than 50,000 unsubsidized apartments will be built this year. I firmly believe that this figure can be increased to 250,000 units a year if the following changes are made to reinstate tax incentives for the apartment industry.

No. 1, repeal section 189 of the Internal Revenue Code or make it inapplicable to rental housing. No. 2, provide a 15-year accelerated depreciation schedule for new rental housing. Of course, an appropriate modification in section 1250 is the next necessary adjunct. No. 3, provide a 12-year accelerated depreciation schedule for low-income housing.

Why does the apartment industry need these special tax incentives? I have developed a hypothetical but typical economic analysis of the 250,000 unit apartment project.

With section 189 in place, the tax benefit the first year is 4.7 percent of the capital invested. I can tell you that oil gives you 85 percent the first year. The one that really hit me the other day was cryogenically frozen bull sperm with a 400-percent writeoff and here we are in the apartment industry with 4.7 percent.

But repeal section 189 and in the first year shelter goes to 37 percent. Now, we are talking about something. Now, we are saying someone might actually invest in an apartment house. The cash flow from my 250 unit project analysis is a loss in the first 2 years with the 18-year life.

Even after tax savings in the 50-percent bracket, the tax is less than that. Let me skip that.

You are probably skeptical when I say that we can go up to 250,000 units with just some simple tax changes. Many of you are no doubt skeptical that with these changes in the tax law we can increase production fivefold within the next few years.

Well, let me make an unusual deal with you. Sunset, the tax provision period. If our industry does not successfully build at the rate of 250,000 units per year or more, then drop the accelerated depreciation and special provisions that we asked for and put apartments back in parity with commercial and industrial property. Give us 3½ years to get the pipeline going and the builders geared up. If we do not produce to your satisfaction then automatically drop the changes we seek on January 1, 1985.

Given the tax benefits, I firmly believe we can get the private investment capital to build. I firmly believe we can produce the new units. It is up to you now, gentlemen and I will go into more detail with each of you separately if you like.

Thank you.

Senator HEINZ. Thank you very much, Mr. Ruby. Mr. Aronsohn.

Mr. ARONSOHN. My name is Alan Aronsohn. I am appearing here on behalf of the National Realty Committee which is a national organization of major owners and investment builders and all kinds of real property, residential and commercial.

We strongly endorse the proposals for capital cost recovery, reform and simplification which this committee will be dealing with.

However, there are a couple of points with respect to buildings as distinguished from equipment that we would like to point. In this respect, Mr. Chairman, I would like to ask that our full statement be placed on the record and I will just summarize the major points.

Senator HEINZ. Without objection, so ordered.

Mr. ARONSOHN. I think our main point is to try and hammer home the recognition of the fact that a building, as opposed to a piece of machinery, is very often a separate investment asset. As a separate investment asset, the maintenance of a viable market for such an asset is very important and is vital, I think, to our economy.

All of us live in, shop in, store our goods in, and work in buildings, many of which are built by investment builders.

There are several aspects of some of the proposals that have been made for capital cost recovery reform which we think would jeopardize this kind of market.

First and foremost, in the administration's proposals there is a suggestion that a separate class of structure be granted very special depreciation treatment. That is, the so-called owner-occupied retail and wholesale distribution class.

In and of itself, this seems harmless enough until you think about in terms of trying to compete as an investment builder with the owner-occupier. Upon any kind of analysis, it just seems not to make any sense that two grocery stores, one on either side of the same street, should be treated differently because one is occupied by its owner and the other is leased.

It not only doesn't make any sense, but since it places the lessor of such a building in an impossible competitive situation, it ultimately means that not only is his business jeopardized, but the business of his tenant is placed in an unfair competitive relationship with the business of the owner-occupied store.

We, therefore, oppose such a distinction and we think that whatever capital cost recovery proposals are ultimately adopted by this committee, there should be a single class of similar buildings whether they are owner-occupied or leased.

Second, we are concerned about any proposal for capital cost recovery which would impose so-called section 1245 or full depreciation or recapture to buildings.

The imposition of that kind of a tax rate upon a disposition of an investment assets means that you don't have very many dispositions. It results simply in a massive lock-in.

We think that this would be very bad for the real estate market, in particular, for the investment market in general and it is unnecessary and really inequitable. We would, therefore, sincerely ask the committee to consider that in adopting any capital cost recovery system that they retain as part of such a system the existing 1250 recapture rules for real property which we think have worked pretty well over the years.

I will be happy to answer any questions members of the committee may have.

Senator HEINZ. Mr. Aronsohn, thank you.

Under present law, Mr. Taube, residential property is depreciated more slowly than commercial property. The administration's bill would greatly reduce the difference in treatment.

Why should the Congress permit residential property to be depreciated faster than commercial as you testified?

Mr. TAUBE. Mr. Chairman, for at least two significant reasons. First of all, if you take a map of the United States and throw a dart at virtually any city in the country, you will find with few exceptions, a flourishing office industry, a flourishing commercial industry, but you will not find, again with few exceptions, any rental housing construction.

That is the first reason. It simply needs the benefits that the other industries do not.

Second, it is just a matter, I think, of priorities. Where are our priorities in this country? When millions of Americans cannot find a place to live, a rental apartment to live in, and yet millions of

Americans can find office space and can find shopping center space, et cetera. I think we have to look at our priorities.

Historically, our tax laws have favored housing and have favored rental housing. This is certainly not the time, in my opinion, to change that priority.

Senator HEINZ. One of the other witnesses indicated that the faster way to increase rental housing availability is to target incentives more intensively toward improving existing rental housing. Yet you recommend 10-year straight line depreciation for new housing and 15 year straight line for existing housing. Wouldn't that mean that the supply of rental housing be lower than it would be by doing the reverse?

Mr. TAUBE. I think in my statement I said that the number one priority would be to take existing rental housing and rehabilitate it, giving it a 5-year writeoff whether it is low or moderate. I wouldn't make the distinction that is under the code presently because we are losing 200,000 to 300,000 rental units a year to abandonment. That would be my No. 1 priority.

My No. 2 priority would be to give a 10-year schedule for new rental housing to get the production of new rental housing or as my colleague, Mr. Ruby has indicated, a 15-year schedule accelerated with no recapture would accomplish virtually the same thing.

My third priority would be more favorable benefits for existing rental housing, not rehab, but just existing rental housing because we have found that historically we want to create the incentives for people to trade property and to sell property because when that is done there are capital improvements by the new owner.

Senator HEINZ. Mr. Ruby, you advocated that we remove disincentives from housing investment. Aren't a lot of the disincentives found not in the tax law, but in the State and local regulatory system, for example zoning regulations and rent control? Isn't that an area that is at least as important?

Mr. RUBY. They are very definitely important. There are probably five major reasons. You have rent control, and the threat of rent control. Along those lines you have construction costs that have risen exorbitantly in the last few years due to inflation. Expenses have gone up tremendously, utilities particularly have gone up. There are a whole myriad of other reasons.

What I am trying to get across is that given the money to build, somehow or other we are going to get through it.

Now, the environmental restrictions are starting to turn the other way. The pendulum is coming back. Even in ultraliberal California we have had a few court cases recently that have tended to indicate that you should be allowed to build on property that you own.

We have a couple of new legislative bills saying that each city must put aside land for apartment construction as part of its master plan. Some of these cities were just excluding it entirely in the suburban areas.

So, yes, there are other reasons. However, if we give——

Senator HEINZ. Maybe you can find Jerry Brown a permanent place to live there.

Mr. RUBY. I thought Doonesbury had found it somewhere. I could talk 2 hours about Jerry Brown, Senator Heinz, if you'd like me to.

Senator HEINZ. No, that's all right. Please continue in the earlier vein.

Mr. RUBY. In any event, I really do believe that given the proper tax incentives, the builder will figure out a way to get the zoning. He will push through a deal that has no cash flow at all.

Why? Because he can get the money from the individual investor. Let's go back to 1972. Where did the money come from? As a result of the 1969 tax act, when Senator Long listened to us and gave special preference to the apartment industry, where did it come from? The REIT industry.

Forty billion dollars came in. Maybe it was too much, maybe it was in excess, but we built 1.5 million apartments during that time. The money came in not from the fancy private institutions, not from the insurance companies, and not from the savings and loans. The money came in from people who wanted to invest $5, $10, $15 or $20,000 in real estate syndications (called REIT's at the time).

Two weeks ago they sold out a $91 million project in Chicago—$91 million was sold in a real estate investment syndication.

I am saying that we can get billions of dollars if we can get enough tax shelter out of it. If you get 4 percent the first year as a write off out of an investment of $1 in an apartment project, and you can get 88 percent out of an oil well, where are you going to put your money?

I guess the other key issue here is, is it going to cost the Government any money? I am saying to you, no. It won't.

I have included a long dissertation in my statement. Maybe some of your computer folks can go through my computer folks' work and see whether they jibe, but what we say is if our plan works, give us a chance. We will provide 200,000 more housing units a year. If it does produce 200,000 more housing units a year, you are going to get $650 million more in tax revenue than you get now. What I am talking about is payroll taxes because a third of all new construction is labor.

If you go one step further and say every year 25 percent of those apartment projects will turn over and the average apartment building in the country is 25 units, then capital gains taxes will be generated.

I am saying that the yield will be over $200 million to the Government while we are putting out 250,000 new units, 200,000 of which wouldn't have been built otherwise.

Now, you can call that supply side economics or whatever you want to, and I don't know how this committee feels about supply side, but I think it could work. If it doesn't, then strike the law in 1985.

Senator HEINZ. Let me ask Mr. Carlson and Mr. Napolitano. Both of you, I believe, have suggested we look at a number of targeted savings incentives proposals. A number of them are being seriously considered by this committee.

If you had to choose the one that would do the most for the construction of housing, which would you choose: Capital gains reduction, excluding a percentage of interest and dividend income larger than we now exclude; expanding the availability and utilization of IRA's or IRA-like housing and education accounts; or dividend reinvestment? Which would do the most?

Mr. NAPOLITANO. As far as the National Association of Homebuilders are concerned the tax incentive for savings would be the one that would do the most good, targeted for housing.

Senator HEINZ. Mr. Carlson, how do you feel?

Mr. CARLSON. There are many objectives that each one of these serves. For instance, the interest deductibility. The first incidence of that goes to lower income people and goes to the elderly, whereas the incidence of more favorable treatment for IRA's generally goes to middle and upper income people and more complete retirement.

So, there are many objectives besides just generating savings. Many of these are helpful. The capital gains certainly would. I guess I would argue that a strategy of a mix of these would be helpful.

I would also like to argue because of the peculiar situation dealing with housing, at the present time, we are dismantling our objective of housing in this country that we have had for 40 years.

Now, the system we have had of specialized institutions and incentives to invest in home ownership is a way of making democracy work much better when you have diffused decisionmaking to ownership of one's home.

The next generation is not going to have that opportunity. Chances are ownership will not be as extensive as it is in our generation. Consequently, we will go back to the company owning the housing much more than we have now or international financial institutions or the Government.

So, I think we have to look at something even narrower, a tax-exempt certificate of deposit.

Senator HEINZ. That is the Bentsen bill, I believe isn't it?

Mr. CARLSON. Yes sir, it moves in that direction. I would put some limits, however, because of the fitting in a revenue loss that would be appropriate for the kind of deficit you want of only excluding up to $1,000 for individuals and $2,000. As far as the tax-exempt interest rate, it could be excluded on one's income tax return.

But, I think it is fundamental to take care of housing and also thrift institutions in distress to go with a rather narrow incentive right now of that kind.

Senator HEINZ. Gentlemen, my time has expired. Let me yield to Senator Byrd.

Senator BYRD. First, in regard to the summary of principal points in Mr. Napolitano's statement. You bring out some very important points. One that I think is the most important is your assertion that the National Association of Homebuilders would vigorously oppose any attempt to limit the homeownership deduction for mortgage interest and property taxes.

It seems to me, if that mortgage interest and property taxes were not made deductible, you folks might as well go out of business. Activity along the line of home building will decline.

Mr. Carlson, you seem to feel a 12 percent across-the-board personal income tax reduction over 6 years would be preferable to a 10 percent tax reduction in across-the-board 3 years. Would you indicate your reason?

Mr. CARLSON. Yes, sir, I think that in any tax relief at this time one half should go directly to stimulate savings and investment.

By my calculations, 20 to 25 percent goes directly in the President's program and that is too anemic. In fact, that is the worst proportion we have had in 20 years directly going to stimulate savings and investment.

The second point is, we cannot afford a $54 billion tax relief program when the spending reductions, even in the first concurrent budget resolution, is just a little over $40, likely to be between $30 and $40, because the difference there is to increase the deficit. You see what is happening in the financial markets. They just do not believe the deficit is going to come down and consequently, inflationary expectations are fueled.

Consequently, the tax relief has got to be more modest. When you have to have a more modest one and one toward directly to savings and investment, I think then you have to trim back Roth-Kemp, allow the certainty, add some multiple year significance to it but take it down to 5 percent per year, not 10 percent. We can't afford to take that blast now of stimulus through consumption.

Senator BYRD. Could I ask the panel, would that be the consensus?

Mr. NAPOLITANO. Well, just speaking for the homebuilders again, we don't particularly have it broken down in the same way. But, the concept of what Mr. Carlson is saying is correct. Whatever is saved, at least half of it or so, should go toward savings.

Senator BYRD. Do any of you have a preference to seeing the so-called 10–5–3 as compared to the 10–7–4–2?

Mr. ARONSOHN. We are on record as opposing the 10–5–3 proposal because of its treatment of 1245 recapture for the 10 year structural class.

I am not sure that the 2–4–5–7–10, I think carved real estate out. The original 10–5–3 did not.

Senator BYRD. Mr. Carlson.

Mr. CARLSON. I would also say that you need a level playing field, at least, and some are proposing more than that. But, at least al because of its treatment of 1245 recapture for the 10-year you identified excludes rental housing completely.

Component depreciation, right now, is equivalent to 18 years straight line and so your costs cross. Your advantage of putting it into industry is 24 percent higher on a present value analysis than to put it in rental housing. Rental housing is in short supply. That would clearly be a mistake.

Mr. RUBY. Senator Byrd, in 1969 apartments were given a benefit and we came up with a couple of million new units built in a few years.

In 1976, apartments were put generally in parity with other types of real estate and we saw the biggest boom of hotels, office buildings, shopping centers that the country has ever seen. However, no apartments were being built so that we have reached the point this year where new apartment starts don't even cover abandonments in terms of the total housing stock.

Now, that tells me that the Tax Code figured significantly in these changes. The plan that is being put before you is an 18-year life for apartments; 15 years for commercial.

So, it takes the 1976 tax act which created parity between apartments and commercial and it flips it over to the point where apartments are on the short end.

If you have 43,000 new apartment units this year in the whole Nation, when we had 500,000 just 8-years ago, I will guarantee you you won't get 4,300 if that 18-year life passes, especially with 15 years for commercial, 10-years for plant.

I mean I can tell you as a builder, I am in the business, I build industrial parks. I am trying to build apartments. I can get all the money I want to build my industrial parks. I am building in 6 States right now in 17 cities. I am here saying I can't get the money to build apartments.

Now, someone asked earlier why we need the extra benefit for apartments. I will tell you. Because it is riskier. You have to face the prospect of rent control, of expenses that you can't pass through. I get a 50-percent increase in utilities expenses on a high rise office building and what happens? My lease automatically passes it through to the tenant. I get a 50-percent increase in a utility bill to a master metered apartment house and what happens? I eat it. Go try to raise the rents on the tenants. They won't even believe what these utilities increases have been.

So, I am indicating that we can get apartment construction only if it has a significant benefit. Parity will not get us apartments. So, when we get down to the 10-5-3 what we are going to end up with is condominium/office parks. You are going to change the whole scope of real estate in America with this one piece of legislation. We are already seeing about 5 percent of real estate in the industrial and office sector being sold as condominiums. Now, if one guy buys his as a condominium unit and gets 10-year life and another guy rents his and the owner of that building has a 15-year life, I can guarantee you that the first guy is going to be able to offer a cheaper product and have a heck of a lot better deal.

So, now we are going to restructure American industry in one fell swoop, one minor change in the law will restructure it to the point where everything is going to be owner occupied.

You will see high rise buildings that will be owner occupied because they will get 10-year life. We already have people approaching us to buy their suite to lock in their rent, and get a 10-year writeoff besides.

People notice these writeoffs. They are a big thing when the tax brackets are so high.

That 18-year life is a pretty dangerous thing. Whatever you do, whatever useful life you set, I am saying as an industrial developer, in nine cities around America, make sure that apartments get a benefit. Make sure apartments get the break, because you won't get any apartments without it.

Senator Byrd. What are the apartments getting right now?

Mr. Ruby. Right now? It depends on your auditing agent. It could be 30 years, 35 or 40, but it is double declining balanced depreciation. In 1976, you passed that recapture law so the average apartment owner is afraid to death to take double declining depreciation because if he keeps it for 7 years it triggers ordinary income tax for him on all the depreciation he has taken during that period of time.

So, as far as I was concerned in 1976, what you did or what the tax committee did was take away first year writeoffs in rule 189. You can put your money in a Savings and Loan and get 15 percent on a T bill but you put it into an apartment project, you get nothing the first year and now you are not even allowed to get the writeoffs for interest and property taxes.

The second year, you get no cash flow. We have already talked about the fact there is no cash flow to speak of and you are scared to death to use double declining balanced depreciation. You have to go back into ordinary depreciation because you are afraid of that recapture.

So, in effect, you took away double declining balance and you took away first year writeoffs and you signaled the industry. You said guys, you did a heck of a good job. You created 2 million apartment units in the early 1970's. We have an oversupply in most of the cities in the land, now let's take that dirty word called a tax shelter away from these investors.

On one hand you told us in 1969, we need an incentive boys, get out there and build those apartments and boy we went out there and built them. In 1976 you said, hey, we have enough apartments, let's get rid of that damn fool tax shelter, that tax dodger.

So, here I am as a builder whip sore and wondering where to go. In the meantime, I just play it safe and go into industrial development only to have a kind of statue of liberty play come in from the side which says that owner-occupied buildings now get 10-year life.

It is an interesting life as a builder in America, I can tell you that right now.

Senator BYRD. That is an interesting presentation. Thank you.

Senator DURENBERGER [acting chairman]. Let me start my questions on one of the points you were just making, Howard, relative to the fault for risk or where do we blame the risky nature of apartment ownership.

I would suggest that perhaps one of the reasons and one of the things we ought to be exploring as tax policy people, is the difference between renting and owning is that you have nobody to pass the costs through to, then you have no tax deduction or whether I am comparing owning or renting or I am comparing commercial investments with investments in apartments.

There is a difference in what the person who needs the facility can do from the tax standpoint with the amount of money that is paid to rent your apartment building.

It seems to me that the risk is complicated by the economy. The risk is complicated by inflation. The risk is complicated by the impact of inflation on the income tax. The risk is complicated by inflationary psychology in this country where people are making bad decisions, bad investments.

The whole problem we are trying to deal with here is much more complicated than just applying supply side economic theories to the apartment house industry. Not that I disagree with anything you have said. From our standpoint, we have to put in some perspective the changes that we make in tax policy and the consequence of those changes.

Now, it seems to me from what I have heard and this isn't the first time we have heard from any of you fellows. You have been in here, I think, for the 2½ years I have been on this committee. There is always a problem of mixing short-term solutions and long-term solutions.

When we talked earlier, I think you were asked the question about targeted savings and so forth.

I want to ask a question of all of you that goes to your advice to us in terms of some short-term tax policies and some long-term tax policies. Are there certain things that as it relates to housing in America, whether it is owned or rental, are there certain things that we ought to be doing recognizing that they are short term only and for example, targeted savings might be one of them. And are there certain things that are long term and would each of you try to tackle that question and pull them apart for us because obviously we are not living in an ideal world?

Some of the recommendations that you all have made are ideal tax policy in an ideal world, but others are not. Others take the reality of today and apply some other kind of a standard to the recommendation.

Do you want to start, Howard?

Mr. Ruby. Yes, sir. I think that is one of the key problems that I lament here. The long-term policy ofttimes becomes short-term policy.

In 1969 you get a tax act and you figure this is good for 20 years and then within a couple of years it is changed. In 1976 you get a new tax act and changes.

I hope I am answering the right way. I am saying if there could be some continuity. If you are going to say to savers, look, we are going to put aside the first $1,000 or $2,000 of interest you get—it's going to be tax free. Well, lord knows they would like to think that that is going to stay there forever, rather than you coming in and taxing the pool of money that they got after being frugal savers for a period of time.

So, consistency, long-term duration rather than short-term solutions, I think is a desperate part of the solution to the thing.

You were eluding to the risk factor before and at that time I did not really get a chance to rebut. The risk factor that I was talking about was risk of rent control, of political ramifications. The list is manifold. The risk of having to get up in the middle of the night and fix the toilet.

You do not have to do that in an office building. Remember, we are not talking about the 1,000 unit building. The average building in America is under 25 units and it is typically owned by a "mom and pop" who are NAA members. It is a fireman or it is a government worker who wants to put aside something for retirement. So, renting an apartment is a risky, troublesome thing.

But, there are at least enough people who want to do it, to keep the industry going, but if they can't get any tax shelter out of it, they are going to put their money elsewhere.

I am saying it is going to cost $10 billion to build 250,000 units. I am saying it is not going to come from the insurance companies, from the savings and loans, because they are broke right now. They are all in real trouble. I am saying it is not going to come from the pension funds because they have a list of rules that you folks passed that makes them so terrorized that they even get afraid of investing in Government bonds. I mean those guys are really afraid over there in——

Senator DURENBERGER. Before the rest of you respond, let me qualify or clarify why I raised the risk question, because before the afternoon is out we will also hear from either homeowners or home renters or representatives. I am addressing myself to all of the things that make it attractive or did make it attractive in this country to own rather than to rent.

There are two sides to this issue and I can raise with all of you the issue of the deductibility of interest paid on home loans or on real estate investment generally and suggest to you that ownership has been a rather attractive thing in America and ownership of shelter in this country has probably driven up the cost of that shelter to the point where it has been unattractive for people to get into the rental business.

I raise that issue so that we can see both sides of the policy recommendations that you are making. I can ask you a question that relates to short-term policy as well as long-term policy.

Mr. TAUBE. Senator, I think that a couple of—there is no such thing as a quick fix in this business. We know that. But, there are a couple of things that Howard and I both agree on very, very strongly. I think we agree on most of what is needed to get rental housing back.

Two very basic, simple things that we think could be done is No. 1: Restore what you gave us, what we had in 1976 and which was taken away from us. That is the concept that every industry in this country gets and that is when I go to the bank and I borrow money and I pay it back and I pay interest, allow me to deduct it when I pay the interest.

We used to have that and we built rental apartments and for some reason in 1976 that was taken away from us.

Second, a part of that same section 189 was when we pay our real estate taxes, it is a tax. It is deductible. A single family homeowner when he pays his property taxes are deducted. Why can't we deduct our real estate taxes during construction?

Section 189 repeal is one very simple thing. It doesn't require any new legislation. It requires giving us back what we had.

The second thing is that the tax laws, today, create incentive for rehabilitating existing rental housing, but only if it is for low income. There are many, many properties, today, and I said to you 200,000 to 300,000 units a year that we are losing to demolition, abandonment, it is the fastest, least expensive way to provide rental housing is get those units back in the market.

A very simple amendment to the code would be to allow the 5-year writeoff for any rehab whether it is low income or not. Those are two simple things.

I think finally, I think depreciation is a short-term but is also a long-term solution to the problem. It is nothing new to the tax code. It is something that we have had in our system for years and years and years.

What Howard is trying to say and what I am trying to say is if you create incentives to attract private capital back into the industry—sure in the old days Howard built apartments with maybe his lender thought he had 20 or 25 percent equity and he might have 0 or 5, he is saying today he and his investors and my investors are willing to put up the equity capital and if we have sufficient equity capital in there the lenders will come back into the market. They really will.

But, today, if they have a choice of investing in something that is subject to rent control and something that has the risks that we have inherent in rental housing, they are not going to do it.

Senator DURENBERGER. Are you coming down on 5 and 10 years on accelerated depreciation because the administration is talking about 10 years in their 10-5-3 scheme or because under the current system there is ready money available for commercial investment? Or if the breaks were not currently all running toward commercial investment or some other use of capital in this country, could you live with some set of years other than 5 years and 10 years?

Mr. RUBY. Currently, under depreciation rules that are in existence, if one wants to accept the 1250 idea, which means you recapture at ordinary rates, then you could build a case that the depreciation is actually in the 16- to 18-year range as it sits today. So the Reagan administration's 18-year straight line plan is actually less depreciation than we have to offer today.

So, if it is less, then let's go to a 15 year. Now, if the industry is getting a 15-year across the board in the Reagan plan, shopping centers, office buildings, industrial plants, then the only thing we are saying in the apartment industry is put some other little extra thing in or else everybody will invest in office buildings and hotels because there is inherently less risk in those plans.

Now, where we see the money coming from is public syndications—the McNeil funds, the consolidated capital, there's dozens of them. Wall Street can go out and get money from the $5 and $10 and $15 and $20,000 investor who doesn't want to be in cryogenically frozen bull sperm. They don't know anything about it. It was shown to me, believe it or not.

So, if we get rid of rule 189 and if we put the 15-year accelerated in, then we can get projects going again. Now, if we don't have that, what kind of rents does it take? Twenty-five percent, 25 to 30 percent higher rents. Without this shelter, it takes 25 to 30 percent higher rents and then you are priced off the charts.

So, our only hope, we think, is to get Wall Street going, get $2.5 to $3 billion coming in, which I think is entirely possible. They sold $91 million in 9 days just a couple of weeks ago. They only have to do that 25 times and we will get the other $7.5 million. I talked to an S&L guy the other day and I said we can cut you in this way and this way if we put 25 percent down, would you do it? He said yes, under those circumstances we would.

Anyway, it is a cry in the dark. Maybe it will work.

Senator DURENBERGER. Can I get brief responses from the others of you on the question?

Mr. NAPOLITANO. Senator, I believe it goes deeper than just the itemized things we have down here. It is a philosophy. The philosophy is do we want to house the American people as we have been housing them.

If the answer is no, then I think, you know, a lot of this is going to go by the wayside. If the answer is "yes," then these are some of the solutions we see to the problem. Most of them, I believe, are long range. I don't believe they are short range in this respect.

In our particular situation, talking about the single family house again, the Bentsen bill is probably the best one and it is long range, that could produce the quickest response in the housing industry and get the most done for the long pull, and the short range as well. We would propose that.

But I think this Congress and the country and the administration has to decide, do we still want to house the American people. It is needed. The demographics out there are 2.1 to 2.3 million, a year. We have to take care of these people, sooner or later, we have to do something with them. It is building up. We are far behind now in the decade of the 1980's. We have to do whatever is necessary to get these people housed.

Mr. CARLSON. Well, yes, I think there are some short-term measures. I think that tax-exempt certificates for depository institutions is of a short-term nature, will bring additional funds. I would tie them to housing. I wouldn't let them just go to the institutions alone. Also, it will help with the transition if those institutions are going and so it serves two purposes. It gets funds into housing and it also helps with the transition the thrift institutions have to go through.

By the way, my comment on the construction interests, as I recall, no hearings were held on section 189. It was passed in conference without any hearings whatsoever.

I am sure the hearings would not have gone ahead with that particular provision.

The other parts of the Tax Code, I think are long term in nature, depreciation reform that you are talking about, the savings incentives, we are a capital short economy. We are short of it in the rental housing in particular, but we will be short of it in all parts of the economy. Capital per worker has gone down every year during the last 5 years. We are going to start having a shortage of workers in the middle part of this decade. We are going to have to have capital deepening.

So, consequently, I do think you have to plan ahead for the total economy, the housing part, as well as the industry part. We have to have something in place that can operate over the longer run.

I would take issue with the viewpoint that is prevalent among people's point of view that we have had overinvestment in housing. The resources going into housing, as a proportion of GNP has gone down for 30 years, and particularly since the last 2 years.

The proportion of funds, loanable funds going into housing has gone down for 30 years, but particularly in the last 2 years.

Our proportion of funds dedicated for housing is much lower than other industrialized countries. It just is not true.

Fred talked about the demographics showing that we have an increased demand for additional housing in this country during the decade of the 1980's which will exacerbate the particular situation.

To your point on depreciation of lives, and my attachment 12, what current law is about equivalent to about—as was pointed out, about 18 years straight life depreciation.

Consequently, any time you change that on the industrial side, making it more favorable, you have a siphoning out of funds, out of housing, which is already doing very badly. You can see the internal rates of return that are associated with that.

Senator DURENBERGER. I just want to clarify one thing. I don't think, in my comment or question, I implied any comments relative to an excess of investment. I was talking about the affordability issue, and whether or not some of the affordability factors were being affected by inflation and by a variety of other factors that I think you know better than I, with regard to the housing market.

Mr. ARONSOHN. I don't think our organization would have any comments to make on short-term solutions, but we have had a consistent approach in terms of our long-term view of the code, and one that is not disposed to look with too much favor on a proliferation of special provisions and special incentives.

Our approach to real property investment over the years has been that the real property field, as a whole, I am not talking about housing, for example, particularly low income housing which obviously needs a tax incentive, otherwise it can't exist, but our approach has been one directed more toward our notions of equality which we think have been lacking to an increasing degree over the years.

You can see a proliferation of special provisions being introduced in the code, that favor, for example, corporate enterprise over unincorporated.

Section 189 has been discussed a great deal this afternoon. Section 189 does not apply to corporations. Section 163(d) does not apply to corporations.

The investment tax limitation, tax credit limitations on noncorporate leasors obviously do not apply to corporations.

The real estate dollar, the investment dollar is not only a competition between housing and commercial property, it is also a competition between real estate and all the other demands on capital that are made in our economy.

Every time the investment tax credit is increased, a certain amount of dollars are siphoned out of real estate in general, and housing in particular.

So that we think over the long haul we might be all better off if things were more or less on an even keel. We are not sanguine that we are going to come out ahead of this lottery of 1969, 1976, 1981, that we will get more goodies than the next fellow.

From that point of view, in terms of the present, we think there is a great opportunity to change the law with respect to capital cost recovery periods, in some sensible way, with broad categories, without trying to make tremendous distinctions for every little thing, and that capital cost recovery should be shortened and that does not mean we are looking for an incentive, but in a highly inflationary economy, the present value of the deduction 20 years from today is zilch, at any discount rate you want to take.

So, it is just a question of nobody is God and nobody can come up with a number and swear that that is it. But, I think there is a general consensus that a simplified, shorter capital cost recovery system would make sense for everybody.

Senator **Durenberger**. Thank you very much.

Senator Bentsen.

Senator **Bentsen**. Thank you very much, Mr. Chairman.

Mr. Chairman, I really enjoyed listening to this testimony and agree with a lot of it. I think we are doing a lot with what we do in the way of accelerated depreciation, whether it is 10-5-3 or 7-10, and in turn, finally do something for the investor, because we materially affect the cash flow and provide the kind of funds necessary, I believe, to buy the new equipment to start rebuilding.

But I am deeply concerned about savings, money savings, in any kind of a financial institution, long-term savings today, with the inflation rates the way they are.

I look at the S. & L.'s, thrift institutions. They lost $28 billion in outflow last year, and $2.5 billion, in February, the highest they have ever lost since about 1966.

They can say, well, they are not going to belly up, but finally you run out of funds. I really don't see much of a change unless we do something to provide some incentives for savings in this country.

We are doing something for the investing side when we talk about capital cost recovery and materially shortening that period.

But we must do it, I think, from the other side also.

I think if we don't, we are going to see the housing market flat on its back for a long time and individual homeownership.

I think you make a very legitimate case for an even playing ground.

I can go back to my home city of Houston, and it is exploding; it is out of control. I have never seen such growth in commercial buildings, and I know they are needed. The same applies to Dallas. But, I can see the housing industry really taking a dive.

These people that try to say we will be spending too much for housing and that is not productive—I think one of the things that gives stability to our society is homeownership and adequate housing.

The point has been made about section 189 as far as forcing capitalization of interest and taxes. I certainly agree with that point of view. In fact, I introduced legislation, S. 317, to repeal it so they can't charge.

But, when I look at this situation between owner occupied, any time you put in those kind of disparities, favoring one over the other, you encourage the playing of games.

I would get concerned as to whether or not—whether you had a facade or you had a dummy corporation on ownership or some of the things that might be done by various groups of people, astute people, who would try to find their way around that law.

Would any of you care to comment on that?

Doesn't it open up that kind of opportunity?

Mr. **Rudy**. Just give me a chance, Senator.

Senator **Bentsen**. Well, I heard you talk about tax shelters. I am very much for seeing us cut them to 70 and 50. I think we will really strike a blow at tax shelters as such.

I was talking to some folks and they were not too exicted about that. Too many deals are made not for economic purposes or solid economic reasons, but because Uncle Sam is going to pay 70 percent of it. It doesn't work.

About the only people who pay 70 percent are people that get surprised and did not do any planning.

We are going to have to look at another thing, though, that happens to you on capital gains, when you get down to 10 and 20 percent, you are going to have to look at the alternative minimum, because you put all your preference items into that one. You are going to get a situation where anyone who makes a capital gain is going to be thrown off automatically on that and pay more than the 20 percent. That is the way it will work out.

So, that one also has to be addressed.

Mr. Chairman, I guess I am just expressing some views and sharing some sentiments with them, because I find a great deal of merit in general with what was said, although I would have to argue a little bit with Mr. Ruby when he talked about ERISA, since I happened to help with the legislation that allowed the prudent investor to be interpreted as someone where you would look at the total portfolio rather than the individual investment.

Some of the people who are trying to tell you they can't invest in a company because it is too high risk are misinterpreting that rule, because I intentionally helped change it and put in one that would say that if you go into something that is high risk, it is allowed, high risk, as long as it is only a small part of an overall large portfolio.

Previously, that one was subject to real problems from the examiner. I know something about that one. I helped draft it and I used to be on your side of the table.

Mr. Ruby. Senator, I have been out talking to pools of commingled funds in the multibillion-dollar ranges that take the money in from the pension fund, and they say, sorry, no apartments, guys, ERISA.

See, what they are doing is, they are blaming on ERISA the fact that they don't want to invest in apartment houses.

Senator Bentsen. That is right.

Mr. Ruby. But, I hear it all the time. We have been talking to pension funds directly on office buildings and whatever, and that is fine. But, you mention apartment houses to them and they turn the other way.

Now, even a $2 billion or $3 billion commingled pension fund account is saying: "Sorry, no apartments."

So, what I am saying is, the only approach is to private investors. I like your idea of the 70 percent going down to 50, because then some of these weirdo schemes where a guy will invest and say: "Oh, it is only going to cost me 30 cents on the dollar, even if I do lose." If it's 50 cents on the dollar he is going to think twice. I think that very few people have ever lost in an apartment project over time.

So, I think the opportunity——

Senator Bentsen. If they hold on to it.

Mr. Ruby. Yes.

Senator **Bentsen**. Is there really a tax shelter in frozen bull semen, as you told me? That is a new one to me.

Mr. **Carlson**. That is no bull. [Laughter.]

Senator **Bentsen**. I think I have had enough time. Thank you, Mr. Chairman.

Senator **Durenberger**. Thank you, gentlemen, very much for your counsel. I appreciate it.

[Statements follow:]

STATEMENT OF

THE NATIONAL ASSOCIATION OF HOME BUILDERS

SUMMARY OF PRINCIPAL POINTS

1. The short-term outlook for the housing industry is, in a word, dismal.

2. The demand for housing is very strong and will grow substantially through the decade of the 1980's.

3. The deregulation of financial institutions and the remarkable growth of the unregulated Money Market Mutual Funds has decimated the supply of mortgage credit for housing.

4. There is a crisis in multifamily housing with record low vacancy rates and a substantial demand for new housing production.

5. NAHB supports the Administration's budget reduction program and immediate movement toward a balanced budget.

6. NAHB supports individual income tax reduction principally directed toward stimulating savings and investment, including S. 701 which would provide a tax exclusion for interest earned on savings if the lender uses the proceeds for residential mortgages.

7. NAHB believes that tax relief should be provided only to the extent that there are comparable federal spending reductions.

8. NAHB supports depreciation reform which will preserve the traditional favorable tax incentive for multifamily rental housing including favorable depreciation schedules, repeal of Section 189 of the Internal Revenue Code, and inclusion of investment tax credits for equipment and machinery installed in rental housing.

9. NAHB supports all legislative changes needed to make the tax exempt mortgage bond program for single-family and multifamily housing fully workable throughout the country.

10. NAHB supports a one-time, limited tax credit of 5% (up to $5000) for purchasers of homes which were built more than one year ago in order to help reduce inventory.

11. NAHB supports legislation to require pension and retirement funds to invest a substantial portion of their assets in residential mortgages and housing securities.

12. NAHB would vigorously oppose any attempt to limit the homeownership deduction for mortgage interest and property taxes.

13. NAHB supports rapid legislative and regulatory changes to reform the inaccurate and inflationary housing component of the Consumer Price Index.

Mr. Chairman and Members of the Committee:

My name is Frederick Napolitano and I am a homebuilder from Virginia Beach, Virginia. I am testifying today on behalf of the more than 123,000 members of the National Association of Home Builders (NAHB) of which I am First Vice President. NAHB is the trade association of our nation's homebuilding industry. Accompanying me today is Robert D Bannister, Senior Staff Vice President for Governmental Affairs. We appreciate this opportunity to present our views on the Administration's Tax Reduction Proposal and other tax-related issues affecting the homebuilding industry, the potential homebuyer, and our financial institutions.

Mr. Chairman, let me begin by saying that I do not envy this Committee's task. There has been considerable agreement on the need for deep budget reductions which affect almost every segment of the domestic federal budget. We share your belief that such action is long overdue and is essential to restore stability to our economy -- and to our industry. We realize that sacrifices must be made in order to ensure a more viable economy -- and lower interest rates. That is why NAHB endorsed the President's budget reduction program at our Board of Directors meeting earlier this month and has pledged to do all in our power to support its passage.

However, there has been considerable disagreement about the tax portion of the Economic Recovery Program. And it seems evident that significant segments of the financial markets and Wall Street community -- along with the Federal Reserve Board -- have shown an uneasiness and skepticism about the program which has been reflected in soaring interest rates over the past few weeks.

That is bad news for an interest-rate sensitive industry like housing which is still reeling from the effects of FED policy and record-high interest rates which began in October, 1979.

Mr. Chairman, I would be the first to say that we do not have the answer to the real dilemma facing your Committee -- whether Reaganomics, Volckernomics or Kaufmanonomics will open the door to a lasting recovery. We discussed these issues at length as they relate to the homebuilding industry at our recent Board meeting. But I think I can present you with a judicious and balanced approach from our perspective which hopefully will lead our country back to work, increase productivity and savings and reduce the underlying rate of inflation.

First, I would like to bring the Committee up to date on the dismal short-term outlook for the housing industry, and the underlying strength of the industry due to unprecedented demand. I believe that an understanding of the current condition of our industry is essential to determine the kind of action needed in the area of tax reduction.

1. Outlook For Housing

The facts are:

- In 1900 we experienced the second most serious housing slump since World War II, with production dropping by 57 percent from the peak of the housing cycle in November, 1978 to May, 1980.
- Total housing production for 1980 was down 26 percent from 1979 - with 1,292,000 units actually started or over 450,000 units less than the 1,745,100 started in 1979.
- Total negative impact to the economy of the housing downturn from 1978 to 1980 was $88 billion.
- Housing production is running currently at under a 1.3 million annual rate.

- o Housing production under government programs are comprising a larger segment of total starts. In 1980, the number of units insured or subsidized under government programs totalled 43.4 percent of total starts, compared to 34.5% in 1979, and 22.8% in 1976.
- o Our Builders Economic Council survey shows a substantial decline in sales and "traffic". For the last three months less than 3 percent of the single-family builders surveyed reported sales to be "good to excellent" -- the lowest ever recorded in this category.
- o Home sales have been declining for the past seven months, and are now 17 percent below the sales pace of a year ago.
- o The inventory of unsold homes stands at 321,000 units.
- o The failure rate in construction is up sharply. In 1980, there was a 127 percent increase in business failure dollar volume for building contractors and a 225 percent increase for subcontractors.
- o Net inflow of loanable funds into thrift institutions continue to be low. For 1980, the thrifts only received $5.7 billion in net new money, down 29 percent from 1979 and down 75 percent from 1978.
- o The unemployment rate in the construction industry in March reached 14.7% -- more than twice the national unemployment rate for all workers. According to government statistics, there were 738,000 construction workers out of work in February.

What about 1981? The latest projections of the NAHB Econometric Model forecast essentially no increase in housing production over the depressed starts rate of 1980 of 1.3 million units and the forecast may be forced down to about 1.2 million if interest rates do not decline soon. Even if there is a a gradual decline in interest rates, we still believe that mortgage rates will remain high - probably in the 13.5 to 14.5 percent range by the end of the year. Our industry faces at least another six months of dismal performance, with a slight improvement by the end of the year. I am deeply troubled that this near-term outlook is not optimistic. But I feel strongly that this Committee should recognize that fact when you are considering the impact of a tax reduction program on the housing industry.

2. Housing Demand

The demand for housing is very strong and will grow substantially through the decade of the 1980's. Projections indicate that during the 1980's, 41 million Americans will reach the prime homebuying age of 30. This compares with about 31 million who reached the age of 30 during the 1970's. The rate of new household formation could be 25 percent higher in the 1980's than during the last decade. This increased rate of family formation is largely the result of the postwar baby boom and the number of increased single person households.

The impact of rapidly escalating housing costs on the potential homebuyer is dramatic. At the current median sales price of $67,100, and assuming all families to be first-time buyers who devote 25 percent of their income to housing costs, only 3.0 million or less than 5 percent of the 57 million American families can afford to buy a median-priced new home at today's 16 to 17 percent interest rates.

All of us are affected by increased costs of home purchase, maintenance, and operation. Those who bought their homes prior to the recent dramatic price increases in the 1970's have been least adversely affected. The equity appreciation in their homes has allowed many to move up to more comfortable homes with very little increase in monthly mortgage payments. Those harmed most by the acceleration in housing costs are those who do not have the "ticket of admission" to the homeownership market -- young families who are potential first-time homebuyers. For these individuals, the rapid increase in the cost of housing has quickly outstripped their own modest increases in income.

A United States Savings Associations report on "Homeownership: Coping with Inflation" has made a number of significant findings regarding the first-time homebuyer. First, inflation has significantly reduced the percentage of first-time buyers in the market. Only 18% of all homebuyers in 1979 were first-time purchasers, compared to 36% of the total in 1977. Second, first-time buyers had to stretch their budgets, even with two incomes, to afford a home. In two-thirds of first-time buyer households with two adults, a second income contributed more than 10% of income. Less than 50% of repeat buyer households had two incomes. Third, the old "25% of income" rule of thumb for housing expenses has been shattered. About 46% of all buyers spent more than one-fourth of their income on housing expenses.

Regarding downpayments, an earlier U.S. League report in 1978 made a number of significant findings regarding the first-time buyer. First, at least one-half of all first-time homebuyers make a downpayment of less than 20%. However, with the high price of housing today, even a low downpayment may require a substantial amount of money. A low downpayment represents a mixed blessing for the average buyer because a lower downpayment means a higher monthly mortgage payment. Second, a major hurdle facing the first-time homebuyer attempting to buy a home is obtaining cash for the downpayment. Over 4 out of 5 first-time buyers use only household savings to accumulate the downpayment. And, as I have stated earlier, most of these buyers need two incomes to generate the savings needed for the downpayment. The availability of low downpayments (through FHA, VA and private mortgage insurance companies) is essential because, as the U.S. League report found, 4 out of 5 buyers who made less than a 20% downpayment could not have afforded to purchase their home if a 20% downpayment had been required.

There is no doubt that first-time homebuyers have been hardest hit by the impact of inflation on home prices.

3. Financial Institution Deregulation

Mr. Chairman, the recent phenomenon of deregulation of financial institutions and the remarkable growth of the relatively unregulated and unsupervised Money Market Mutual Funds (MMMFs) threatens the viability of our traditional depository institutions, especially the thrifts, and has decimated the supply of mortgage credit for housing. This situation comes at the same time that the homebuilding industry is experiencing a severe slump brought on by record high interest rates and uncertainty in the mortgage markets.

The growth of MMMFs has made a significant contribution to the disastrous condition of the thrift industry. Unless action is taken to restore an adequate supply of affordable mortgage credit, this does not bode well for the future of housing. The tremendous shift of funds from passbook savings to higher rate short term money market certificates has already all but eliminated the long term savings needed to make long-term mortgages. As of February 1981, 38.4 percent of Savings and Loan deposits and 35.5 percent of mutual savings bank deposits were in money market certificates. Continued disintermediation to the MMMFs will obviously further reduce the asset base on which the thrifts can make mortgage loans.

In 1980, about two thirds of nearly $500 billion in mortgage investments of the thrift industry carried interest rates of less than 10 percent. At the same time, the rates the thrifts paid to borrow soared well beyond that. Obviously, the thrifts cannot continue to pay market interest rates to attract deposits without increasng chaos in the industry.

4. Rental Housing Crisis

Apartment vacancy rates in many parts of the country are at record low levels. According to statistics developed by the National Association of Realtors from selected HUD area offices, vacancy rates in most cities are at a critical level. For example, in Chicago the vacancy rate is one percent.

There are various reasons why new multifamily rental projects are not being built despite the low vacancy rates and the substantial need for housing, particularly when potential first-time buyers have been priced out of the homeownership market. High interest rates, increased operating costs, expansion of rent controls (and the threat of controls), as well as local statutes prohibiting conversion to condominiums have all but dried up the private market in rental housing construction. But the most important factor is that it is simply not economically feasible to build and operate multifamily rental housing. Rents have not kept pace with rapidly escalating construction costs. Present depreciation schedules do not encourage multifamily construction and are no longer sufficient to eliminate the gap. In addition, several provisions added to the 1976 Tax Reform Act are major disincentives to the development of new multifamily rental housing. As a result, an increasing percentage of the new multifamily units which are being produced are being constructed under the federal subsidy programs. This is a trend which should be reversed. And it is clear that this Administration intends to reduce and eliminate various government-assisted multifamily production programs -- without providing appropriate incentives to promote private development of rental housing.

What is our approach to deal with the scenario I have just outlined?

First, we strongly support major reductions in federal spending and immediate movement toward a balanced budget as embodied in the Administration's budget reduction program.

Second, we support an individual income tax reduction program whose principal emphasis is directed toward stimulating savings and investments, including a tax incentive for savers targeted to housing.

Third, we believe that tax relief should be provided only to the extent that comparable net reductions in federal spending are made.

Regarding items two and three, see attachment "A," a letter to the President, which is co-signed by the six major shelter industry trade association Presidents.

Fourth, we believe that any change in business capital cost recovery should maintain the historical and traditional relationship of favorable tax incentives for multifamily rental housing (both low-income and other than-low-income) as regards other nonresidential investment, including (1) favorable depreciation schedules, (2) repeal of Section 189 of the Internal Revenue Code to allow current deductibility of construction period interest and taxes, and (3) inclusion of investment tax credit benefits for equipment and machinery in rental housing.

Fifth, we share the view expressed to us by HUD Secretary Pierce that tax-exempt revenue bonds are an important source of financing for single-family and multi-family housing. We urge that all needed legislative changes be made to make this program fully workable throughout the country.

Sixth, as a short-term remedy to reduce the substantial unsold inventory and allow our builders to begin building new homes, we support a limited 5% tax credit (up to $5000) to the purchaser of a home which was constructed at least one year ago.

Seventh, we believe that private and public pension and retirement funds have become the largest growing source of long-term investment funds in the country. We urge the enactment of legislation to require pension and retirement funds, in order to maintain their tax free status on earnings, to invest a substantial portion of their assets in residential mortgages and housing securities.

Eighth, we believe that the homeowner deductions for mortgage interest and property taxes are a prerequisite to homeownership for millions of Americans. We would vigorously oppose <u>any</u> attempt to limit the deduction for mortgage interest and property taxes.

Ninth, it is universally accepted that the housing component of the consumer price index substantially overstates inflation. The use of an inflationary CPI in indexed programs only builds inflationary pressures. We would support rapid legislative and/or regulatory changes in the weighting and computation of the housing component of the index.

TAX INCENTIVES FOR SAVERS

NAHB has endorsed the concept of tax-free interest on savings used for residential mortgages. This concept is embodied in legislation introduced by Senator Bentsen, the "Home Mortgage Incentive Act of 1981" (S. 701). America is suffering from the lowest savings rate of any industrialized nation. Our savings rate as a percentage of disposable income has declined steadily from a level of 8.6 percent in 1975 to 5.6 percent today. One of the major reasons for the decline in productivity growth has been due to the fact that Americans tend to consume -- rather than save -- too large a portion of their income. The most important benefit of the Bentsen concept is that it would encourage people to channel funds into savings institutions such as banks, thrifts and credit unions, which then could be used for housing production.

A study released last week by the Joint Economic Committee (which is attached as Exhibit "B") strongly supports the Bentsen concept of tax free treatment of all interest earned on savings deposits used for residential mortgages. The JEC study, which was conducted to evaluate the macroeconomic impact of the proposal using the computer model of Wharton Econometrics, found that the proposal would "generate a notable increase in economic growth." It would "produce a general economic boom" which would be "broad-based, with both consumption and real domestic private investment moving sharply higher." It would create over one million new jobs within a year of enactment, reducing unemployment by 1.1%. The boom is projected to add 1.4% to the rate of real economic growth in the year following enactment. Per capita disposable income (adjusted for inflation) is projected to grow by 1.1% in the year of enactment, while the personal savings rate would rise by 1%.

As regards the housing industry, production of private new housing would rise by 135,000 units in the year of enactment and 487,000 units in the year following enactment. As importantly, the simulation projected a real growth rate in <u>nonresidential</u> fixed private investment in the year following enactment of 1.1%.

There were two findings which we believe should be of great significance to this Committee. First, the projected boom was found to be <u>not inflationary</u>. This is largely due to projected increased savings and productivity and the fact that the housing industry has "large excess capacity" which is able to sustain increased demand "without noticeably generating inflationary pressures." Second, "the Bentsen proposal will generate a noninflationary economic boom in conjunction with either the full three-year Administration tax and spending program or with a scaled-down one-year variation. It will compliment and reinforce either program -- adding one percentage point to real GNP growth, reducing the deficit, boosting real nonresidential investment, and increasing housing activity compared to the results projected to occur without enactment of the Bentsen proposal." We commend the study and the concept to the Committee for your review and consideration as part of the 1981 tax bill.

A tax incentives for savers program such as the Bentsen approach would also help lending institutions compete with money market mutual funds on a more "level playing field." It is a better long-term approach than other possible "competitive instruments" or money certificates for the thrifts, since it would develop more stable deposits, as opposed to the volatility of the short-term six month money market certificates which have discouraged mortgage lending activity. The program would bolster the thrifts without an expensive federal bailout. The program could generate sufficient funds for residential mortgages, at reasonable interest rates, to allow t~~he housing~~ industry to meet housing demand in the 1980s.

DEPRECIATION REFORM

Mr. Chairman, we believe that this Committee recognizes that there is a growing crisis in multifamily housing in this country. The proposed budget cuts by the Administration already largely agreed to by Congress will substantially reduce federal assistance to multifamily housing in FY 81 and FY 82. Therefore, favorable depreciaion reform is essential to maintain even a reasonable level of production.

Accelerated depreciation for business is at the top of most lists for necessary tax reform this year. Various depreciation reform proposals have been made as a means to stimulate capital investment and increase productivity in U.S. business.

However, we are very concerned that many of these proposals overlook the housing industry. The Adminisration's proposal, for example, is actually detrimental to the housing sector of the economy, and would represent less favorable treatment for rental housing than under current law.

Under the Administration proposal, multifamily housing would be allowed 18-year straight line depreciation with 15-year straight line for low income housing. Thus, the effect of passage of the proposed 10-year accelerated depreciation for certain owner occupied commercial and industrial property would be a further shift of captial investment away from housing into other sectors of the economy. The result would be an even greater reduction in the number of apartments being built and a lower vacancy rate.

Mr. Chairman, we are pleased that the White House and the Treasury Department have recognized the possible inequity in the current proposal and have indicated that review is underway in order to ensure that residential real estate is treated equitably vis-a-vis industrial and commercial investment.

Our conceptual position is simple. We believe that housing has traditionally had a relationship of favorable tax incentives as regards other areas of the economy for which the Internal

Revenue Code provides incentives. We urge that the historical relationship be maintained for rental housing in any revisions to the Code. We also believe that there is no adequate justification for a distinction in useful life determinations based upon the status of ownership of non-residential property -- whether owner-occupied or leased.

Unfortunately, implementation of that simple concept requires substantial amplification. We support the concept of an audit proof useful life for depreciable real property, as proposed by the Administration.

We believe that 10-year straight line depreciation for all Section 1250 property (with 8-year straight line depreciation for low-income housing as proposed in Representative Gonzalez's bill H.R. 752) provides the type of incentive necessary to stimulate the development of rental housing.

The adoption of the 10-year/8-year proposal would greatly simplify the computation of depreciation. All existing accelerated depreciation formulas would be eliminated with respect to Section 1250 property. There would be a certainty in the useful lives of depreciable real property which would benefit both the businessman and the IRS auditor. The frequent audits of apartment properties and the inconsistency in useful lives prescribed by various I.R.S. auditors discourage builders from becoming involved in the development of multifamily housing.

The NAHB Economics Department estimates that the 10-year/8-year depreciation provision would increase multifamily starts by 100,000 units. This in turn would generate over $1.4 billion in wages, and $352 million in additional federal personal and corporate tax.

We believe that there should be a more favorable depreciation schedule for multifamily housing than for other commercial and industrial investments because of the critical need for rental housing production and because of the governmental and economic restrictions which make rental housing non-competitive with other comparable investments. In addition, because of the particular need for production of low-income housing and the substantial impediments to development, there should be an additional increment to promote low-income housing.

Our members have advised us that it would be most desirable to allow the option of straight-line depreciation as well as to continue the availability of the owner's selection of an accelerated depreciation method subject to present recapture rules. But what we regard as most important is that the favorable treatment for rental housing as regards commerical and industrial investment be retained in any new depreciation schedule.

One other tax change is perhaps even more essential than the capital cost recovery period.

Current Deduction of Construction Period Interest and Taxes

NAHB urges that Section 189 of the Internal Revenue Code be repealed, and that construction period interest and taxes be allowed as deductions in the year in which the payments were made. Section 189 has been a major impediment to the development of rental housing.

We can see no justification for capitalizing construction period interest and taxes. Real estate should not be penalized while others are not subject to this restraint. These items are akin to current expenses. So long as there is no attempt to avoid legitimate taxes by prepaying interest attributable to other periods, interest and tax deductions should be allowed in the year in which payments are made.

Construction interest is attributable to a construction loan which exists only during the twelve to twenty-four month period when a multifamily housing project is under construction. When construction is complete, the construction loan is paid off, a new permanent take-out loan is issued and a new, recurring interest charge begins. Construction period interest is clearly an expense of the short construction term, and should be allowed as deduction during that period.

The current expensing of construction period interest as compared to the current practice of 10 year amortization period would most affect the multifamily rental construction sector. In 1981 it is anticipated that there will be about 157,000 rental apartment units constructed, without the proposed tax change, which will require about $1 billion in construction interest. If allowed to deduct all the construction interest during this year, it would reduce revenues to the Treasury by about $480 million but this will be offset by a net of at least $123 million in increased direct federal tax revenues produced by 35,000 additional units. In addition, multiplier effects throughout the economy will produce additional revenues that could at least double the federal income taxes, both personal and corporate.

In succeeding years there will be a positive net impact on the federal Treasury, given that the construction financing will be expensed in the first year. Thus, after a small net cost to the Treasury in the first year, the overall tax impact will be positive. In addition, private construction will be spurred, thus increasing the return to the Treasury.

Investment Tax Credit

Mr. Chairman, The Administration has proposed to encourage capital investment by liberalizing existing investment tax credit provisions for business. Generally, with few exceptions, residential construction has not been eligible for investment credit. We believe that rental property should be treated equitably in this area as well. We believe that equipment or machinery, even though a fixture or otherwise an integral part of the building, which operates independently should be eligible for investment tax credit benefits. Such equipment could include heating and air conditioning, compressors, dishwashers and the like. We are currently developing specific language in this area and would be pleased to furnish the Committee with a more detailed draft in the near future.

TAX EXEMPT REVENUE BONDS

In such an uncertain economic climate, the availability of tax exempt revenue bond financing for single-family and multifamily housing is crucial.

The issuance of tax exempt revneue bonds is essential to the survival of many builders and represents probably the only short-term solution to the lack of adequate mortgage funds at reasonable interest rates for the homebuyer and renter.

The Mortgage Subsidy Bond Act of 1980 contains a number of unclear and probably unworkable limitations which seriously jeopardize the ability of state and local housing financing agencies to use tax exempt revenue bonds to finance housing. These include: a 1% arbitrage rule, bond certification, an inflexible first-time homebuyer requirement, "targeted area" provisions and questions regarding assumption of FHA/VA mortgages.

As of today, the Department of Treasury has not promulgated the regulations governing the issuance of tax exempt revenue bonds under the Act. And as of today, not a single bond had been issued under the new law due to the inability to comply with the law in the absence of clarifying regulations.

We urge the introduction and enactment of legislation which will make needed technical corrections and revise the unworkable provisions of the Act which cannot be resolved by regulation, such as the 1% arbitrage rule. We would also hope that Members of this Committee would contact the Secretary of the Treasury to urge expedited issuance of these regulations. We believe that many questions raised by the Act could be resolved through reasonable interpretation and properly drafted regulations.

The situation is critical. The ability to use tax exempt revenue bond financing could allow us to meet the demand for lower-priced housing for those who have been priced out of the housing market. Likewise, it could mean the difference between survival or bankruptcy for thousands in the homebuilding industry this year.

We would urge this Committee to review closely proposed legislation to be introduced shortly by Representative Duncan (R-TN) which would resolve most of the questions regarding issuance of single-family bonds. Regarding multifamily bond programs, we believe that the 20 percent requirement for low and moderate income tenants should be clarified so that it is defined as no less than 80% of area median income (the current Section 8 definition). We are concerned because pending legislation would restrict the occupancy of Section 8 projects to 50% of area median income which would render multifamily bond projects economically infeasible. Similarily, we believe that the units in bond financed projects should be "made available for" individuals of low and moderate income, which represents an achievable standard. We are concerned that the current language which provides for "occupancy" by low and moderate income may be interpreted to be an inflexible requirement incapable of being met by project owners or state or local agencies.

5% TAX CREDIT FOR INVENTORY HOMES

At the present time there are about 321,000 unsold units in inventory. A solution to the immediate reduction of these unsold units is a tax credit for the purchase of an inventory home which could be defined as a home on which construction began more than one year ago.

Senator Riegle introduced S. 790 which provides for a 5% tax credit of the purchase price of an inventory home up to a maximum of $5000. The tax credit is limited to one residence per individual or couple and applies only to homes whose construction began by February 15, 1981.

The federal tax impact of a 5% tax credit up to $5000 to purchasers of unsold inventory more than one year old is estimated to be about $178 million, as a high estimate. The estimate is based on the assumption that about 55,000 units would qualify. The unit estimate is derived from current U.S. Census Bureau data adjusting for a time frame in the legislative process. These 55,000 units would carry an average sales price of about $65,000 with an average tax credit of $3,250 per unit. (The estimate of the cost of the Riegle bill is about $894 million, based upon the assumption that 275,000 units would qualify.)

There are some offsetting revenue impacts to the Treasury that would lower the net loss in tax revenue that are difficult to measure, but they should be mentioned. Some new construction activity will be generated as a result of inventory reduction producing tax revenues. In addition, it will reduce the potential tax losses from builders who are showing operating losses from carrying the inventory.

In many areas of the country, this type of legislation may mean the difference between survival or bankruptcy for many builders.

Pension Funds

During the last ten years, the assets of this nation's pension and retirement funds have more than doubled and are now at a level almost equal to the total assets of the savings and loans. Pension funds for the small saver have to a great extent replaced the traditional savings account which the smaller saver used for retirement and protection in his later years. Thus, thrift institutions, which by law and custom have put the great bulk of their funds into residential mortgages, are no longer receiving the same proportion of the savings of the people who look to their savings institutions for a mortgage loan when they plan to buy a home.

Pension funds, however, since the early '60s have taken an investment course away from residential mortgages and into corporate equities. It is the opinion of NAHB that the very heavy investment of pension fund assets in corporate securities in not in the best interests of the beneficiaries of the pension funds, nor does it serve the social purposes for which the pension funds were created.

Evidence of this is borne out each time Wall Street takes a turn for the worse and the stock market falls. Neither corporate equities nor corporate bonds provide the protection of principal that residential mortgages provide. However, the investment of pension fund assets in these corporate issues continues to increase.

Attached are two tables detailing the investment patterns of pension fund assets for the years 1967 through 1980. The tables detail in both amount and percentages the distribution of pension fund investment for private non-insured pension funds, state and local government employee funds and a total of the private and government employee funds. You will note the drastic reduction in mortgage investment by the private pension funds from 4.7 % in 1967 to 2.2 % in 1980. Equally significant is the reduction of state and local government employee fund mortgage investment from 6.1% to 1.9% for the same period while the increase in total assets was over 375%. The investment of these funds in corporate shares is about ten times the 1967 level.

A number of residential mortgage investments yielding higher overall returns than corporate equities are and have been available for pension fund investment.

Examples are the Government National Mortgage Association's Mortgage-Backed Pass-Through Securities and the Federal Home Loan Mortgage Corporation's Participation Certificates. These instruments are guaranteed to return both principal and interest, are freely traded in the open market and represent funds for housing in America.

We as a nation have established a decent home as one of the prime goals of our society. One of the major barriers to achieving this goal, for even the middle class in the past few years, has been the cost of housing, especially the cost of monthly mortgage payments for the homebuyer, or the renter whose rent must reflect his landlord's mortgage payments. Supplying a greater volume of funds for residential mortgages should help considerably to moderate the price of those funds and the fluctuation in their supply.

NAHB believes the pension funds, which enjoy a very favorable tax position, should own up to their social responsibilities to both the pension fund beneficiary by protecting his assets, and to the nation as a whole as a repository of the people's savings. It is for these reasons that we urge that pension funds be required to invest a substantial percentage of their assets in residential mortgages. This requirement would go a long way toward helping this nation meet its housing demand during the 1980's.

HOMEOWNER TAX DEDUCTIONS

Mr. Chairman, regarding the homeowner interest and property tax deductions, we are pleased that the Administration opposes any attempt to limit this deduction. We appreciate the clarification that we received from Chairman Dole on this issue and particularly your recognition of the impact of any limit on the already overburdened middle-class homeowner and the home building industry.

We intend to be vigilant on this issue in order to protect the interests of the potential homebuyers who are already being priced out of the market by inflation and high interest rates.

We would be pleased to provide any background information to the Committee on this issue if limitation becomes a subject of active consideration in the future.

RESTRUCTURE THE CONSUMER PRICE INDEX

The incomes of over 46 million Americans are tied to the cost of living index directly through bargaining agreements or Congressionally mandated adjustments in social security benefits and retired federal employee pension programs. The overstatement of inflation in the CPI adds to the problem of inflation by raising incomes of some Americans above their real increase in expenses.

The housing component of the CPI overstates the actual increase in housing expenses for the overwhelming majority of households. The weighting in the current index is a major cause of the problem. Given the CPI's importance in measuring inflation, it must be restructured to more accurately reflect the actual changes in housing cost to most Americans, particularly the elderly who generally are not buying new homes.

Under a revised CPI formula proposed by the previous Administration, the CPI would have registered a 10.9% increase for the year ending last November instead of the 12.6%. That change would have more accurately reflected the change in the cost of living and reduced the federal deficit by $4 billion.

OTHER TAX ISSUES

Estate and Gift Tax Reform

We support estate and gift tax reform including, but not limited to, total exclusion from taxation of family businesses, an unlimited marital deduction, substantial increase in the general estate tax deduction, liberalization of extended deferred payments at low interest rates or outright repeal of estate and gift taxes.

We believe that the value of estates has been grossly exaggerated by inflation and the major portion of many estates is made up of wealth accumulated with after tax dollars. Estate and gift taxes force the sale of assets thereby destroying many small or family businesses. Estate and gift taxes also force individuals, who wish to avoid forced sales to pay estate taxes, to invest substantial sums of money in insurance to cover estate and gift taxes and the insurance premiums are a nonproductive expense.

Lastly, only a small percent of IRS revenues are generated from estate and gift taxes and the tax revenues do not offset the administrative costs, costs of estate planning, court costs and legal fees in handling estates, the insurance premiums, nor the costs of an IRS estate audit.

2. Solar Energy Tax Credit

NAHB supports enactment of S. 498, the Passive Solar tax credit for builders, introduced by Senator Gary Hart. This legislation passed the Senate last year by an overwhelming margin, but was not acted on by the House. The legislation would provide a maximum tax credit of $2,000 to builders of homes that employ certain passive solar features. The amount of the credit available would be based on the extent the passive system decreased the home's conventional heating load.

A passive solar home can cut the energy load of a conventional home by up to 70% in many instances. However, these types of designs are only employed by a small minority of builders because of the added risks involved. These risks include added construction costs for passive solar features, but more importantly, the added risk that the home may not sell. Very few home buyers today demand passive solar homes simply due to a lack of knowledge. Home builders do not ordinarily build homes unless they have some confidence that the home will sell. Especially with today's high interest rates, builders can't afford to build homes that are not in demand. If builders can somehow lessen the risk of building an "unconventional home", potential homebuyers have the opportunity to learn first hand of the potential benefits of passive solar. As demand increases for passive solar homes, builders will be encouraged to incorporate passive solar features into their standard designs.

The credit is designed to reduce this risk for builders for a period of time that allows consumer demand for passive solar homes to grow and to promote construction of the most energy efficient homes as soon as possible.

The Joint Committee on Taxation has estimated that the direct revenue loss for FY 82 would be only $9 million and that the total revenue loss through 1987 (when the credit would terminate) would be only $437 million. The amount of energy and money saved over the life of passive solar homes will substantially outweigh any direct revenue loss to the Treasury.

CONCLUSION

Mr. Chairman, the plate is full this year when it comes to issues of tax reduction of interest to the hard-pressed housing industry. We wish you well as you begin your deliberations in this area, particularly since the state of the economy is so precarious and the road to recovery does not seem to be a simple or straight path. We are confident in the future of our industry and our national economy. But we know that our future depends upon the wise and judicious actions of this Congress and our President.

We appreciate the opportunity to appear before you today to present our views, and look forward to responding to any questions you may have.

February 13, 1981

The President
The White House
Washington, D.C. 20500

Dear Mr. President:

We strongly support major reductions in federal spending. We feel that all Americans, including the members of our organizations, should join in sacrifices to reduce federal spending.

Tax relief should be provided only to the extent spending reductions are made to cause the federal deficit to decline towards balance each year. This would reduce pressures on interest rates and provide lower interest rates for productivity-increasing investment and adequate housing.

We feel it is important that the principal emphasis of tax relief should be directed toward stimulating savings and investment.

Respectfully,

Lee E. Gundersen, President
AMERICAN BANKERS ASSOCIATION

Albert B. Hooke, Chairman
NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS

Thomas H. Shealy, President
MORTGAGE BANKERS ASSOCIATION OF AMERICA

John R. Wood, President
NATIONAL ASSOCIATION OF REALTORS

Herman J. Smith, President
NATIONAL ASSOCIATION OF HOME BUILDERS

Rollin D. Barnard, President
UNITED STATES LEAGUE OF SAVINGS ASSOCIATIONS

A SIMULATION OF THE ECONOMIC IMPACT OF TAX EXEMPT HOME MORTGAGE SAVINGS ACCOUNTS

A Staff Study

Prepared For The Use Of The

JOINT ECONOMIC COMMITTEE

CONGRESS OF THE UNITED STATES

April, 1981

A SIMULATION OF THE ECONOMIC IMPACT OF TAX EXEMPT HOME MORTGAGE SAVINGS ACCOUNTS

By George R. Tyler*

Introduction

A host of proposals were introduced in the 96th Congress and in the current session of the 97th Congress designed to stimulate savings and boost the national pool of investible funds. Some of this legislation offers a broad-based approach featuring general tax rate reductions, while other legislation targets specific saving instruments or industries. This study focuses on one of the latter. Using the Wharton Econometric Model, it is an evaluation of the macroeconomic impact of excluding interest earned on mortgage-dedicated savings from Federal income taxes. This analysis specifically focuses on S.701, the "Home Mortgage Incentive Act of 1981", introduced March 12, 1981, by Senator Lloyd M. Bentsen. This Act excludes from federal taxes the interest earned on savings accounts whose proceeds are utilized by lenders to finance residential mortgages.

Housing Industry Characteristics

The housing industry is one of the most volatile major domestic industries. Housing starts are the most widely recognized indicator of that industry's economic condition. Over the last decade, the annual rate of housing starts has fluctuated in a range from 2.37 million units to 1.17 million units. The swing from year to year has been as large as 705,000 units -- a remarkably large 35 percent change for an annual production series.

This volatility is the result of housing's vulnerability to fluctuations in the supply of mortgage funds and in mortgage rates. The primary source of retail residential mortgage funds is saving and loan institutions (S&Ls) which hold fully one-half of all mortgages held by institutions (see Table I). They hold over $500 billion in mortgages today, the result of a striking growth in assets since World War II: their outstanding mortgage holdings have doubled every six or seven years for the past 40 years, a compound growth rate far above the rate of inflation over that period or even the double-digit rate of recent years.

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*Economist, Joint Economic Committee

The other institutional mortgage lenders -- mutual savings banks, life insurance companies, and commercial banks -- have experienced sizable growth in mortgage assets, as well, although activity at the latter two is generally less oriented to residential property. The share of all mortgages held by individuals has declined to 13 percent from 17 percent as recently as 1970. Residential mortgages constitute 75 percent of all mortgages by value, with the balance divided between commercial property (18 percent) and farm property.

TABLE I

OUTSTANDING MORTGAGE DEBT HELD
BY INSTITUTIONS
(1939-1980)

Year	Savings and Loans	Commercial Banks	Life Insurance Companies	Mutual Banks
1939	20%	23%	31%	26%
1949	27	27	30	16
1959	37	19	27	17
1969	42	21	21	16
1974	46	24	16	14
1979	51	26	13	10
1980	50	27	13	10

Mortgage Holder of Record
(1980)

Institutions:	69%
Federal Entities:	18
Individuals:	13

Source: Economic Report of the President, January, 1981, Table B-69, and Federal Reserve Bulletin, March, 1981, p. A39.

With a substantial portion of their assets in long term fixed rate mortgage instruments, S&Ls and mutual savings banks have traditionally confronted a liquidity and profit squeeze in periods when the Federal Reserve Board pursued a relatively tight monetary policy. In fact, they have generally suffered disintermediation as savers convert deposits into higher yielding assets of one form or another.

The reflow from outstanding mortgages provides a base for continued lending activity in periods of tight money by these institutions. Yet, this typically is insufficient to sustain mortgage lending activity at or near the previous peak. For example, the Federal Reserve Board in both 1973-74 and 1979-80 adopted monetary policies designed to minimize the domestic impact of world oil price increases. The New York Federal Reserve Bank's Discount rate was increased over 300 basis points in each period. These policies failed to control inflation. The urban Consumer Price Index in 1974 accelerated 40 percent over 1973 to 12.2 percent; it rose 12.4 percent last year. The Federal Reserve policies, however, did slow economic activity in both periods, resulting in negative productivity and economic growth and a reduction in real disposable income. The rise in interest rates during each episode was accompanied by a decline in deposit growth which reduced housing starts by 35 percent in 1974 and by 26 percent last year. These slumps in housing activity occurred despite the variety of new instruments adopted by mortgage lenders during the past decade, including variable-rate accounts and jumbo CD's, designed to increase or maintain deposit growth during such periods.

It has been said, for good reason, that the housing industry is at the whip end of the Federal Reserve Board's monetary policy.

The Housing Industry Today

A sea change in inflation expectations occurred in financial markets during 1980 which increased mortgage rates, reduced the quantity of housing demanded, and may well leave the housing industry stagnant at a relatively low level of capacity utilization in the future. Investors have come to anticipate the continuation of double-digit inflation rates; and matching double-digit yields on long-term (and short-term) financial instruments are rapidly being institutionalized. Yields on 10-year maturity U.S. Treasury notes, for example, now exceed 13 percent and new home mortgage yields (FHLBB) broached that same 13 percent level in April, 1980, and again in November where they remain.

The sharp turn in inflationary expectations last year caused the flow of savings into inflation hedges, which began in the late 1970's, to become a flood. Especially favored were short-maturity investments and tangible assets over longer-term investments. Corporate, state and local bonds declined to 17.5 percent by value of all credit market instruments in 1980 from 21.6 percent in 1970, despite vigorous efforts by borrowers to reduce maturities and utilize floating-rate instruments. In 1979 and 1980, the value of money market mutual funds grew a sharp sevenfold to $74.4 billion from only $10.8 billion at the end of 1978. The flow of capital to such hedges by inflation conscious investors has continued this year at the expense of mortgage lenders and the housing industry. And, with some $102 billion of deposits still in low-yielding passbook accounts, S&L deposit growth is subject to further erosion.

The marked revision during 1980 in inflationary expectations compounded the housing industry's liquidity difficulties. That expectation revision, however, created an even more permanent and debilitating change in housing. S&Ls and mutual savings banks made little if any profit last year. And the impending need this year to refinance over $200 billion in Certificates of Deposits will intensify this profit squeeze. This squeeze and the seemingly permanent escalation of inflation and interest rates to double-digit levels pulled mortgage rates up, as well. The resulting slump in mortgage demand has left the housing industry barely utilizing one-half its peak historical capacity. And the future offers nothing better.

This long-term sag in annual housing production occurs in the face of substantial potential demand at lower mortgage rates. Two million new households were formed last year, well above the 1.3 million new housing starts in 1980. This pattern of inadequate supply will persist into the future as children of the postwar baby boom enter their peak years of household formation.

The institutionalization of double-digit interest rates poses an insurmountable hurdle to dealing successfully with this housing gap. In this inflationary environment, S&Ls have only been able to maintain deposit flows by issuing money market CD's. These instruments, with average maturities of six months, comprise one-half of all S&L deposits now. The great volatility of such deposits scarcely warrant an expansion of mortgage lending activity. More significantly, CD's are expensive and have forced mortgage rates up and profits down. The new variable rate mortgages may ease some pressure on mortgage rates as lenders reduce inflation premiums. But, they face uncertain consumer acceptance and will not address the fundamental issue of lagging deposit growth at mortgage lending institutions. Another option, shared-appreciation mortgages, could facilitate an expansion in housing demand. But the delayed return character of such instruments is scarcely appealing to institutions confronting a historic profit squeeze. And volatile NOW transaction accounts are a weak foundation on which to expand 30-year mortgage commitments.

Mortgage lending is a troubled industry facing unknown future capital costs and uncertain deposit flows. And the depressed housing industry tied so closely to it has no prospect for recovery until mortgage rates and inflation decline noticably.

A Stabilized Housing Industry

Initiatives to stabilize the supply of housing will reap the benefits of several factors not characteristically found in other industries. A substantial demand for housing is foreseen at levels well above present rates of production, if mortgage rates can be reduced. In addition, the housing industry may be able to meet that additional demand without adding to inflationary pressures. The median single family new house price last year rose only 2.7 percent, well below the rate of inflation. And, since 1974, new single family house price increases have exceeded the rise in (December over December) consumer prices four times, but have risen at a slower pace three times. Housing construction is a relatively competitive industry, confronting a substantial prospective demand if mortgage interest rates could be reduced.

Steps to increase the flow of savings to mortgage lenders would reduce mortgage rates and assist the housing industry deal with the institutionalization of double-digit interest rates. It would increase the demand for housing and eventually the supply, as well. Savings flows could be increased by a variety of steps. The approach examined here is straightforward and effective: increase the effective after-tax yield on savings devoted to residential mortgages.

Senator Bentsen's Home Mortgage Incentive Act provides for the exclusion from Federal taxes of interest earned on deposits utilized to finance residential mortgages. The macroeconomic impact of this proposal was evaluated using the Wharton EFA Annual and Industry forecasting model. The impact of this proposal on housing activity, inflation, economic growth, and a host of additional variables was identified, and compared to baseline projections. The results are presented in Table II.

Simulation Findings

The Bentsen simulation indicates that excluding taxes on interest earned on home mortgage-dedicated savings accounts will generate a notable increase in economic growth compared to the baseline Wharton control projection. The direct impact of this tax exclusion on the housing industry will produce a general economic boom. That boom is projected to add 1.4 percentage points in the year following enactment to the rate of real economic growth projected by the baseline Wharton control simulation. The boom will be broad-based, with both consumption and real domestic private investment moving sharply higher. Unemployment will be reduced 1.1 percentage points by the year following enactment, with over one million new jobs being created by the Bentsen policy change. Per capita disposable income, adjusted for inflation, is projected to grow 1.1 percentage points faster in the year of enactment due to the Bentsen policy initiative.

Of particular interest is the finding that the boom is not inflationary. This surprising conclusion results from these phenomena revealed by the Wharton model:

* The rise in savings and associated decline in interest rates reduces captial-user costs.

* The decline in capital user costs and the associated surge in gross domestic investment, in turn, increases productivity and reduces unit labor costs.

* The climb in housing starts to more than two million units by the year following enactment is absorbed by the housing industry's large excess capacity without noticably generating inflationary pressures.

The savings and supply-oriented policy change has a dramatic impact on gross private domestic fixed investment, of which residential construction represents about one-quarter. The simulation found that the first order boost in savings and housing activity yielded substantial second order economic activity. The policy change generates sufficient new savings and investment flows that a diversion of savings from other productive investment to housing was not found to occur; both nonresidential real and residential real private fixed investment increase compared to the baseline Wharton control solution as a consequence of the housing-led economic boom. In fact, the Bentsen simulation projected a rate of real growth in <u>nonresidential</u> fixed private investment in the year following enactment which is 1.1 percentage points above the projected real growth rate in the baseline Wharton control solution. As expected, this savings-oriented tax change is projected to alter the share of GNP devoted to consumption and investment. While the real growth of both variables was larger in the Bentsen simulation than in the baseline Wharton control simulation, investment rose relatively more than consumption; the investment share of GNP is projected to be 0.8 percentage points higher in the year following enactment compared to the baseline Wharton control simulation.

As the initial beneficiary of the policy change, the housing industry rebounds sharply. Housing starts are projected to be 487,000 units higher in the year following enactment and occupancy levels 0.6 percentage points less than projected in the baseline Wharton control simulation.

This evaluation included the government sector. Because the proposal generates substantial new economic activity, Federal tax receipts recover quickly from the tax cut. The Wharton simulation found that the entire nominal tax revenue loss from the tax exclusion was recovered in higher tax receipts by the year following enactment. The recovery of tax receipts so quickly is unusual. The proposal was found, in effect, to impose only a one-time, one-year revenue loss. Even this loss is offset to a degree by the Bentsen-induced reduction in Federal expenditures created by the boom. The Wharton simulation found that this boom reduced Federal spending by $7 billion and the Federal deficit by over $7 billion in the year following enactment of the Bentsen proposal. The spending reductions consisted largely of unemployment compensation claims ($4.8 billion) and lower interest charges on the national debt ($2.1 billion).

This evaluation would be incomplete without a discussion of the baseline simulations used to evaluate the Bentsen tax policy proposal. That proposal was found to generate a broad-based boom independent of the underlying economic program enacted this year by Congress and the Administration. The Bentsen proposal will generate a noninflationary economic boom in conjunction with either the full three-year Administration tax and spending program, or with a scaled-down, one-year variation. It will complement and reinforce either program -- adding one percentage point to real GNP growth, reducing the deficit, boosting real nonresidential investment, and increasing housing activity compared to the results projected to occur without enactment of the Bentsen proposal.

TABLE II

MORTGAGE SAVINGS INTEREST EXCLUSION SIMULATION RESULTS
(General Indices Change from
Baseline Wharton Projection)

Index	Year of Enactment	Year following Enactment
Growth in Real GNP (percentage point change)		
Bentsen	+0.8	+1.4
GNP Price Deflator (percentage point change)		
Bentsen	*	*
Unemployment Rate (Percentage point change)		
Bentsen	-0.33	-1.1
Personal Savings Rate (percentage point change in share of disposable income being saved)		
Bentsen	+1.0	+0.95
Growth in Gross Real Private Domestic Investment (percentage point change)		
Bentsen	+3.6	+6.0
Growth in Real Per Capita Disposable Income (percentage point change)		
Bentsen	+1.1	+0.7
Productivity Growth (percentage point change, all industries)		
Bentsen	+0.4	+0.4

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*Signifies no change from the baseline Wharton control projection.

Index	Year of Enactment	Year following Enactment
Expenditure Shares of GNP (percentage point difference)		
Gross Private Domestic Fixed Investment		
Bentsen	+0.3	+0.8
Growth in Nonresidential Real Fixed Investment (percentage point change)		
Bentsen	+0.4	+1.1
Change in Private Housing Starts		
Bentsen	+135,000	+487,000
Housing Occupancy Rate (percentage point change)		
Bentsen	-0.1	-0.6

Table I

FINANCIAL ASSETS OF PRIVATE PENSION FUNDS
(in billions of dollars)

Year	Total Financial Assets	Demand Deposits & Currency	Time Deposits	Corporate Equities	Credit Mkt. Instruments	Treasury Issues	Agency Issues	Corporate Bonds	Mortgages	Home Mortgages	Misc. Assets
1967	$ 89.4	$0.9	$0.4	$51.1	$32.8	$2.0	$0.3	$26.4	$4.1	$1.8	$4.2
1968	101.5	1.0	0.6	61.5	33.8	2.4	0.4	27.0	4.1	1.8	4.6
1969	102.4	1.0	0.6	61.4	34.6	2.2	0.6	27.6	4.2	1.8	4.7
1970	110.4	1.1	0.7	67.1	36.6	2.1	0.9	29.4	4.2	1.8	4.9
1971	130.1	1.3	0.3	88.7	35.0	2.1	0.6	28.6	3.7	1.5	4.8
1972	156.1	1.6	0.3	115.2	34.0	3.0	0.7	27.6	2.7	1.1	5.0
1973	134.3	1.4	1.1	90.5	36.3	3.1	1.3	29.5	2.4	0.8	5.1
1974	115.5	1.3	3.7	63.3	41.9	3.0	2.6	34.0	2.4	0.8	5.3
1975	146.8	1.5	2.4	88.6	48.9	7.4	3.3	35.8	2.4	0.7	5.5
1976	171.9	1.6	2.3	109.7	52.5	11.1	3.6	35.5	2.4	0.6	5.7
1977	178.5	1.7	4.8	101.9	65.0	15.9	4.2	42.1	2.7	0.7	5.2
1978	198.6	1.8	10.3	107.9	73.3	17.5	4.7	48.0	3.1	0.7	5.4
1979	222.4	1.9	8.9	123.7	82.2	19.4	5.6	53.7	3.5	1.0	5.8
1980	286.1	1.9	11.3	171.1	95.6	23.5	8.1	60.1	4.0	1.1	6.2
					Percent Distribution						
1967	100.0%	1.0%	0.4%	57.2%	36.7%	2.2%	0.3%	29.5%	4.6%	2.0%	4.7%
1968	100.0	0.9	0.6	60.6	33.3	2.4	0.4	26.6	4.0	1.8	4.5
1969	100.0	1.0	0.6	60.0	33.8	2.1	0.6	27.0	4.1	1.8	4.6
1970	100.0	1.0	0.6	60.7	33.2	1.9	0.8	26.6	3.8	1.6	4.4
1971	100.0	1.0	0.2	68.2	26.9	1.6	0.5	22.0	2.8	1.1	3.7
1972	100.0	1.0	0.2	73.8	22.8	1.9	0.4	17.6	1.7	0.7	3.2
1973	100.0	1.0	0.8	67.4	27.0	2.3	1.0	22.0	1.8	0.6	3.8
1974	100.0	1.1	3.2	54.8	36.3	2.6	2.2	29.4	2.1	0.7	4.5
1975	100.0	1.0	1.6	60.3	33.3	5.0	2.2	24.4	1.6	0.5	3.7
1976	100.0	0.9	1.3	63.8	30.6	6.3	2.1	20.7	1.4	0.3	3.2
1977	100.0	0.9	2.6	57.1	36.4	8.9	2.3	23.6	1.5	0.4	2.9
1978	100.0	0.9	5.2	54.4	36.9	8.8	2.4	24.2	1.5	0.3	2.7
1979	100.0	0.9	4.0	55.6	37.0	8.7	2.5	24.1	1.6	0.4	2.6
1980	100.0	0.7	3.9	59.8	33.4	8.2	2.8	21.0	1.4	0.4	2.2

SOURCE: Flow of Funds, 1969-1979, p. 12, 19.

NOTE: Details may not add to totals due to rounding.

Table II

STATE AND LOCAL GOVERNMENT EMPLOYEE RETIREMENT FUNDS
(in billions of dollars)

Year	Total Financial Assets	Demand Deposits & Currency	Corporate Equities	Credit Market Instruments	U.S. Government Securities	Treasury Issues	Agency Issues	State & Local Obligations	Corporate Bonds	Mortgages	Home Mortgages
1967	$ 42.6	$0.5	$ 3.9	$38.3	$ 7.0	$ 6.2	$ 0.8	$2.4	$23.9	$5.0	$2.6
1968	48.0	0.6	5.8	41.6	7.3	5.9	1.4	2.4	26.6	5.4	2.7
1969	53.2	0.5	7.3	45.5	7.0	5.4	1.6	2.3	30.6	5.6	2.8
1970	60.3	0.6	10.1	49.6	6.6	5.1	1.5	2.0	35.1	5.9	2.9
1971	69.0	0.7	15.4	52.9	5.4	3.9	1.5	2.2	39.0	6.3	3.0
1972	80.6	1.0	22.2	57.4	5.7	3.6	2.1	2.0	43.2	6.5	3.0
1973	84.7	1.3	20.2	63.1	5.8	2.5	3.3	1.7	48.4	7.1	3.2
1974	88.0	1.8	16.4	69.8	6.2	1.6	4.6	1.0	54.9	7.7	3.2
1975	104.8	1.4	24.3	79.1	7.8	2.5	5.3	1.9	61.9	7.5	2.9
1976	120.6	1.4	30.1	89.1	10.9	4.1	6.8	3.4	67.1	7.7	2.8
1977	132.6	1.7	30.0	100.9	16.5	6.6	9.8	3.5	72.7	8.2	3.0
1978	153.0	2.8	33.3	116.9	22.8	10.5	12.4	4.0	81.4	8.7	3.3
1979	170.1	4.0	37.1	129.0	29.7	13.5	16.3	3.9	86.0	9.4	3.6
1980	202.7	4.1	54.2	144.5	39.5	17.5	22.0	4.0	91.1	9.9	3.8

Percent Distribution

Year	Total Financial Assets	Demand Deposits & Currency	Corporate Equities	Credit Market Instruments	U.S. Government Securities	Treasury Issues	Agency Issues	State & Local Obligations	Corporate Bonds	Mortgages	Home Mortgages
1967	100.0%	1.2%	9.2%	89.9%	16.4%	14.6%	1.9%	5.6%	56.1%	11.7%	6.1%
1968	100.0	1.3	12.1	86.7	15.2	12.3	2.9	5.0	55.4	11.2	5.6
1969	100.0	0.9	13.7	85.5	13.1	10.2	3.0	4.3	57.5	10.5	5.3
1970	100.0	1.0	16.7	82.2	10.9	8.5	2.5	3.3	58.2	9.8	4.8
1971	100.0	1.0	22.3	76.7	7.8	5.7	2.2	3.2	56.5	9.1	4.3
1972	100.0	1.2	27.6	71.2	7.1	4.5	2.6	2.5	53.6	8.1	3.7
1973	100.0	1.5	23.9	74.6	6.9	3.0	3.5	2.0	57.2	8.4	3.8
1974	100.0	2.0	18.6	79.3	7.0	1.8	5.2	1.1	62.4	8.7	3.6
1975	100.0	1.3	23.2	75.5	7.4	2.4	5.1	1.8	59.1	7.2	2.8
1976	100.0	1.2	24.9	73.9	9.0	3.4	5.6	2.8	55.6	6.4	2.3
1977	100.0	1.3	22.6	76.1	12.4	5.0	7.4	2.6	54.8	6.3	2.3
1978	100.0	1.8	21.8	76.4	14.9	6.9	8.1	2.6	53.2	5.9	2.2
1979	100.0	2.4	21.8	75.8	17.5	7.9	9.6	2.3	50.6	5.5	2.1
1980	100.0	2.0	26.7	71.3	19.5	8.6	10.9	2.0	44.9	4.9	1.9

SOURCE: Federal Reserve, "Flow of Funds Accounts 1969-1979" p. 12, 19.
NOTE: Details may not add to totals due to rounding.

STATEMENT
on behalf of the
NATIONAL ASSOCIATION OF REALTORS®
regarding
THE ADMINISTRATION'S TAX PROPOSALS
to the
SENATE FINANCE COMMITTEE
by
DR. JACK CARLSON
May 18, 1981

I am Jack Carlson, Executive Vice President and Chief Economist of the NATIONAL ASSOCIATION OF REALTORS®.

On behalf of the more than 700,000 members of the National Association, we greatly appreciate the opportunity to recommend tax policy to help achieve a healthy economy for the benefit of all Americans.

We compliment the President and the Congress for taking the first steps toward economic policies to fight inflation, achieve lower interest rates and insure improvement in food, clothing and shelter for all Americans. However, we, as well as the financial markets, are concerned that the $695 billion spending limit in the First Concurrent Budget Resolution will likely be broken in the months ahead and exceed $715 billion, which would result in a higher and inflationary deficit in 1982 and beyond.

RECOMMENDATIONS FOR TAX RELIEF*

(1) We strongly recommend that the First Concurrent Budget Resolution spending ceiling be enforced in all authorization and appropriation actions. We are and have been doing our part by recommending cuts that affect our constituency (Attachments 1 and 2).

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* Same as recommendations made consistently for 2 years (Attachments 3 and 4).

(2) We strongly recommend that tax relief be significantly smaller than likely spending reductions, $25 to $35 billion in 1982, until a balanced budget is achieved, hopefully before 1984. This is also the strong recommendation of the entire housing industry (Attachment 5).

(3) We strongly recommend that personal income tax cuts be delayed until at least January 1, 1982, and be limited to 5% across-the-board in 1982 and 5% each year thereafter until 30% is achieved, which would offset the Federal revenues generated solely because of inflation.

(4) We strongly recommend that <u>one-half of any tax relief be used directly to stimulate both savings and investment.</u>

(a) This should include broad encouragement of savings, such as raising the limit on dividend and interest income excludable from Federal taxation to at least $500 for individual returns (and $1,000 for joint returns) now and expanding this ceiling to at least $1,000 (and $2,000 for joint returns) during the next 4 years. This would both increase total savings and particularly benefit lower income households and elderly people. This should include raising the ceiling on annual contributions to Individual Retirement Accounts (IRA) from the current level of $1,500 to $7,500 during the next four years and extending eligibility for IRA contributions to people with inadequate private pension plans. This would not only increase savings but improve retirement protection for more Americans (Attachment 6).

(b) This should include encouragement of savings directed for housing, such as tax-exempt certificates of deposit dedicated for home financing (Attachment 7). Even though the need for housing is high, investment as a percent of the Gross National Product and loanable funds is down and has declined for 30 years. This is creating and will continue to create a shortage of housing and future inflation. The currently high inflation and high and fluctuating interest rates are causing a dismantlement of housing institutions and incentives and, without substitutes, could result in only the rich owning homes in the future. Less than 10% of American households who do not already own their own house can qualify to finance their own home. The non-rich may be forced to live in rental housing owned by their employers, international financial institutions or government. This undermines the American democracy built on private home ownership and privacy and would lead to the inferior pattern of housing found in the 1920's and in other countries (Attachments 8, 9 and 10).

(c) Investment should be encouraged by lowering the depreciation life to 15 years straight-line for commercial, industrial and rental housing structures in 1982 and lowering the economic life of machinery to 5 years phased in during the next 3 years (Attachments 11 and 12).

(d) Construction should be encouraged by allowing current expensing of interest and taxes incurred during construction and remove the unfair $10,000 investment interest limitation on individuals which is not imposed on corporations (Attachment 13).

RESULTS OF TAX RELIEF

The Administration's personal income tax cuts of 10% for each of the next 3 years and mandatory depreciation schedules of 18-15-10-5-3 will not fight inflation, reduce interest rates, or improve housing; the improvement in business investment would not improve productivity enough to offset inflation caused by larger deficits. Moreover, if only about one-half of the spending reductions are achieved, which would be equivalent to $715 billion outlays in 1982, then inflation and interest rates would be higher through excessive stimulation of the economy.

In sharp contrast, the REALTORS®' recommendations would reduce prices by about 2 percent, lower mortgage interest rates by 2%, increase commercial and industrial investment substantially, provide nearly 1.5 million more housing units between now and 1984, create nearly 1 million jobs and increase average household income by nearly $1,000 in 1984 (Attachment 14).

These benefits would occur in every state and would offset any losses from lower Federal spending. The economy would be much healthier than the current forecast (Attachments 15 and 16).

ATTACHMENT 1

NATIONAL ASSOCIATION OF REALTORS

John R. Wood, President
Julio S. Laguarta, First Vice President
Jack Carlson, Executive Vice President

925 15th Street, N.W., Washington, D.C. 20005
Telephone 202 637 6800

January 21, 1981

Dear Association Member:

For more than 14 months now, the NATIONAL ASSOCIATION OF REALTORS®, on behalf of its more than 750,000 members, has been stressing the effect of poor economic policies on the housing industry.

However, it is not just our industry that has suffered and continues to be damaged by high inflation. Virtually every area of our nation's economy is feeling the burden of the poor mix of fiscal and monetary policies.

On both January 16 and January 19 we offered recommendations to the new administration and Congress and we stressed that we are willing to sacrifice in areas that affect housing and other real estate because in the long run we are confident our industry will benefit.

I am taking this opportunity to ask you to join in this approach -- sacrifice now for future economic strength -- and have enclosed the advertisement we employed and some of our material. First, insist that our government slow overall spending, reduce the federal deficit, provide tax relief directly for encouraging savings and investment as proposed in the attached advertisement we placed in major newspapers January 19. Second, do your part by recommending programs that benefit your industry be trimmed, as we have.

If we can be helpful to you, please call me at 202/637-6891.

Together we can get our economy and our industries back on track. And now is the most appropriate time to begin.

Sincerely,

Jack Carlson

Jack Carlson

Enclosures

ATTACHMENT 2.1

HUD PROGRAMS ON WHICH REALTORS® HAVE EXPRESSED VIEWS
(In Millions)

PROGRAM		Carter Budget Proposal Announced January, 1981 for FY 1982	Reagan Changes to Carter Budget, proposed 3/10/81 for FY 1982 (Final figures identified in HUD's March document)	Other Reductions proposed by REALTORS® January, 1981*	Explanation of REALTOR® Proposals
Community Development Block Grant (CDBG) and Urban Development Action Grants (UDAG)	BA: O:	4,635 4,606	-469 +5	-941 -670	
Comprehensive Planning Assistance (Section 701)	BA: O:	35 35	-35 -24		
Subsidized Housing Programs Total	BA: O:	28,775 6,918	-10,039 -125	-2,689 -67	(Carter and Reagan include all programs; NAR does not.) NAR assumes 40:60 (New/Existing Mix) and Tenant Rents Increased 5% in Section 8/Public Housing
Construction Loans for Elderly and Handicapped (Section 202)	BA: O:	774 780	0 0		
Public Housing Operation Subsidies	BA: O:	1,265 1,141	-60 -90	-253 -228	NAR assumes 20% Reduction Annually to Phase-out
Government National Mortgage Association (GNMA) Tandem	BA: O:	492 1,173	+2,137 -4		

* Prior to the submission of the Reagan budget revisions, the NATIONAL ASSOCIATION OF REALTORS® suggested areas in which reductions in HUD program activity and funding might be made. The National Association now accepts and supports the direction of the Reagan proposals.

ATTACHMENT 2.2

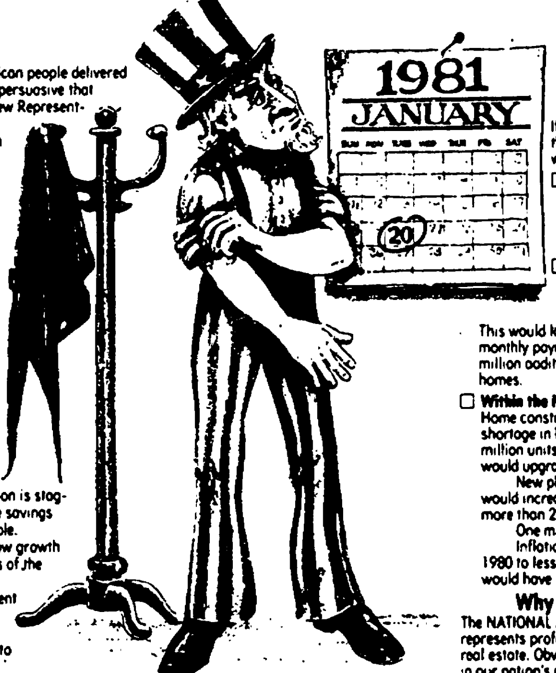
PROGRAM		Carter Budget Proposal Announced January, 1981 for FY 1982	Reagan Changes to Carter Budget, proposed 3/10/81 for FY 1982 (Final figures identified in HUD's March document)	Other Reductions proposed by REALTORS® January, 1981*	Explanation of REALTOR® Proposals
Direct Rehabilitation Loans (Section 312)	BA:	134	-134		
	O:	135	-199		
Neighborhood Self-Help Development	BA:	9	-9	-9	
	O:	9	-6	-9	
Housing Counseling Program	BA:	10	-6	-10	
	O:	10	-5	-10	
Solar Energy/Energy Conservation Bank	BA:	125	-125		
	O:	134	-134		
Research	BA:	50	-15	-5	
	O:	49	-6	-5	
Salaries and Expenses	BA:	356	-19	-12	
	O:	356	-18	-12	
Flexible Subsidies for Troubled Projects	BA:	65	-15 (reestimate of recapture)		
	O:	100	-15 (reestimate of recapture)		
Davis-Bacon Labor Standards	BA:			-160	Assumes Repeal with CBO Est. of Savings
	O:			-179	
TOTAL	BA:	36,725	-8,789		
	O:	15,446	-621		

April 23, 1981

ATTACHMENT 3

Appeared on January 19, 1981 in: The Washington Post, The Wall Street Journal, The New York Times, The Washington Star, Christian Science Monitor, Los Angelès Times, REALTOR® News and Washington Report.

THE AMERICAN PEOPLE DEMAND ACTION TO ATTACK INFLATION AND HIGH INTEREST RATES. AND THEY WANT IT NOW!



That was the message the American people delivered on November 4, 1980. It was so persuasive that it elected 18 new Senators, 74 new Representatives and one new President—Ronald Reagan—and gave them a strong directive for immediate action.

To the new administration and Congress the American people said, "We need help! Reduce inflation and the burden of government by slowing deficit spending and providing tax relief."

There was no mistaking the message...or its urgency. The American people want evidence that policymakers heard their message and felt its urgency.

Restoring prosperity.

Inflation, recession and excessive government are the major problems each of us faces.

The price we pay for inflation is staggering. It has eaten away the life savings of millions of hard-working people.

Inflation, recession and slow growth have caused the living standards of the average worker to decline.

Inflation and bad government policies have skyrocketed interest rates to the point that many people cannot afford to purchase homes or cars.

Money for modern buildings and equipment has disappeared, thus shrinking jobs, productivity and income.

And the American people have said, "Enough!" The more than 700,000 individual members of the NATIONAL ASSOCIATION OF REALTORS® also have said, "Enough!"

The 2% Solution to a healthier economy.

We have proposed specific ways to fight inflation and help restore our standard of living.

Here is what the new President and Congress should do:

1. Slow federal spending by at least 2% in the current 1981 fiscal year from a likely $665 billion to $650 billion.
2. Slow federal spending in future years to a rate 2% less than the growth of people's income. Even then the government will spend as much as $715 billion in fiscal year 1982.
3. Insure that by 1984, the cost of federal government will shrink to less than 21% of people's income—a drop of more than two percentage points.
4. Direct one-half of any tax relief specifically to encourage savings and investment.
5. Stimulate savings by allowing $500 for individuals and $1,000 for couples of interest and dividends to be excluded from taxable income. Allow more funds to be set aside for Individual Retirement Accounts.
6. Through tax relief, encourage investment to overcome the rental housing shortage and to improve worker productivity.
7. Provide tax relief to offset the effect of inflation on personal income taxes.
8. Achieve a balanced budget at high employment by the end of fiscal year 1983.
9. Provide lower and more stable interest rates through Federal Reserve Board policies that mandate steadier growth of money supply and somewhat higher and more realistic money growth targets.
10. Reduce unnecessary and costly government regulations and repeal the President's authority to allocate credit.

How this platform will improve our lives.

If our government adopts these recommendations, here's what we can expect:

☐ **This Year**
Inflationary expectations and interest rates would drop and continue to decline during the next 12 months.

☐ **Within Two Years**
The rate of inflation and long-term interest rates would decrease two percentage points. This would lower the average homebuyer's monthly payment by $150—and allow two million additional families to afford their own homes.

☐ **Within the Next Four Years**
Home construction would accelerate, and the shortage in housing would be reduced by two million units. An additional four million families would upgrade their housing.

New plant and equipment investment would increase by 20%, increasing output by more than 2%.

One million more jobs would be created.

Inflation would decrease from 13.5% in 1980 to less than 8%, and the average family would have $4,000 more in spendable income.

Why we're speaking out.

The NATIONAL ASSOCIATION OF REALTORS® represents professionals involved in all phases of real estate. Obviously, we have an important stake in our nation's economic health—as do America's 55 million homeowners, several million would-be homeowners, 25 million renters, and owners of commercial, industrial and agricultural real estate. All have been hurt badly by the economic policies of the past few years.

As a result of these policies, people are required to work in out-of-date buildings with obsolete equipment, and live in less-than-adequate housing. Home construction declined 52% from the fall of 1979 to the spring of 1980 and has not recovered yet. Existing home sales dropped 41%. Mortgage commitments fell 33%. Rental housing shortages exist in most cities.

Little wonder that the American people, who spend one-third of their income on housing (businesses spend more than one-half of their income on improving workplaces and productivity)—voted for a change!

Americans will be watching for actions and results.

Americans expect new policies and new priorities. And their mandate is for action now.

They will back tough decisions and actions that must be initiated in the days immediately ahead by the new administration and Congress.

That is the message of November 4, 1980.

NATIONAL ASSOCIATION OF REALTORS®
Working for America's property owners.™

REALTOR®

ATTACHMENT 4

Appeared on March 23, 1981 in: The Washington Post, The Wall Street Journal, The New York Times and The Washington Star.

HOW TO WIN THE WAR AGAINST INFLATION AND STILL PROVIDE ADEQUATE HOUSING.

We applaud President Reagan's battle to get our government off our backs and beat inflation so that we can have adequate housing.

We petitioned our government 12 months ago to slow government spending to 2% less than the growth of people's income. We are pleased that President Reagan has provided the leadership to do just that.

But each of us must do our bit.

Sixty-six days ago, on January 16, we identified major Federal programs that assist real estate. We proposed that they be cut by at least 10%. After taking office, the President proposed similar cuts in these and in other programs throughout the government.

These cuts will hurt in the short run. But sacrifice now means a better tomorrow for all Americans.

Our sick economy has crippled housing.

We are desperately short of housing. We entered the 1980s more than a million homes behind. By the end of this year, we'll be short by more than two million. Just to keep pace with new families formed in the '80s, America must build at least two million homes each year.

This growing shortage makes housing more and more expensive. Last year, competition for housing and competition for financing drove up the typical homebuyer's monthly payment from $480 to $630—an increase of 30% in just one year.

Clearly, the dream of home ownership is fading for most Americans who don't already own a home.

Rental housing, too, is scarce as never before. The national vacancy rate is the lowest on record.

Spending reductions must be achieved now to make room for tax relief.

The battle for spending reductions is also the battle to earn tax relief. Tax relief must be tied to spending reductions to reduce the deficit and lower inflation and interest rates.

Tax relief must be provided where it is needed most.

One-half of the tax relief should encourage directly savings and investment to fight inflation. America's savings rate has dropped to 4% of people's income—the lowest of any industrial nation.

We are pleased that members of the Congress are considering boosting savings by expanding self retirement programs and raising the tax exclusion for interest income and dividends to at least $500 for individuals and $1,000 for joint returns this year.

And double that in future years.

The President has wisely called for shorter depreciation lives for all structures.

We endorse the principle and would go one step further. Depreciation lives for all structures should be set at 15 years. In that way money could be provided for apartments as well as industrial buildings—not for one at the expense of the other.

Let's win the war against inflation and provide adequate housing.

The NATIONAL ASSOCIATION OF REALTORS® and its more than 700,000 members believe that with the President's leadership, with our suggestions and with the approval of the Congress, the economy will improve for all Americans by:

- Lowering inflation 2%;
- Lowering interest rates by one to two percentage points;
- Providing two million additional new homes;
- Creating the opportunity for an additional four million families to upgrade their existing housing;
- Producing one million new jobs.

And lead to a balanced budget by 1984.

This would put us on the road to beat inflation and provide housing for many more Americans.

REALTOR®

NATIONAL ASSOCIATION OF REALTORS®

ATTACHMENT 5

February 13, 1981

The President
The White House
Washington, D.C. 20500

Dear Mr. President:

We strongly support major reductions in federal spending. We feel that all Americans, including the members of our organizations, should join in sacrifices to reduce federal spending.

Tax relief should be provided only to the extent spending reductions are made to cause the federal deficit to decline towards balance each year. This would reduce pressures on interest rates and provide lower interest rates for productivity-increasing investment and adequate housing.

We feel it is important that the principal emphasis of tax relief should be directed toward stimulating savings and investment.

Respectfully,

Lee E Gunderson

Lee E. Gunderson, President
AMERICAN BANKERS ASSOCIATION

Albert B. Hooke, Chairman
NATIONAL ASSOCIATION OF MUTUAL
SAVINGS BANKS

Thomas H. Shealy, President
MORTGAGE BANKERS ASSOCIATION
OF AMERICA

John R. Wood

John R. Wood, President
NATIONAL ASSOCIATION OF REALTORS

Herman J. Smith, President
NATIONAL ASSOCIATION OF HOME
BUILDERS

Rollin D. Barnard, President
UNITED STATES LEAGUE OF SAVINGS
ASSOCIATION

ATTACHMENT 6

IMPACT OF PROPOSED TAX INCENTIVES FOR SAVERS ON THE ECONOMY BY THE END OF 1984

	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 5 years	Constant $1000/$2000 Over 5 Years	
Gross National Product (Percent Difference in Levels)	0.4	0.6	0.9	0.3
Consumer Prices (Percent)	-0.2	-0.3	-0.4	-0.1
Long Term Interest Rates (Percentage Points)	-0.4	-0.6	-0.9	-0.3
Average Spendable Income per Household with Interest Income and/or IRA ($, 1981 Prices)	230	450	670	600
Employment (Jobs)	100,000	150,000	220,000	100,000
New Housing Starts (Units)	120,000	170,000	230,000	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
Gross Revenue Reductions	7.2	12.6	19.0	8.0
Net 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.

ATTACHMENT 7

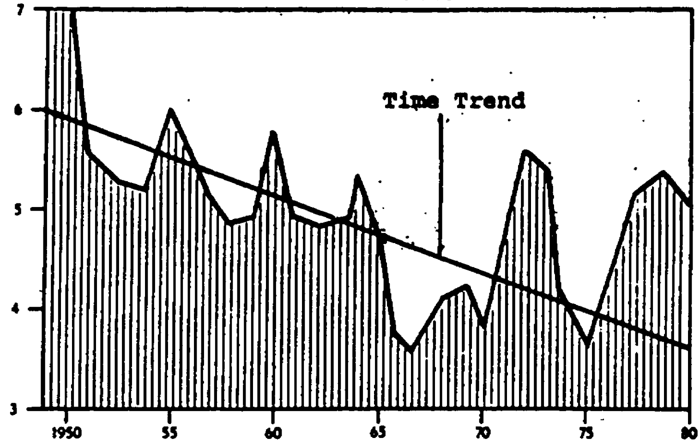
TAX-EXEMPT CERTIFICATES OF DEPOSIT

The housing industry has been disproportionately harmed by the recent heavy reliance on tight monetary policy and excessive growth of federal deficit spending and taxes. Additional savings could be stimulated, and the inequitable burden on housing from the inflation fight reduced, if savings institutions were allowed to issue a certificate of deposit on which the interest earned was excluded from gross income for federal income tax purposes. The certificate would be offered at an interest rate equivalent to 60 percent of the yield on the 1-year Treasury note and would have a 1-year term. The proceeds from the issuance of the certificate must be used by the savings institution for home mortgage lending purposes in order for the interest to be excludible from gross income by the holder of the certificate. The total amount of interest from such certificates that could be excluded would be $1,000 in the case of an individual or a married individual filing a separate return and $2,000 in the case of a joint return. These exclusions should be in addition to any other general exclusions of interest and dividends from federal individual income taxes.

While the revenue loss to the Treasury would be modest (around $1.5 billion in FY 1982, the beneficial impact on the housing industry would be substantial. In FY 1982, up to 150,000 additional housing starts could result from the use of these certificates and average mortgage rates reduced by 0.7 percentage points. Even larger gains would accrue in subsequent years.

ATTACHMENT 8

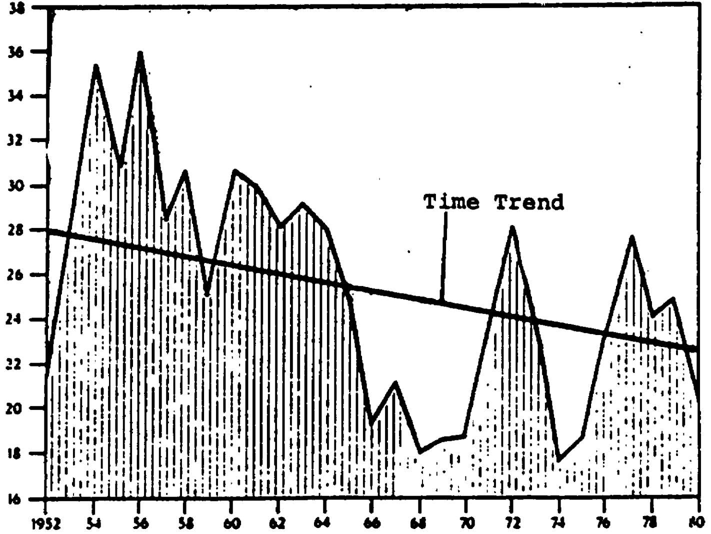
Ratio of Net Residential Fixed Investment to Gross National Product



Source: GNP Accounts

ATTACHMENT 9

Ratio of Net Residential Mortgage Credit to Total Funds Raised, 1952 to 1980



Source: Flow of Funds Accounts, Board of Governors of the Federal Reserve

ATTACHMENT 10

Residential Investment as a Percent of Gross Domestic Product

Year	United Kingdom	Japan	Germany	Canada	United States
1965	4.5	6.1	7.7	5.4	4.6
66	4.2	6.0	7.7	4.8	3.8
67	4.4	6.3	7.5	4.8	3.6
68	4.5	6.7	7.1	5.1	4.0
69	4.2	6.9	6.6	5.5	4.1
70	3.7	7.0	6.7	4.7	3.8
71	3.9	6.9	7.4	5.9	4.8
72	4.1	7.6	8.2	6.4	5.4
73	4.2	8.7	8.0	6.8	5.2
74	4.4	8.1	6.6	6.7	4.1
75	4.5	7.7	5.8	6.2	3.6
76	4.3	7.9	5.9	7.2	4.2
77	3.8	7.6	6.0	6.8	5.1
78	3.7	7.5	6.2	6.4	5.2
79	N.A.	N.A.	N.A.	N.A.	5.0

Source: OECD
N.A. = Not Available
Date: January 15, 1981

ATTACHMENT 11

ADVANTAGE OF SHORTER DEPRECIATION LIVES
($100,000 Structures, 15% Discount Rate)

Depreciation Life	First Year Depreciation Allowance	Present Value of Depreciation Allowances	
		Dollars	As a % of Original Cost
18 Straight Line	$ 5,555	$34,044	34%
15 Straight Line	6,667	39,002	39%
10 Accelerated	10,000	57,721	58%

The 10-year life with accelerated write-off effectively lowers the cost of the building about 19% or $19,000 compared with a depreciation life of 15 years and straight line write-off and by about 24% or $24,000 compared with a depreciation life of 18 years and straight line write-off. The only fair depreciation reform is to set the same economic life for all structures.

ATTACHMENT 12

IMPACT OF ALTERNATIVE DEPRECIATION SCHEMES ON RETURNS TO INVESTMENT IN NEW NONRESIDENTIAL BUILDINGS

Rank	Description of Depreciation Method*	Net Change in Internal Rate of Return Compared With Current Law
1	10-yr, Administration	7.8%
2	12-yr, Double Declining Balance	6.3
3	15-yr, Double Declining Balance	4.0
4	12-yr, Straight Line	2.6
5	18-yr, Double Declining Balance	2.5
6	20-yr, Double Declining Balance	1.7
7	15-yr, Straight Line	0.9
8	Current Law**	-0-
9	18-yr, Straight Line	-.2
10	20-yr, Straight Line	-.7

* On real property component; personal property follows the administrative 5-yr write-off with Section 1245 recapture.

** 40-yr, 150% on building shell (40% of depreciable basis); 15-yr, 150% on building systems (50% of depreciable basis); and 7-yr, Double Declining Balance on personal property (10% of depreciable basis) with Section 1245 recapture.

Note: All cases have an ITC of 10% on the personal property component.

IMPACT OF ALTERNATIVE DEPRECIATION SCHEMES ON RETURNS TO INVESTMENT IN NEW RENTAL RESIDENTIAL BUILDINGS

Rank	Description of Depreciation Method*	Net Change in Internal Rate of Return Compared With Current Law
1	12-yr, Double Declining Balance	6.2%
2	15-yr, Double Declining Balance	4.0
3	12-yr, Straight Line	2.7
4	18-yr, Double Declining Balance	2.5
5	20-yr, Double Declining Balance	1.7
6	15-yr, Straight Line	1.0
7	Current Law **	-0-
8	18-yr, Straight Line	-0-
9	20-yr, Straight Line	-.6

* On Real property component; personal property schedule follows the administrative 5-yr write-off with Section 1245 recapture.

** 40-yr, Double Declining Balance on building shell (50% of depreciable basis); 15-yr, Double Declining Balance on building systems (35% of depreciable basis); and 7-yr, Double Declining Balance on personal property (15% of depreciable basis) with Section 1245 recapture, there is no investment tax credit on the personal property component.

ATTACHMENT 13

REVENUE REDUCTION FROM REALTORS®' TAX PACKAGE
($ Billions, Fiscal Years)

	1981	1982	1983	1984	1985
Business Portion of Package.					
15 Year Straight Line Write-off on New Residential and Nonresidential Structures	0.1	0.7	1.2	1.8	2.6
5 Year Write-off on New Equipment (With 3 Year Phase-In)	0.9	6.2	13.9	23.1	28.8
Tax Exempt Certificates of Deposit	0.7	1.5	2.5	3.6	5.1
Current Expensing of Construction Period Interest and Taxes	0.4	1.0	1.0	0.8	0.8
Remove Limitation on Deductions of Investment Interest	0.05	0.1	0.1	0.1	0.1
Individual Portion of Package					
Reductions in Personal Income Tax Rates	---	12.6	31.7	53.4	77.9
Tax Incentives for Savers					
Exclusion of $500/$1,000 in 1981 and 4 year phase-in of $1,000/$2,000 of interest and dividends from Federal taxes	0.8	4.0	7.0	9.0	14.4
Expansion of Contribution Ceilings from $1,500 to $7,500 during 4 years and Expansion of Eligibility on Individual Retirement Accounts	0.2	0.5	1.0	2.0	4.0
Totals:	3.25	26.6	58.4	93.8	133.7
Gross Tax Reduction					
Less Offsetting Increase in Revenue from a Stronger Economy	1.0	8.0	17.5	28.1	40.1
Equals Net Tax Reduction	2.2	18.6	40.9	65.7	93.6

ATTACHMENT 14

IMPACT ON THE U.S. ECONOMY CAUSED BY THE ADMINISTRATION'S TAX RELIEF PROPOSALS COMPARED WITH THE REALTORS®' RECOMMENDATIONS IN 1984

	ADMINISTRATION'S TAX RELIEF PROPOSALS		REALTORS®' TAX RELIEF RECOMMENDATIONS	
	With First Concurrent Budget Resolution Spending Cuts $695 bil. Budget	With one half of First Concurrent Budget Resolution Spending Cuts $715 bil. Budget	With First Concurrent Budget Resolution Spending Cuts $695 bil. Budget	With one half of First Concurrent Budget Resolution Spending Cuts $715 bil. Budget
Real U.S. Output (GNP)	1.4%	2.4%	2.5%	3.5%
Consumer Inflation (CPI)	0.2%	1.0%	-1.8%	-0.7%
Mortgage Interest Rates (% Points)	0.2%	0.8%	-2.0%	-0.5%
Real Investment				
Nonresidential Structures	10.5%	7.5%	10.3%	9.0%
Equipment	11.0%	9.3%	15.0%	1.0%
New Housing:				
1982-84	10,000	-250,000	1,500,000	1,200,000
Jobs	300,000	700,000	700,000	1,000,000
Productivity	1.1%	1.7%	1.8%	2.5%
Average Household Income ($ dollars 1981 Prices)	1,040	1,620	1,063	1,639
Federal Surplus (+) or Deficit (-) (FY 1984, $billions)	+0.5	-60	+58	-2

ATTACHMENT 15

U.S. ECONOMIC OUTLOOK
(May 1981)

	QUARTERS								YEARS				
	Actual		Forecast						Actual		Forecast		
	80:4	81:1	81:2	81:3	81:4	82:1	82:2	82:3	1979	1980	1981	1982	1983
AGGREGATE ECONOMY													
Gross National Product ($ billions)	2,731	2,827	2,898	2,980	3,076	3,181	3,292	3,405	2,414	2,626	2,945	3,347	3,752
Percent Change	14.9	14.9	10.4	11.9	13.5	14.3	14.7	14.5	12.0	8.8	12.2	13.6	12.1
Percent Change (without inflation)	3.8	6.5	0.8	2.4	3.4	5.0	5.2	4.9	3.2	-0.2	2.6	4.0	3.2
Consumption	7.0	4.7	1.4	3.0	2.7	4.5	4.0	3.5	2.9	0.5	3.3	3.4	2.7
Residential Investment	64.2	0.8	-13.6	-10.5	-1.2	7.0	17.1	22.1	-5.2	-18.6	1.0	5.9	12.0
Nonresidential Investment	3.9	12.5	1.2	2.3	8.0	11.6	10.8	10.8	6.5	-3.0	3.1	8.7	7.0
Structures	9.0	11.5	-1.9	0.2	8.9	11.4	10.4	7.4	8.7	-0.1	1.6	7.7	6.1
Equipment	1.9	12.6	2.7	3.2	7.7	11.6	11.0	12.2	5.5	-4.2	3.8	9.1	7.3
Exports	-7.5	20.5	-9.9	0.3	2.7	7.1	5.9	6.3	15.2	9.6	0.6	3.8	3.9
Imports	25.9	16.3	1.2	3.5	4.5	7.2	9.1	8.5	6.0	-0.1	4.6	6.4	7.4
Government Purchases	2.2	4.3	-1.7	0.2	2.0	1.6	1.0	2.0	1.5	2.9	0.8	1.0	0.9
Residential Investment (% of GNP)	3.4	3.4	3.2	3.1	3.1	3.1	3.2	3.3	4.0	3.2	3.2	3.3	3.5
Nonresidential Investment (% of GNP)	10.6	10.7	10.7	10.7	10.8	11.0	11.2	11.3	11.0	10.7	10.8	11.2	11.6
Inventory Change ($ billions)	-17.4	-7.9	2.1	8.5	13.1	15.2	23.1	27.9	17.5	-5.9	3.9	25.0	39.6
Mfg. Capacity Utilization Rate (%)	79	80	79	80	80	82	83	84	86	79	80	84	85
Manufacturing Industrial Production (% change)	23.6	5.9	1.3	5.2	7.7	12.5	11.9	9.6	4.6	-4.5	4.3	9.2	5.8
Employment (millions)	97.3	98.0	98.4	98.8	99.6	100.6	101.6	102.1	96.9	97.3	98.7	101.7	104.2
Unemployment Rate (%)	7.5	7.3	7.4	7.5	7.1	6.9	6.7	6.5	5.8	7.1	7.3	6.6	6.3
Disposable Income per Household (average)	24,649	25,221	25,843	26,640	27,089	28,355	29,048	29,923	21,592	23,750	26,198	29,690	32,793
Percent Change -- Year Ago (w/o inflation)	-0.1	0.2	1.9	2.1	1.1	3.2	3.3	3.3	2.2	-0.2	1.3	3.5	2.9
Total Taxes per Household (average)	12,690	13,274	13,641	13,812	14,261	14,129	14,581	15,006	11,120	12,058	13,697	14,762	15,737
Percent Change -- Year Ago	10.0	12.7	15.1	14.3	12.4	6.4	8.5	8.6	10.5	8.4	13.6	7.8	6.7
Consumer Price Inflation (CPI)	12.9	10.8	10.1	10.0	10.2	9.7	9.6	9.9	11.3	13.5	10.7	9.8	8.9
Gross National Product Inflation (GNP Deflator)	10.7	7.8	9.6	9.3	9.8	8.9	9.1	9.1	8.5	9.0	9.3	9.2	8.7
Personal Consumption Inflation	9.6	8.0	9.4	8.6	8.8	8.8	8.9	8.5	8.9	10.2	8.9	8.7	8.0
Residential Construction Inflation	2.0	11.3	8.3	9.8	11.0	11.0	10.7	10.8	12.8	9.4	8.4	10.6	10.9
Nonresidential Construction Inflation	6.8	6.1	9.0	10.4	11.4	11.4	11.2	11.6	12.6	13.4	9.1	11.1	11.5
Producers Price Inflation (WPI)	10.7	8.9	1 .6	10.8	12.0	11.4	11.2	10.5	12.5	14.1	11.0	11.2	10.5
Compensation per Manhour (% change)	9.7	11.5	[illegible].4	9.4	9.3	10.3	9.6	9.5	9.5	9.8	10.1	9.7	9.7
Productivity (% change)	-2.0	2.5	0.3	1.3	2.6	1.4	3.5	3.7	-0.8	-0.6	0.9	2.3	2.5
Unit Labor Cost (% change)	11.9	8.5	9.2	8.0	6.6	8.8	5.9	5.6	10.4	10.4	9.0	7.2	7.1
Before Tax Corporate Profits ($ billions)<2>	267	273	252	260	276	279	300	319	255	258	265	307	343
Corporate Tax Liability	85	83	75	77	82	81	88	95	88	82	79	91	101
'Windfall Profits' Tax Receipts	17	27	29	33	35	37	39	40	0	13	31	39	40
After Tax Profits	164	162	148	151	159	161	173	184	168	163	155	178	202
Profits from Current Production (with IVA, CCA)	98	107	114	117	121	132	142	152	109	100	115	147	172
Adjusted for Inflation (80:4 base)	98	105	110	110	111	118	125	131	126	104	109	127	137
Percent Change - Year Ago	-12.6	-7.8	6.8	7.9	13.0	12.7	13.8	18.7	-1.6	-15.7	4.5	16.7	7.9
Per Unit of Output (% of GNP)	3.6	3.8	3.9	3.9	3.9	4.1	4.3	4.5	4.5	3.8	3.9	4.4	4.6
Effective Corporate Tax Rate (%)<2>	46	44	40	40	41	39	39	39	45	45	41	39	38
Federal Tax Receipts (Unified basis)	508	514	743	631	601	570	839	700	481	533	622	692	747
Federal Expenditures (Unified basis)	642	655	661	690	715	725	725	749	509	601	680	742	795
Surplus or Deficit (Unified basis) <1>	-134	-141	82	-59	-114	-155	114	-49	-28	-68	-58	-50	-48
Full Employment Surplus or Deficit	2	25	38	31	23	39	49	48	15	0	29	52	75

<1> Assumptions include a $30 billion (annual rate) cut in personal income tax liabilities beginning 82:1 and a 5 year reduction in tax lifetimes for equipment and a 7 year reduction for structures with a phase-in beginning 81:1.
<2> Adjusted to include impact of windfall profits tax on domestic crude oil production.

Source: Model developed by the NATIONAL ASSOCIATION OF REALTORS, and Data Resources, Inc.
Assumptions and simulations by Dr. Jack Carlson, Hugh Graham, Kenneth Kerin, and Glenn Crellin.

ATTACHMENT 16

REAL ESTATE AND FINANCIAL MARKETS
(May 1981)

	QUARTERS								YEARS				
	Actual		Forecast						Actual		Forecast		
	80:4	81:1	81:2	81:3	81:4	82:1	82:2	82:3	1979	1980	1981	1982	1983
REAL ESTATE MARKETS													
Existing Single-Family Home Sales (thousands)	2,997	2,553	2,769	3,106	3,345	3,428	3,462	3,592	3,701	2,881	2,943	3,542	3,946
Percent Change - Year Ago	-13.6	-15.1	12.4	1.6	11.6	34.3	25.0	15.6	-4.2	-22.2	2.2	20.3	11.4
Dollar Volume (billions)	222.1	193.5	218.1	255.0	272.8	286.1	299.9	321.2	237.6	209.7	234.9	310.1	382.4
New Single-Family Home Sales (thousands)	541	492	464	503	542	576	553	551	709	531	500	562	628
Percent Change - Year Ago	-11.8	-7.5	2.6	-16.4	0.2	17.1	19.3	9.6	-13.7	-24.4	-5.9	12.3	11.8
Private Housing Starts (thousands)	1,535	1,386	1,304	1,388	1,447	1,532	1,637	1,748	1,745	1,292	1,386	1,685	1,813
Single-Family	1,001	868	785	850	903	967	1,049	1,113	1,194	852	851	1,070	1,222
Multi-Family	534	518	519	538	563	564	608	635	551	440	535	615	591
Subsidized	174	136	156	155	177	164	139	148	120	156	156	153	181
Mobile Home Shipments (thousands)	245	243	243	252	264	269	279	296	276	224	251	288	303
Housing Inventory (millions)	84.0	84.2	84.4	84.6	84.8	85.1	85.3	85.6	82.8	83.7	84.5	85.5	86.7
New Construction Put In Place - (Value)													
New Commercial Buildings (% Change)	25.7	39.3	-12.6	7.5	26.8	23.3	14.3	21.0	33.9	19.3	7.7	17.2	17.4
New Industrial Buildings (% Change)	22.8	19.9	4.6	8.1	13.5	15.3	19.7	23.1	37.2	-5.5	5.4	16.0	26.4
Rental Vacancy Rate (%)	4.8	4.9	5.0	5.2	5.2	5.1	5.1	5.0	5.3	5.2	5.1	5.0	5.0
Unsold New Homes (% of sales)	61.7	68.1	61.6	61.8	59.7	59.4	60.5	59.9	59.3	70.2	62.8	60.0	58.4
Office Vacancy Rate (%)<1>	4.1	4.2	4.1	4.1	3.9	3.9	3.8	3.7	4.4	3.7	4.1	3.8	3.5
Industrial Vacancy Rate (%)<1>	3.7	3.9	4.0	3.9	3.7	3.6	3.5	3.5	3.0	3.5	3.9	3.5	3.3
Existing Home Prices - Median ($1000's)	63.3	64.4	67.4	70.8	70.6	72.5	75.5	78.1	55.7	62.2	68.3	76.3	84.9
Percent Change - Year Ago	12.8	9.5	9.4	9.9	11.5	12.6	11.9	10.3	14.1	11.7	10.1	11.7	11.3
Monthly Mortgage Payment (P&I, 80%, 30 yr.)	616	668	678	696	688	698	723	747	435	589	683	731	816
Percent of Household Income	25	27	26	26	25	25	25	25	20	25	26	25	26
New Home Prices - Median ($1000's)	66.6	67.8	69.2	70.9	72.9	75.0	77.0	79.2	62.9	64.6	70.2	78.2	87.4
Percent Change - Year Ago	6.9	6.5	9.1	7.8	9.4	10.5	11.4	11.8	12.9	2.7	8.2	11.4	11.7
New Home Prices--Mean ($1000's, Quality Adjusted)	76.5	79.8	82.8	85.4	87.0	89.3	93.1	96.2	67.7	75.2	83.8	94.2	103.4
Percent Change - Year Ago	8.4	10.8	11.0	11.5	13.7	11.9	12.4	12.6	14.2	11.1	11.8	12.4	9.8
FINANCIAL MARKETS													
Total Time and Savings Deposits (% change)	12.3	11.3	3.1	1.6	3.7	4.9	7.6	9.5	8.5	7.3	7.3	5.5	8.8
Savings Rate (%)	5.1	4.7	4.8	5.3	4.5	6.0	5.6	5.9	5.3	5.6	4.8	5.8	7.0
Money Supply (M1B) (% change)	11.3	5.4	10.1	4.6	6.8	6.6	8.1	8.4	7.8	6.4	8.0	7.2	7.0
Money Supply (M2) (% change)	9.4	7.1	11.7	5.4	4.3	5.1	6.3	8.6	8.9	9.1	9.1	6.2	8.8
New Mortgage Commitments ($ billions)	102.6	89.6	78.1	85.5	95.2	102.7	109.8	117.9	129.0	88.0	87.1	114.8	152.6
Percent Change - Year Ago	-5.0	10.3	67.1	-29.5	-7.2	14.7	40.6	37.9	-9.2	-31.8	-1.0	31.8	32.9
Mortgage Debt Outstanding ($ billions)	1,450	1,471	1,494	1,524	1,552	1,585	1,615	1,647	1,272	1,399	1,510	1,632	1,782
Selected Interest Rates (Percent)													
New Home Mortgage Commitment Rate	14.40	15.42	14.90	14.57	14.43	14.20	14.15	14.15	11.35	14.02	14.83	14.18	14.22
Rate on Mutual Savings Bank Deposits	7.03	7.05	7.00	6.98	7.18	7.37	7.55	7.73	6.69	6.97	7.05	7.64	8.21
Dividend/Interest Rates Paid By S&Ls	7.84	7.96	8.05	8.21	8.32	8.48	8.63	8.73	7.48	7.95	8.13	8.68	9.17
Corporate Bond Rate (AAA)	12.83	13.16	13.27	12.15	12.23	12.34	12.49	12.69	9.63	11.94	12.70	12.59	12.67
Rate on Money Market Fund Shares	15.54	15.66	15.12	15.79	16.10	15.20	14.98	14.52	11.12	12.89	15.67	14.91	13.05
Commercial Paper Rate	15.26	15.34	14.88	15.58	15.82	14.94	14.72	14.25	10.97	12.66	15.41	14.64	12.84
Prime Rate	16.73	19.22	16.66	15.76	16.89	17.06	16.81	16.29	12.67	15.27	17.13	16.67	14.33
Federal Funds Rate	15.85	16.57	15.82	16.46	16.87	16.28	16.05	15.60	11.19	13.36	16.43	15.95	13.60

<1> Historical data courtesy of Coldwell Banker.

Source: Model developed by the NATIONAL ASSOCIATION OF REALTORS, and Data Resources, Inc.
Assumptions and simulations by Dr. Jack Carlson, Hugh Graham, Kenneth Karin, and Glenn Crellin.

STATEMENT OF THE NATIONAL APARTMENT ASSOCIATION BEFORE THE SENATE FINANCE COMMITTEE CONCERNING TAX INCENTIVES FOR INVESTMENT IN RENTAL HOUSING

SUMMARY OF STATEMENT

Recognizing the shortage of rental housing facing this nation in the 1980's, the National Apartment Association recommends the following tax incentives to encourage the production and preservation of rental housing:

1) Ten year straight line depreciation for new rental housing construction.
2) Fifteen year straight line depreciation for existing rental housing.
3) A five year write off for rehabilitation expenditures.
4) An option to elect either the proposed depreciation schedules or depreciation under the existing tax code provision.
5) An immediate deduction of construction period interest and taxes.
6) Deductibility of business expenses from the time of construction of a rental project.
7) Expansion of eligibility for individual retirement accounts and an increase in IRA contribution limits.
8) Expansion of the interest and dividend exclusion.
9) A maximum tax on all income, whether salary or investment income.

STATEMENT OF STANLEY TAUBE, PRESIDENT OF THE NATIONAL APARTMENT ASSOCIATION* BEFORE THE SENATE FINANCE COMMITTEE CONCERNING TAX INCENTIVES FOR INVESTMENT IN RENTAL HOUSING

May 18, 1981

Mr. Chairman and Members of the Committee:

My name is Stanley Taube, and I am an apartment owner and developer from Minneapolis, Minnesota. I am President of the National Apartment Association, a trade association of approximately 105 local and state affiliates whose combined membership includes about 45,000 owners, managers, and developers of multifamily housing.

The Rental Housing Shortage

The purpose of these hearings is to consider the tax aspects of President Reagan's economic program to encourage greater incentives for investment, reduce inflation, and increase the prosperity of this nation. Much of the proposed legislation has concentrated on faster depreciation for machinery and factories in order to encourage the so-called "reindustrialization" of America. The National Apartment Association supports these goals which through increased productivity and reduced inflation will lead to greater prosperity for every American. However, in our effort to improve worker productivity, we must not overlook one of the basic necessities of life -- shelter.

Unless this Congress passes a tax bill which provides sufficient tax incentives for the production and preservation of residential rental housing, there will be a serious shortage of housing in this country which will ultimately defeat any attempts to increase worker productivity.

*The National Apartment Association is an association of 105 state and local apartment associations whose combined membership includes over 45,000 developers, owners, and managers of multifamily housing. Its headquarters are located at 1825 K Street, NW, Washington, D.C. 20006 and its national officers are: President Stanley M. Taube of Minneapolis, Minnesota; President-Elect Robert E. Esrey of Kansas City, Missouri; Vice President James L. Reeder, Jr. of Fremont, California; Treasurer S. Cody Engle of Chicago, Illinois; Secretary Roland Freeman of Dallas, Texas, and National Apartment Council Chairman Marvin Isgur of Houston, Texas.

According to a 1978 study prepared for the Joint Economic Committee, there will be a demand for approximately 6,149,000 additional rental units in buildings of two or more units from 1980 through 1989, or 614,900 additional units per year.[1] Compared to the projection of less than 300,000 multifamily rental starts in 1981, this potential shortfall is staggering.

As table A indicates, the number of multifamily rental starts has decreased significantly in 1979 and 1980 from previous years. In fact, in 1980 rental starts were down 42% from 1978. Over 50-60% of multifamily rental starts in 1979 and 1980 were government subsidized. With President Reagan's proposed cuts in federal subsidy programs for rental housing plus continuing high interest rates, there is absolutely no possibility that rental housing production will satisfy demand.

Already, the vacancy rate has dropped to the 5% level, the lowest in the twenty-four years that the data has been kept. The FHA and other housing experts generally use 5% as the minimum vacancy rate for an appropriate balance between supply and demand. The latest data released by the Department of Commerce indicates that the vacancy rate in the fourth quarter of 1980 dropped to 4.8% compared to 5.2% in the fourth quarter of 1979.

It is apparent from table A that the vacancy rate has been declining significantly over the last 6 years. In fact, only the relatively high number of rental completions in 1978 through 1980 has prevented the vacancy rate from dropping below 5% in the last few years. However, the pipeline of rental units under construction is shrinking. We project a 25% decrease in the number of multifamily rental completions in 1981 and as a result, a drop in the vacancy rate to below 5%. In the first two months of 1981, multifamily completions have dropped 34% compared to the same period in 1980.

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[1] Multifamily Housing Demand, 1975-2000, study prepared for the Joint Economic Committee by Professors George Sternlieb and Robert W. Burchell, Center for Urban Policy Research, Rutgers University, November 14, 1978.

Considering the low number of multifamily rental starts projected for 1981 and in the near future, this nation is facing a serious shortage of rental housing during this decade.

Once this shortage becomes apparent to the general public, the members of Congress will be faced with increased public demands for new and expensive federal housing programs to supply desperately needed housing. In order to avoid new budget busting federal subsidy programs, Congress should act immediately to provide tax incentives to encourage private investment in rental housing. Due to the length of time from planning to completion of rental housing (up to 2 years), actions taken now will only begin to have a favorable impact in 1983.

President Reagan's Tax Cut Proposal

As you know, President Reagan's tax cut proposal (S. 683) would provide 18 year straight line depreciation for residential rental housing, 15 year straight line depreciation for low income rental housing and other real property, such as an office building, and 10 year accelerated depreciation for qualified owner-occupied real property.

UNLESS RESIDENTIAL RENTAL HOUSING IS PROVIDED WITH A FASTER WRITE OFF THAN COMMERCIAL BUILDINGS, THE UNSUBSIDIZED RENTAL HOUSING INDUSTRY WILL BE DESTROYED.

Under existing law, rental housing receives a faster write off than commercial buildings. Even with such a tax benefit, commercial property is considered a more attractive investment than rental housing. Without these greater tax incentives, investment capital would be totally diverted away from rental housing to commercial buildings. The reason for this is simple. To quote former HUD Secretary Moon Landrieu, "Rental housing today is not perceived as a good investment in the building and financial community."[2]

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[2] Testimony before the Senate Subcommittee on Housing and Urban Affairs on February 27, 1980.

As table B indicates, rental income in residential rental housing has lagged behind increases in operating costs over the last decade.

However, in most commercial office buildings, leases are written with escalator clauses to pass on to the tenant increased operating costs. Such a solution is not feasible for residential rental housing. The incomes of residents occupying rental housing are generally not sufficient to pay the necessary rents to encourage increased production of rental housing. A report issued by the General Accounting Office noted that housing experts conclude that market rents would have to increase about 25% above current levels in order to stimulate new investment in the private unsubsidized multifamily rental market.[3]

Let me pose a question. Under the Administration's proposal, would you rather invest in an apartment building or an office building? The answer is obvious -- the office building would receive your investment dollar. Yet a recent article in the Realtor News noted that many experts feel that there could be an oversupply of commercial buildings in several cities by the end of 1982.

Any change in the tax code to provide faster write offs to encourage investment must provide faster write offs for residential rental housing compared to commercial buildings in order to encourage investment in rental housing and avoid the rental housing shortage facing this nation.

New Rental Housing Construction

The NAA recommends 10 year straight line depreciation for investments in new rental housing construction. Ten year straight line depreciation would provide the necessary tax incentive to attract private capital for much needed rental housing construction despite the problems of high interest rates and low rental income revenue that I described earlier in my testimony. The Administration's proposal would

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[3] Rental Housing: A National Problem That Needs Immediate Attention, General Accounting Office, CED-80-11, November 8, 1979.

provide considerably less depreciation than under existing law.

Table C sets forth projected depreciation deductions for a new multifamily rental project being considered by a member of the NAA. As you can see, under the Administration's proposal, in the first four years the investor would receive $166,000 less in depreciation deductions than under existing law using double declining balance. This is a 17% decrease in allowable depreciation in the first four years, the most crucial period in deciding the feasibility of a new rental project. Ten year straight lined depreciation would increase depreciation deductions considerably compared to existing law, providing the necessary incentive to produce new rental housing.

The revenue loss to the Treasury from ten year depreciation for rental housing is surprisingly small. According to an estimate by the Joint Committee on Taxation made in 1980, the revenue loss from fiscal years 1982 through 1985 would average only $250 million dollars per year. Over 75% of the revenue loss would occur in the last two years. This revenue estimate does not take into consideration increased tax revenue as the result of increased housing production.

As under the Administration proposal, the NAA proposal would provide that depreciation would be considered straight line depreciation, eliminating ordinary income recapture on the sale of a property. Under existing law, excess depreciation (accelerated depreciation less straight line depreciation) is taxed as ordinary income up to a 70% marginal rate on the sale of the rental property. By eliminating ordinary income recapture a considerable deterrent to investment in rental housing will be removed.[4]

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[4] In addition, straight line depreciation will eliminate excess depreciation which is a tax preference item. Tax preference items are subject to the minimum tax. Also, tax preference items reduce dollar for dollar income protected by the 50% maximum tax. Both the minimum tax and the loss of maximum tax benefits discourage investment.

Existing Rental Housing

The NAA supports 15 year straight line depreciation for existing rental housing in place of the Administration's 18 year proposal. Under current law by using component depreciation, rental housing which is 5-10 years old when purchased can generally be depreciated over a 13-20 year period. By providing 15 year straight line depreciation for existing rental housing, in many cases depreciation will be as great if not greater than under the present system. The net result will be to encourage purchases of existing rental housing. My experience has shown that when an existing building is purchased, the new owner invests in greater capital improvements than the previous owner would have if the property had been retained. Additionally, the fixed depreciation schedule will eliminate both the need for the costly appraisals necessary when electing component depreciation on an existing building, and in addition provide investors with audit proof certainty concerning depreciation deductions.

Rehabilitation of Existing Rental Housing

In addition, we recommend that the tax code be amended to provide additional tax incentives for rehabilitation of existing rental housing.

Presently, under section 167(k) of the tax code rehabilitation expenditures for low-income rental housing may be amortized over five years. This provision is scheduled to expire after December 31, 1983. This provision should be made permanent and extended to all rental property.

Over 41% of the nation's rental housing was built in 1939 or earlier. Older units tend to house lower income families. To quote the General Accounting Office

> Given the importance of the older rental units in terms of being a significant portion of the existing stock and of housing primarily lower income tenants, it is imperative that such units are preserved and remain affordable to lower income tenants.

According to Professor Sternlieb in his report to the Joint Economic Committee, which I cited earlier, the loss of rental housing in buildings of five or more units due to abandonment and demolition could be as high as 2½% per year. In smaller buildings the rate is lower, at 1% per year. Though these numbers are rough estimates, they indicate that at least between 200-300,000 multifamily rental units are abandoned or demolished each year. In fact, a significant portion of demand for rental housing in the 1980's will be replacement demand.

Preserving an existing rental unit is less expensive than constructing a new rental unit. Providing incentives to preserve existing rental units, will not only conserve resources but also provide less expensive housing to low and middle income families. Five year amortization for rehabilitation expenditures on rental housing will provide the needed incentive for investment in the preservation of all rental housing.

A more technical point relating to five year amortization involves the minimum tax, the maximum tax and ordinary income recapture.

Under section 56 of the tax code, a 15% minimum tax is imposed on all tax preference items. Presently, the tax code treats excess depreciation (the amount by which accelerated depreciation exceeds straight line depreciation) as a tax preference item, subject the minimum tax. Consequently, if accelerated depreciation is elected, certain taxpayers will be subject to an additional 15% tax.

In addition, when rental property is sold for a gain, the excess depreciation is "recaptured" and taxed at ordinary income tax rates (up to the 70% bracket) instead of the much lower capital gains rate.

Finally, the amount of excess depreciation reduces the amount of personal service income protected by the 50% maximum tax.

Many investors would be reluctant to take advantage of section 167(k) due to the disadvantages I just described. Considering the urgent need to provide incentives to preserve the aging rental stock, excess depreciation resulting from an election under section 167(k) should not be subject to the minimum tax or ordinary income recapture. Nor should the election of section 167(k) result in the loss of some of the maximum tax benefits.

Set Depreciation Schedule Optional

The proposals before this Committee will encompass a significant change in the tax law as it relates to depreciation deductions. In some situations, the depreciation deductions could be less under the proposed schedules than under existing law, defeating the intent of the legislation. Therefore, the election of the proposed depreciation schedules should be optional.

For example, a set depreciation schedule for existing rental housing will not provide greater depreciation in some situations involving older buildings or in some cases even relatively new buildings. Table D sets forth depreciation deductions for a building to be purchased after 5 years. Under either the Administration's 18 year schedule or the NAA 15 year schedule, depreciation deductions are considerably less than under existing law.

Also, under the Administration's proposal, tax incentives for rehabilitation of existing rental housing will be decreased. For example, under existing law a new roof placed on an existing building could be depreciated over 10 to 15 years. By electing accelerated depreciation such as double declining balance, the depreciation deduction could be as high as 20% in the first year. Under the Reagan proposal, yearly depreciation would only equal 5.5%.

In order to avoid unintentional loss of deductions, the new depreciation schedules should be optional. Thus, if there are any unintended adverse results, taxpayers could elect to depreciate property under the existing useful life method.[5]

Similarly, the five year write off under the Administration proposal should be optional at least during its phase in period. In many situations during the proposed phase in period for a five year write off, depreciation under the existing component system will be greater than under the Administration's proposal.

Low Income Rental Housing

Under existing law, both low, moderate and upper income rental housing receive the same rate of depreciation. The NAA opposes providing faster write offs for low income housing as compared to moderate and upper income housing as proposed by the Administration. Low income housing already receives significant federal subsidies and tax incentives. Even under the Administration's budget cuts there will be budget authorization for almost $20 billion for low income housing in fiscal year 1982. In addition, the tax code provides tax incentives for low income rental housing through issuance of tax exempt mortgage revenue bonds. There is no need for providing differential depreciation rates for different types of residential rental housing.

Deduction of Construction Period Interest and Taxes

Section 189 of the Internal Revenue Code should be repealed. This section added by the Tax Reform Act of 1976 requires, in the case of residential rental property and other real property, ten year amortization of construction period interest and taxes. In other industries, a deduction is allowed for taxes in the year paid. Construction period interest is an expense attributable to the

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[5] Congress should also instruct the Treasury to set up class lives for real property so that such property will be eligible for ADR depreciation.

construction loan used to finance the one to two year phase in building rental housing. Once the building is completed the loan is paid off. Construction period interest is a short term expense and should be allowed as an immediate deduction. Repeal of tax code section 189 would permit the immediate deduction of these expenses, which are actual out of pocket expenses when incurred.

In today's market, rental housing construction can no longer be leveraged to the same extent as in the early seventies. A much larger equity investment must be made. To encourage equity investment in rental housing with the prospect of little or no positive cash flow, the developer must look to the advantages of expensing these costs.

Expenses Incurred Prior to the Realization of Income

The Internal Revenue Service contends that in the case of real estate activities involving the construction and operation of property, the expenses incurred by the owner of property, prior to the actual realization of income are not immediately deductible. The rationale for this view is that the developer has not entered a trade or business until he completes the building and offers it for rent.

This position is without merit. The tax code should be amended to provide for the deductibility of expenses paid or incurred in connection with the acquisition, development, construction or erection of residential rental properties or other real estate from the time construction begins. Such a change will provide the needed certainty of the tax consequences of real estate investment and thereby encourage such investment.

Savings Incentives

The Administration's tax cut proposals would cut individual income tax rates by 30%, phased in at 10% per year. Though we supp individual income tax cuts, we feel that a portion of these tax cuts should be directed to encourage increased savings. Without increased savings, our industry will not have sufficient capital to build enough rental housing to satisfy the growing demands of this decade.

The NAA supports:

1) An expansion of eligibility for tax deductible IRA constributions to include individuals covered by employer sponsored retirement plans,
2) An increase in the IRA contribution limits, and
3) An expansion of the interest and dividend exclusion.

These proposed changes will provide tax incentives for increased savings. However, in addition to encouraging increased savings, Congress should provide legislation to insure that a fair share of increased savings will be made available to provide financing for rental housing construction in order to produce sufficient rental housing to meet the growing demand. Otherwise the present bias in our tax system for homeownership will direct the increased savings to owner-occupied housing.

Maximum Tax on Investment Income

Presently, the marginal tax rate on wages is limited to 50%, while the marginal tax rate on investment income may be as high as 70%. In essence, we are providing a penalty tax for individuals who delay consumption in favor of investment. By providing the same maximum tax rate for all income no matter the source, additional investment will be encouraged.

This concludes my statement. Thank you for the opportunity to express the views of the National Apartment Association.

TABLE A

MULTIFAMILY RENTAL STARTS AND COMPLETIONS AND ITS IMPACT ON THE VACANCY RATE

	Rental Starts* (2 units or more per building)	Rental Completions (2 units or more per building)	Vacancy Rate
1974	319,000	596,000	6.2%
1975	223,000	321,000	6.0%
1976	312,000	268,000	5.6%
1977	445,000	322,000	5.2%
1978	455,000	408,000	5%
1979	378,000	434,000	5%
1980(est.)***	260,000-270,000	400,000-410,000	5.2%**
1981(proj.)***	270,000-290,000	300,000-310,000	

*This column includes only multifamily rental starts excluding for sale multifamily housing such as condominiums and cooperatives.

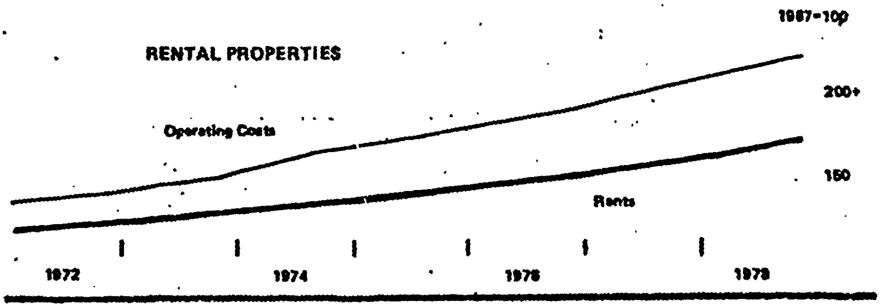
**1980 vacancy rates calculated under a new method raises vacancy rates by approximately .2% - .3%.

***National Apartment Association estimate as of January 1, 1981.

Source: Characteristics of New Housing, Construction Reports C-25, U.S. Department of Commerce.

TABLE B

INCREASES IN RENTS AND OPERATING COSTS



SOURCE: Federal Reserve Bulletin
Rental Housing: A National Problem That Needs Immediate Attention, GAO, CED 80-11, November 8, 1979.

EXPLANATION: This table indicates that over the last decade operating expenses of rental properties increased faster than rental income.

TABLE C

DEPRECIATION DEDUCTIONS FOR NEW RENTAL HOUSING CONSTRUCTION

Building (30 useful year life)	$3,440,000
Central Air Conditioning Equipment (8 useful year life)	220,000
Total	$3,660,000

	Existing Law* (Double Declining Balance)	Administration Proposal (18 year straight line)	Depreciation lost under Administration Proposal compared to existing law		NAA Recommendation (10 year straight line)
1981	$284,300	$203,300	$ 81,000	$166,800	$366,000
1982	$255,300	$203,300	$ 52,000		$366,000
1983	$230,700	$203,300	$ 27,400		$366,000
1984	$209,700	$203,300	$ 6,400		$366,000
1985	$191,400	$203,300	$-11,900		$366,000
1986	$179,800	$203,300	$-23,500		$366,000
1987	$169,000	$203,300	$-34,300		$366,000
1988	$158,900	$203,300	$-44,400		$366,000
1989	$132,000	$203,300	$-71,300		$366,000
1990	$123,300	$203,300	$-80,000		$366,000

*Under existing law new residential rental housing may be depreciated under the double declining balance method (DDB). Under DDB, the depreciation deduction is based upon a depreciation rate of 200% of the straight line rate.

TABLE D
DEPRECIATION DEDUCTIONS FOR EXISTING RENTAL HOUSING

Total Building Value	$3,060,134
Depreciation deductions using component Depreciation under existing law (straight line)	$ 225,974 per year
Depreciation deductions under the Administration's proposal (18 year straight line)	$ 170,007 per year
NAA Recommendation (15 year straight line)	$ 204,008 per year

	Original Useful Life	Remaining Economic Life	Value	Depreciation (Existing Straight Line) component	Administration Proposal (18 yr. s.l.)	NAA Recommendation (15 yr. s.l.)
Basic Structure	45 years	40 years	$978,000	$24,450	*	*
Exterior Wall Finish	20 years	15 years	206,000	13,733	*	*
Roof Cover	15 years	10 years	54,000	5,400	*	*
Vinyl Tile	10 years	5 years	17,000	3,400	*	*
Ceramic Tile	18 years	13 years	53,000	4,084	*	*
Sheetrock	20 years	15 years	241,000	16,066	*	*
Tile Wall Finish	18 years	13 years	81,000	6,230	*	*
Plumbing	15 years	10 years	411,000	41,100	*	*
Electrical	15 years	10 years	236,000	23,600	*	*
Heating and Cooling	15 years	10 years	285,000	28,500	*	*
Cabinets, Doors, and Windows	15 years	10 years	437,000	43,000	*	*
Concrete Paving	15 years	10 years	17,000	1,700	*	*
Asphalt Paving	8 years	3 years	44,134	14,711	*	*
Total		14 years (Value/Depreciation)	$3,060,134	$225,474	$170,007	$204,008

* No Component Depreciation

Summary of the Statement of
Howard Ruby
National Multi Housing Council
Senate Committee on Finance

Monday, May 18, 1981

- Rental housing is scarce. National rental vacancy rates are at their lowest point in 25 years; in many large cities vacancy rates are 1%.

- The production of conventionally financed rental housing has dropped dramatically since the passage of Section 189 of the Tax Reform Act of 1976 (185,000 in 1977 to 43,000 last year).

- Recent projections indicate a 3.5 million rental unit shortage during the 1980's.

- Present tax law is a severe disincentive to investment in rental housing construction.

- The following three point program contains the minimum tax revisions necessary to revitalize rental construction and avoid a potentially disastrous national shortage of rental housing:

    1. Repeal Section 189 or make it inapplicable to rental property, thereby allowing immediate deductions of construction period interest and taxes.

    2. A 15-year accelerated depreciation schedule with no recapture at ordinary rates, making the investment in rental housing an attractive alternative to commercial projects.

    3. A 12-year accelerated depreciation schedule for low income housing.

- The passage of the three-point program should stimulate the construction of an additional 200,000 rental units each year; historical precedent supports this premise.

- The passage of the three-point program will not cost the government money; in fact, it will generate increased tax collection. If 200,000 additional units are built, the net tax collected after deducting tax benefits to investors should reach nearly $2 billion in five years.

It is in all our best interests to give special tax incentives to the rental industry. The housing of the growing legions of Americans unable to afford a home depends upon it. Few will dispute the need. We need your help to meet that need.

STATEMENT OF HOWARD RUBY, NATIONAL MULTI HOUSING COUNCIL, BEFORE THE SENATE COMMITTEE ON FINANCE

MONDAY, MAY 18, 1981

Mr. Chairman:

My name is Howard Ruby. I am Chairman of R & B Enterprises, based in Los Angeles. We are operators of over 20,000 apartment units throughout the United States and have been in the business for 21 years. I am Chairman of the California Housing Council, an organization of large apartment developer/operators, whose purpose is to encourage the production of conventional rental apartments. In addition, I am a founding member of the Board of Directors of the National Multi Housing Council, which, on the national level, functions to foster rental housing production, as well.

Today, however, I am speaking to you as a former major apartment developer who would like to start developing apartments again. In the early seventies we were one of the largest apartment builders in the country, developing as many as 5,000 units in one year. Last year my company built no apartments. This year we will be able to build no apartments. Next year, and in ensuing years, it will most likely be the same. I feel comfortable in speaking not only for my company, but for most other apartment builders as well, in stating that very few units will be built unless the Reagan Administration and the Congress take definitive steps to foster the regrowth of unsubsidized private sector apartment construction.

In the face of the constantly dwindling numbers of federally subsidized housing due to budget constraints, this lack of production of both conventionally financed and federally subsidized apartments will shortly become a national disaster, a tremendous hardship on millions of Americans who cannot afford today's single family home prices, and a disgrace to the country that prides itself on having the best housed citizenry in the world.

Why is this outlook so grim for the development of new apartments by my company and most other developers in the business today? Well, there is an old saying, "Given the money to build, a builder will, in fact, build." Today there is virtually no money to build conventional apartments; apartment construction is down to the lowest levels since World War I. If the Reagan Administration proposal goes forward without modification, this bleak situation will deteriorate even further.

But let's go back just a few short years to 1973. In California, Virginia, and Texas, where our projects were located, and I can speak from firsthand experience, we were experiencing a huge oversupply of apartments. Our vacancy rates often exceeded 20 percent, even after significant rent reductions (in some cases nearly 30 percent). We routinely gave the first month's rent free, often times paid for the cost of moving the tenant, and even gave free trips to Acapulco just to get a resident into one of our buildings.

Today, just eight years later, exactly the opposite is true. National rental vacancy rates are approaching 5% and stand at their lowest point in 25 years.1/ In many metropolitan areas, vacancy rates are 1%.

The production of unsubsidized rental housing has declined dramatically since the passage of the Tax Reform Act of 1976. In 1977, there were approximately 185,000 unsubsidized rental unit starts. This number dropped to 144,000 units in 1978, to 76,000 units in 1979, and to an estimated 43,000 unsubsidized multifamily rental units in 1980.2/ (See Exhibit "A" attached.)

This drop in production, combined with the loss of rental units as existing stock ages, has led experts to estimate a gap between rental needs and production in the 1980's totaling

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1/ Bureau of Census, U.S. Department of Commerce, Washington, D.C.

2/ Combination of Bureau of Census and Office of Housing, U.S. Department of Housing and Urban Development statistics.

1.2 to 4.6 million units.[3] The most recent estimates show a shortage of 3.5 million rental units in this decade.[4]

How could the industry experience this vast swing from huge oversupply to extreme shortgage in just a few years? The answers you have heard are all partially true:

a. Environmental controls have become stricter, lowering the density allowed on a typical piece of land.

b. Housing construction costs have skyrocketed.

c. Mortgage interest rates have gone up 50 percent or more.

d. Operating expenses, especially in the highly volatile utility field, have exceeded rent increases.

e. The ever-present fear of rent control which threatens future net income.

f. Finally, and most important, is the fact that there has been a shortage of money for the past several

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[3] Anthony Downs, The Future of Rental Housing in America, The Brookings Institution, Washington, D.C., October, 1979. Also: Need for a Rental Housing Production Program (Office of Policy and Budget, Office of Housing, HUD, June 1980, Unpublished).

[4] Housing Needs in the Eighties, IFC Incorporated, Washington, D.C., February, 1981.

years. Some call it money, some call it equity capital or investment capital, some call it cash down payment requirements, some call it mortgage money, but whatever you call it, money is the key ingredient to get apartment construction.

Why this lack of money for apartment construction? There is no lack of money for commercial real estate investment. The scarcity is merely in money that is available for investment in conventionally financed apartments. You have all heard of the Pan Am Building in New York selling for $400 million cash. Perhaps you have heard that the World Trade Center in New York may shortly be for sale in the $2 billion range, enough money to build over 50,000 apartments, and yet the list of buyers announced as "ready to buy" numbers six to eight. You have heard of the $60 billion that the pension funds of America anticipate putting into real estate in the next few years. You have heard of the billions of dollars of foreign capital pouring into the United States to buy investment property. Perhaps you have even heard that a few weeks ago a Wall Street firm was able to sell nearly $100 million in just nine days for just one real estate investment syndication. I submit then that there is plenty of money for real estate investment. The money simply is not available to be invested in apartments in today's unfavorable tax and investment climate.

But let's go back again even further to 1969. At that time a group of us representing the National Apartment Association met with and urged Senator Long to give special tax consideration to the investor who was willing to invest in the highly speculative conventional apartment ownership business. When the 1969 Tax Act emerged from this committee the rental housing industry stood to benefit from special tax incentives maintained in the code. These incentives included a provision allowing accelerated depreciation for apartments, while eliminating most similar benefits for other types of investments, such as shopping centers, office buildings, and warehouses (which were considered lower risk investments).

The outstanding impact of that special tax incentive contained in the 1969 Tax Act can be seen from the accompanying Exhibit "A" where we see the rapid growth of apartment construction shortly thereafter. Within two years apartment construction shot up to nearly 500,000 units in one year. A whole new investment industry was formed around that tax act to allow the small private investor an attractive investment option. Over $40 billion was invested by private investors largely to fund apartment development to take advantage of the tax incentives created in the 1969 act. By 1973 the industry experienced that huge oversupply of which I spoke of a few moments ago. That oversupply created enormous benefits to the tenants in the form of lower rent levels, first month's rent free, etc.

These tax incentives were, in the minds of most professionals, directly responsible for the creation of several million new apartment units, both subsidized and unsubsidized, in just a few years. In the process many individuals who invested their savings in apartment construction received large tax benefits. Those tax benefits became the villain and "tax shelter" became a dirty word. The press was filled with horror stories of wealthy individuals who, using these awful "tax shelters," paid little or no income tax. Congress, in its haste to plug these loopholes, seems to have neglected to consider that these same individuals were responsible for the largest apartment boom in the nation's history. So, the tax laws were changed in 1976.

As you know, the minimum tax was increased to 15 percent. Frankly, it would have been better to have stopped right there, making sure that all taxpayers, no matter how sheltered, paid some tax. Unfortunately, it is my opinion that you may have overcorrected; most of the tax incentives for investing in apartment construction vanished.

First, Section 189 was passed, taking away the all-important first year tax benefits, the year of construction, when the investor receives no cash yield. He could now better put his money in 15 percent CDs or money market funds.

Second, while keeping accelerated depreciation, a change to Section 1250 was passed which requires that when an investor sells his apartment house he has to pay ordinary income tax in the year of sale at a rate of 70 percent, instead of the previous law which phased out Section 1250 over a period of eight years of ownership.

We took these Congressional initiatives as a clear message to the apartment industry: "Guys, you did your job. We have plenty of apartments for now. Invest your money elsewhere." And the investors did.

After the oversupply created in 1973, apartment construction fell as expected in 1974-1975. It was starting to pick up in 1976, when the revisions I have just outlined were passed. In 1977, new starts went up to 185,000, as units previously in the pipeline were completed. By 1978, however, the trend took a downturn. Perhaps this downturn was caused by a coincidence of negative factors hitting our industry, but, in light of continued investment in commercial projects, I submit that it was the 1976 Tax Act which drove the final nail in the coffin. (See Exhibit "A" which sets forth rental unit starts over the past 15 years).

Based on current projections, it appears that no more than 50,000 unsubsidized apartment units will be built this year.

That figure does not take into consideration units lost from the rental stock by way of condo conversion, abandonment, change to office or retail, or demolition.

I firmly believe that this figure can be increased five-fold to 250,000 units within one year if Congress and the Reagan Administration make the following changes to reinstate tax incentives for apartment investment:

a. Repeal Section 189 of the Internal Revenue Code or make it unapplicable to rental housing, thereby allowing full tax deduction for interest and property taxes paid during the construction years.

b. Provide a 15 year accelerated depreciation schedule for new rental housing. Of course, an appropriate modification in Section 1250 is a necessary adjunct.

c. Provide a 12 year accelerated depreciation schedule for low income housing to encourage the construction of urgently needed low and moderately priced apartments.

Why does the apartment industry need these special tax incentives? With the indulgence of the Committee, I have developed a hypothetical but typical economic analysis of a 250 unit apartment project (Exhibit "B"). With Section 189 in place, the tax benefit in the first year is 4.71% of the capital invested. If this is compared to other currently offered investment options, the problem is crystalized. A recent ad in the Wall Street Journal offered a 288% tax benefit for investing in medical equipment leased to doctors. Or, what about the 85% first year benefit for investment in a typical oil deal? Or, going to the completely ridiculous, what about the 400% shelter recently offered in cryogenically frozen bull sperm as an investment? Would you invest in apartments with all of the inherent risks for a 4.71% tax benefit?

But, repeal Section 189 and the first year shelter goes to 37.6% of the downpayment of $2,500,000 (Exhibit "C"). Still not as good as other investment tax benefits but, all things being equal, many people would prefer real estate and apartments as an investment alternative. It is tangible and they understand and trust it; with somewhat comparable tax benefits they will invest in it again.

Going back to my hypothetical for a moment, the cash flow from my 250 unit project is a loss in the first two years

(Exhibit "D"). With the 18 year straight-line depreciation, even after tax savings in the 50% bracket, the yield is less than 10% for the first four years. Obviously, much better yields are available in absolutely safe, trouble-free Treasury Bills.

But, if a 15 year accelerated depreciation schedule is applied (Exhibit "C") the after tax yield is 18% - 16% - 14% & 13% for the first four years--enough to risk investment if full capital gains treatment is given rather than the amount of accelerated depreciation recaptured as ordinary income at sale.

The key question is how much will all this cost the treasury? I respectfully submit that it will cost nothing. In fact, it will create net tax revenue. To demonstrate this, I have created another hypothetical model (Exhibit "E") based upon my conservative belief that our proposals would stimulate the construction of an additional 200,000 rental units each year.

If you believe, as I do, that our three point program can and will create more apartments, then tax collections will actually increase. Two factors cause this. First, the average apartment cost has been estimated to be about one-third labor. If one figures the income taxes collected (not including the savings in unemployment benefits, etc.) from that pool of labor, building the extra 200,000 units per year could actually increase the payroll tax collections by nearly $650 million per year. This would also mean the addition of approximately 60,000 jobs while increasing net tax receipts to the government.

Second, the historical pattern would indicate that 25% of the units would be sold each year, and our model shows that the capital gains tax collected would be nearly $3 billion while we are creating 1.5 million new apartments in the next six years (Exhibit "F"). The net tax collected after deducting tax benefits to investors would reach nearly $2 billion in five years.

If you think that this increase of 200,000 units is wishful thinking, then I invite your attention to the statistics in Exhibit "A". Historical precedent is on our side.

If one assumes that my figures are even close, a pool of capital of $10 billion would be needed each year to create these 250,000 units. Of that amount, $2.5 billion would be required as the capital investment from private or institutional investors. Based on historical precedent after the 1969 Tax Act, these funds would come pouring into apartment investment once you signal your willingness to help apartment construction with the necessary tax incentives.

I would next like to address the other $7.5 billion in loans. Where will it come from? Our model shows that real estate lenders would get a 25% interest in the rent increases and profits and a variable mortgage rate which calculates to a 17% yield. This would get the S&Ls, insurance companies and pension funds back into apartments as they were in the early seventies.

I would be remiss if I avoided mentioning the laundry list of other problems which have negatively impacted rental construction: environmental restraints; high construction costs; operating expenses; and rent controls.

I firmly believe many of these impediments will disappear over the next few years. For example, many localities are rethinking the impact of excessive environmental constraints; lowered inflation will abate construction and operating costs; and a healthy supply of new apartments is the best hedge against rent control. In fact, your colleagues are looking at legislation which would mitigate the negative effects of rent control.

In summary, I repeat: "Given the money to build, builders will, in fact, build." We need the investment capital which only tax incentives can attract to the industry. It is true, and always will be true that hotels, office buildings, and shopping centers want tax benefits, too. But, it is in all our best interests to give special tax incentives to the rental industry. The housing of the growing legions of Americans unable to afford a home depends upon it. Few will dispute the need. We need your help to meet that need.

We have gone over some very complicated formulas today, and I appreciate your attention. I have tried to show that relatively minor changes in the tax laws have enormous impact on vital segments of our economy. For simplicity my figures were based upon 250 unit buildings, but the average project constructed in America is less than 25 units. Each year thousands of investors get together with their accountants and tax counselors to decide where to invest their capital. Without change, it is unrealistic to expect them to invest in that risky troublesome headache, with all of the attendant problems, called an apartment project.

Unless there is a special benefit in the form of tax-favored treatment, apartments will languish, and highrise office buildings, hotels, and shopping centers will continue to get the lion's share of available investment capital. Of critical significance is the fact that, in reality, the assistance we seek will not cost the government tax dollars.

I urge the committee to seriously consider:

a. Repealing Section 189 or making it inapplicable to rental property;

b. Providing a 15 year accelerated depreciation schedule with no recapture at ordinary rates; and

c. Providing a 12 year accelerated depreciation schedule for subsidized housing.

If you do that, my company and the thousands of other apartment developer professionals will give you a boom in new apartment construction that will amaze all the doomsayers.

Many of you must certainly be skeptical of the proposition that these few changes in the tax law can increase apartment construction five fold within the next few years. Well, let me make a deal with you: <u>sunset the tax provisions</u>. If our industry does not successfully build at the rate of 250,000 units per year or more, then drop the accelerated depreciation and special provisions and put apartments back in parity with commercial and industrial property. Give us 3-1/2 years to get the pipeline going and the builders geared up. If we do not produce to your satisfaction, then automatically drop the changes we seek on January 1, 1985. Given the tax benefits, I firmly believe we can get the money to build; I firmly believe we will produce the new units.

If apartments are not given significant tax advantages over other forms of real estate, then the government may have to provide for all of this country's apartment needs in the future -- not a pleasant thought.

EXHIBIT A

PRIVATELY OWNED MULTI-FAMILY RENTAL HOUSING STARTS 1965 - 1980 (1)

(Thousands of Units)

Year	Units in Building of 5 or More Units	Condominiums	Federally Subsidized and/or Insured Units	Unsubsidized Rental Units
1965	423	42	69	312
1966	325	32	60	233
1967	376	37	70	269
1968	527	52	146	329
1969	571	57	147	367
1970	536	56	277	203
1971	781	120	293	368
1972	906	202	212	492
1973	795	203	115	477
1974	382	104	54	224
1975	204	26	43	135
1976	289	38	93	158
1977	414	57	172	185
1978	462	89	229	144
1979	429	126	227	76
1980	330	123	164	43

NOTE:

(1) Sources: Combination of The Census, United States Department of Commerce; Office of Housing, United States Department of Housing and Urban Development

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                        250 UNIT APARTMENT BUILDING                                      EXHIBIT B
                        ECONOMIC ANALYSIS
                        SECTION 189 EFFECTIVE
                        STRAIGHT LINE DEPRECIATION - 10 YEAR LIFE

TOTAL COST $10,000,000                                   GROSS INCOME 1983 250 UNITS X $600 X 12 MONTHS
LAND COST  $ 2,500,000                                   OPERATING EXPENSES 40% OF GROSS INCOME
CONSTRUCTION LOAN 15%  12 MONTH CONSTRUCTION PERIOD      NOI INCREASED 6% PER YEAR STARTING IN 1984
PERMANENT LOAN 15% 30 YR AMORTIZATION  $7,500,000        INVESTOR TAX RATE DURING 10 YEARS @ 50%
   KICKER 25% OF GROSS INCOME INCREASE PLUS 25% OF NET   INVESTOR TAX RATE AT SALE AT 28% CAPITAL GAIN RATE
   PROCEEDS AFTER SALE OF ASSETS
EQUITY $2,500,000


CONSTRTN    MONTH 1  MONTH 2  MONTH 3  MONTH 4  MONTH 5  MONTH 6  MONTH 7  MONTH 8  MONTH 9 MONTH 10 MONTH 11 MONTH 12    TOTAL
===============================================================================================================================
LAND        2500000                                                                                                  2500000
IMPRVMNTS    332897   466056   532636   599215   665795   732374   732374   665795   599215   532636   466056   232897  6557945
          ---------------------------------------------------------------------------------------------------------------------
            2832897   466056   532636   599215   665795   732374   732374   665795   599215   532636   466056   232897  9057945
INTEREST              35411    41680    48858    56959    65994    75973    86078    95476   104160   112120   119347   842056
PROP TAX                                                                                                      100000   100000
          ---------------------------------------------------------------------------------------------------------------------
TOTAL       2832897  3334345  3908680  4556753  5279507  6077875  6886222  7638095  8332786  8969581  9547757 10000001 10000001
          =====================================================================================================================


     .         1982     1983     1984     1985     1986     1987     1988 .   1989     1990     1991     1992 RESIDUAL CALCS
===============================================================================================================================
GROSS INC         0  1800000  1908000  2022480  2143829  2272459  2408806  2553334  2706534  2868927  3041062 SALES PR 18246373
OPER EXP          0   720000   763200   808992   857532   908983   963522  1021334  1082614  1147571  1216425 LOAN BAL -7201938
          -------------------------------------------------------------------------------------------------          --------
NOI               0  1080000  1144800  1213488  1286297  1363475  1445284  1532001  1623921  1721356  1824637          11044435
                                                                                                             KICKER   -2761109
DEBT SERV         0  1138000  1138000  1138000  1138000  1138000  1138000  1138000  1138000  1138000  1138000          --------
KICKER                     0    27000    28420    30337    32157    34087    36132    38300    40598    43034           8283326
          ------------------------------------------------------------------------------------------------- EQUITY   -2500000
CASH FLOW         0   -58000   -20200    46868   117960   193318   273197   357849   447621   542758   643603          --------
                                                                                                             EXCESS    5783326
PRIN AMRT         0    13927    16166    18766    21783    25284    29348    34068    39542    45900    53278          ========
189 AMORT   -117757  -117757  -117757  -117757  -117757  -117757  -117757  -117757  -117757
DEPREC            0  -364330  -364330  -364330  -364330  -364330  -364330  -364330  -364330  -364330  -364330 xxxxxxxxxxxxxxxxx
          ------------------------------------------------------------------------------------------------- GAIN CALCS .
TAX INC     -117757  -526160  -486121  -416453  -342344  -263485  -179542   -90151   122833   224328   332551 =================
          ================================================================================================= SALES PR 18246373
% SHELTER      4.71    21.05    19.44    16.66    13.69    10.54     7.18     3.61                            BASIS     5414645
                                                                                                                      --------
CASH FLOW         0   -58000   -20200    46868   117960   193318   273197   357849   447621   542758   643603 GAIN     12831728
TAX @ 50%     58879   263080   243061   208227   171172   131743    89771    45075   -61416  -112164  -166276          ========
          ------------------------------------------------------------------------------------------------- TAX @28%  3592884
AFTER TAX                                                                                                             ========
CASH FLOW     58879   205080   222861   255095   289132   325060   362968   402944   386204   430594   477328           4690442
          =================================================================================================           ========

CASH FLOW
% RETURN       0.00    -2.32    -0.81     1.87     4.72     7.73    10.93    14.31    17.90    21.71    25.74 IRR         16.79

AFTER TAX
% RETURN       2.36     8.20     8.91    10.20    11.57    13.00    14.52    16.12    15.45    17.22    19.09 IRR         16.48

                                                                                                  YIELD TO LENDER      17.0
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EXHIBIT C

250 UNIT APARTMENT BUILDING
ECONOMIC ANALYSIS
SECTION 189 NOT EFFECTIVE
ACCELERATED DEPRECIATION - 15 YEAR LIFE

TOTAL COST $10,000,000
LAND COST $ 2,500,000
CONSTRUCTION LOAN 15% 12 MONTH CONSTRUCTION PERIOD
PERMANENT LOAN 15% 30 YR AMORTIZATION $7,500,000
KICKER 25% OF GROSS INCOME INCREASE PLUS 25% OF NET PROCEEDS AFTER SALE OF ASSETS
EQUITY $2,500,000

GROSS INCOME 1983 250 UNITS X $600 X 12 MONTHS
OPERATING EXPENSES 40% OF GROSS INCOME
NOI INCREASED 6% PER YEAR STARTING IN 1984
INVESTOR TAX RATE DURING 10 YEARS @ 50%
INVESTOR TAX RATE AT SALE AT 28% CAPITAL GAIN RATE

CONSTRTN	MONTH 1	MONTH 2	MONTH 3	MONTH 4	MONTH 5	MONTH 6	MONTH 7	MONTH 8	MONTH 9	MONTH 10	MONTH 11	MONTH 12	TOTAL
LAND	2500000												2500000
IMPRVMNTS	332897	466056	532636	599215	665795	732374	732374	665795	599215	532636	446056	232897	6557945
	2832897	466056	532636	599215	665795	732374	732374	665795	599215	532636	446056	232897	9057945
INTEREST		35411	41680	48858	56959	65994	75973	86078	95476	104160	112120	119347	842056
PROP TAX												100000	100000
TOTAL	2832897	3334345	3908680	4556753	5279507	6077875	6886222	7638095	8332786	8969581	9547757	10000001	10000001

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	RESIDUAL CALCS	
GROSS INC	0	1800000	1908000	2022480	2143829	2272459	2408806	2553334	2706534	2868927	3041062	SALES PR	18246373
OPER EXP	0	720000	763200	808992	857532	908983	963522	1021334	1082614	1147571	1216425	LOAN BAL	-7201938
NOI	0	1080000	1144800	1213488	1286297	1363475	1445284	1532001	1623921	1721356	1824637		11044435
												KICKER	-2761109
DEBT SERV	0	1138000	1138000	1138000	1138000	1138000	1138000	1138000	1138000	1138000	1138000		
KICKER		0	27000	28620	30337	32157	34087	36132	38300	40598	43034		8283326
												EQUITY	-2500000
CASH FLOW	0	-58000	-20200	46868	117960	193318	273197	357869	447621	542758	643603		
												EXCESS	5783326
PRIN AMRT	0	13927	16166	18766	21783	25284	29348	34068	39542	45900	53278		
189 AMORT	-942056												
DEPREC	0	-874393	-757807	-656766	-569197	-493304	-427530	-370526	-321123	-278307	-241199		
												GAIN CALCS	
TAX INC	-942056	-918466	-761841	-591132	-429454	-274702	-124985	21411	166040	310351	455682		
												SALES PR	18246373
% SHELTER	37.68	36.74	30.47	23.65	17.18	10.99	5.00					BASIS	4067793
CASH FLOW	0	-58000	-20200	46868	117960	193318	273197	357869	447621	542758	643603	GAIN	14178580
TAX @ 50%	471028	459233	380921	295566	214727	137351	62493	-10705	-83020	-155175	-227841		
												TAX @28%	3970002
AFTER TAX CASH FLOW	471028	401233	360721	342434	332687	330649	335689	347163	364601	387582	415762		4313324
CASH FLOW % RETURN	0.00	-2.32	-0.81	1.87	4.72	7.73	10.93	14.31	17.90	21.71	25.74	IRR	16.79
AFTER TAX % RETURN	18.84	16.05	14.43	13.70	13.31	13.23	13.43	13.89	14.58	15.50	16.63	IRR	21.77

YIELD TO LENDER 17.0

EXHIBIT B

250 UNIT APARTMENT BUILDING
INVESTOR POSITION
COMPARATIVE SUMMARY
($ IN THOUSANDS)

SL DEPR

SEC 189	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	TOTAL
CASH FLOW	0	-58	-20	47	118	193	273	358	448	543	644	2546
CASH FROM SALE											8283	8283
% RETURN ON $2700	0	-2.32	-0.81	1.87	4.72	7.73	10.93	14.31	17.90	21.71	25.74	
TAX INCOME (LOSS)	-118	-526	-486	-416	-342	-263	-180	-90	123	224	333	-1741
TAX INCOME - SALE											12832	12832
% SHELTER ON $2500	4.72	21.04	19.44	16.64	13.68	10.52	7.20	3.60				96.84
AFTER TAX CASH FLO	59	205	223	255	289	325	343	403	386	431	477	3416
AFTER TAX CF- SALE											4690	4690
AFTER TAX % RETURN	2.36	8.20	8.92	10.20	11.56	13.00	14.52	16.12	15.44	17.24	19.08	
IRR AFTER TAX	16.48											

ACCEL DEPR
NO SEC 189

CASH FLOW	0	-58	-20	47	118	193	273	358	448	543	644	2546
CASH FROM SALE											8283	8283
% RETURN ON $2500	0	-2.32	-.81	1.87	4.72	7.73	10.93	14.31	17.90	21.71	25.74	
TAX INCOME (LOSS)	0	-918	-762	-591	-429	-275	-125	21	166	310	456	-2147
TAX INCOME - SALE											14179	14179
% SHELTER ON $2500	0.00	36.72	30.48	23.64	17.16	11.00	5.00					124
AFTER TAX CASH FLO	471	401	361	342	333	331	336	347	365	388	416	4091
AFTER TAX CF- SALE											4313	4313
AFTER TAX % RETURN	18.84	16.04	14.44	13.68	13.32	13.24	13.44	13.88	14.60	15.52	16.64	
IRR AFTER TAX	21.77											

250 UNIT APARTMENT BUILDING

ASSUMPTIONS

1. Cost of Construction:

Land	$ 2,500,000
Improvements	6,557,994
Construction Interest	842,056
Construction Property Tax	100.000
Total Cost	$10,000,000

2. Construction period equals 12 months

3. Construction loan at 15%

4. Permanent loan $7,500,000 15% 30 year amortization 15.17% constant. Contingent interest kicker equal to 25% of increase in gross income plus 25% of net proceeds after payment of loan balance on sale of assets.

5. Equity contribution $2,500,000

6. Gross income in 1983 equals 250 units x $600 per unit x 12 months

7. Operating expenses equal 40% gross income

8. Net operating income increased 6% per year starting in 1984

9. Two alternatives prepared with Section 189 and depreciation being variables:

   Section 189 effective with straight line depreciation on an 18-year life

   Section 189 not effective with double declining balance depreciation on a 15-year life

10. Investor tax rate during 10 year analysis at 50%

11. Investor tax rate at sale at 70% - capital gain effective rate is 28%

12. No Section 1250 depreciation recapture as ordinary income computed upon sale - all gain treated as capital gain

50,000 VS 250,000 APARTMENT UNITS CONSTRUCTED
SUMMARY OF NET TAXES GENERATED
($ IN THOUSANDS)

EXHIBIT E

50,000 UNITS SL DEPR - SEC189	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
1982	118048	1496	28092	61188	94684					
1983		118048	1496	28092	61188	94684				
1984			118048	1496	28092	61188	94684			
1985				118048	1496	28092	61188	94684		
1986					118048	1496	28092	61188	94684	
1987						118048	1496	28092	61188	94684
TOTAL	118048	119544	147634	208824	303508	303508	185460	183964	155872	94684
NET TAXES GENERATED - CUMULATIVE TOTAL	118048	237572	385228	594052	897560	1201068	1386528	1570492	1726364	1821048
250,000 UNITS ACCEL DEPR - NO SEC 189										
1982	178242	-152820	65740	362910	588740					
1983		178242	-152820	65740	362910	588740				
1984			178242	-152820	65740	362910	588740			
1985				178242	-152820	65740	362910	588740		
1986					178242	-152820	65740	362910	588740	
1987						178242	-152820	65740	362910	588740
TOTAL	178242	25422	91162	454072	1042812	1042812	864570	1017390	951650	588740
NET TAXES GENERATED - CUMULATIVE TOTAL	178242	203664	294826	748898	1791710	2834522	3699092	4716482	5668132	6256872
CUMULATIVE NET INCREASE (DECREASE) IN NET TAXES GENERATED BETWEEN ALTERNATIVES	60194	-33928	-90402	154846	894150	1633454	2312564	3145990	3941768	4435824

EXHIBIT F

50,000 VS 250,000 APARTMENT UNITS CONSTRUCTED
NET TAXES GENERATED
($ IN THOUSANDS)

50,000 UNITS SL DEPR - SEC 189	1982	1983	1984	1985	1986	TOTAL
# OF UNITS SOLD		12500	12500	12500	12500	50000
SALES PRICE PER UNIT(INC 10% PER YR)		50	55	61	67	
GROSS SALES PRICE		625000	687500	762500	837500	2912500
COST PER UNIT - $36		-450000	-450000	-450000	-450000	-1800000
ACCUMULATED DEPR - SL		18200	36400	54600	72800	182000
TOTAL GAIN		193200	273900	367100	460300	1294500
CAPITAL GAIN TAX RATE @ 28%		54096	76692	102788	128884	362460
TAX ON LABOR (30% OF IMPROVEMENT COST ON A 250 UNIT APT BLDG - $6558 X 30% X 33% TAX RATE X 200)	129848					129848
TAXES GENERATED	129848	54096	76692	102788	128884	492308
TAX SAVINGS	-11800	-52600	-48600	-41600	-34200	-188800
NET TAXES GENERATED	118048	1496	28092	61188	94684	303508

250,000 UNITS ACCEL DEPR - NO SEC 189						
# OF UNITS SOLD		62500	62500	62500	62500	250000
SALES PRICE PER UNIT(INC 10% PER YR)		50	55	61	67	
GROSS SALES PRICE		3125000	3437500	3812500	4187500	14562500
COST PER UNIT - $36		-2250000	-2250000	-2250000	-2250000	-9000000
ACCUMULATED DEPR -ACCEL		218500	408000	790750	933000	2350250
TOTAL GAIN		1093500	1595500	2353250	2870500	7912750
CAPITAL GAIN TAX RATE @28%		306180	446740	658910	803740	2215570
TAX ON LABOR (30% OF IMPROVEMENT COST ON A 250 UNIT APT BLDG - $6558 X 30% X 33% TAX RATE X1000)	649242					649242
TAXES GENERATED	649242	306180	446740	658910	803740	2864812
TAX SAVINGS	-471000	-459000	-381000	-296000	-215000	-1822000
NET TAXES GENERATED	178242	-152820	65740	362910	588740	1042812

50,000 vs. 250,000 UNIT ANALYSIS

ASSUMPTIONS

1. Comparison made assuming that 50,000 units would be constructed per year if Section 189 is effective with straight line depreciation on an 18-year life and that 250,000 units would be constructed per year if Section 189 is not effective with accelerated depreciation on a 15-year life.

2. The analysis assumes that 25% of the units constructed would be sold per year thus generating capital gains tax.

3. The capital gains tax is computed at an effective 28% rate.

4. No Section 1250 depreciation recapture as ordinary income computed - all gain treated as capital gain.

5. Tax on labor associated with the improvement cost computed as follows:

   30% of improvement cost is assumed to be labor

   Tax rate of 33% used to compute taxes generated.
   20% income tax and 13% payroll taxes (employer and employee share)

6. Taxes generated equals capital gain tax plus tax on labor

7. Tax savings equals the tax benefit generated from the taxable losses from the 250 Unit Apartment Building Analysis at a 50% tax rate.

8. Net taxes generated equals the difference between taxes generated and tax savings.

Statement of the National Realty Committee

The National Realty Committee, Inc., a non-profit business league whose membership includes owners, operators and developers of all types of real estate throughout the United States, offers the following statement regarding the proposed "Economic Recovery Tax Act of 1981" (the "Act").

The National Realty Committee supports the tax rate cuts proposed by the Act and generally supports the concept underlying the Accelerated Cost Recovery System proposed as a substitute for the current depreciation rules.

Although liberalization of depreciation is obviously desirable, and a system of scheduled capital cost recovery periods as proposed by the Act offers many advantages over the current system of determining depreciation upon the basis of guesstimated economic useful lives, we have very substantial reservations concerning the proposed treatment of investments in real property assets.

We are in favor of the reindustrialization of the United States and we are aware of the serious problems faced by American industry in competing with foreign enterprises. In this connection, we could support a proposal to provide very rapid capital cost recovery periods for factories and similar manufacturing facilities, directly involved in the production of goods, as an essential part of industrial revitalization.

As major builders and owners of all types of rental structures in the United States, however, we are concerned that tax incentives designed to assist in the modernization of America's industrial capabilities not be indiscriminately extended to investments which do not require a similar high degree of tax incentive.

We do not believe that special tax incentives are required to induce the construction of all of the office buildings, hotels, warehouses and shopping centers which the nation requires. Frankly, we are concerned that if excessive tax incentives are offered for the construction of non-residential buildings, the inevitable result will be a boom in tax-shelter motivated investment followed by the inevitable bust resulting from uneconomic overpricing or overproduction.

On the other hand, many areas in the country obviously lack sufficient rental housing. In light of this circumstance, it appears anomalous to us that the Act proposes a longer life for residential property than for commercial buildings.

Of even greater concern to us is the introduction by the Act of a distinction for capital cost recovery purposes between certain "owner-occupied" buildings and buildings held for rent. Tax incentives traditionally granted to homeowners have resulted in a nation with a relatively high degree of home ownerhsip as opposed to rental. There may be valid social objectives achieved by this tax treatment. What comparable social goals are achieved by encouraging the ownership, rather than the rental, of commercial facilities?

The prospect of two identical grocery stores or gasoline stations on opposite sides of a street, one owned by the user, the other leased, being treated for tax purposes in a radically different manner does not seem reasonable or desirable. Under the Act, it will take the owner of the leased facilities more than 10 years to recover the same percentage of his cost for federal income tax purposes that the owner-occupier across the street recovers in 5 years. Obviously, therefore, the owner-lessor cannot offer to lease his property to his tenant at a rental competitive with the imputed net-after-tax rental cost to the owner-occupier.

While members of Congress have been encouraged to support this proposal by various trade associations representing small business people, it is hard to see how the enactment of this distinction can benefit the small businessman who cannot afford to build his own facility as compared to the major national corporation whose borrowing capacity permits a rational choice between ownership and leasing. In addition, since the proposed tax benefits only apply to buildings placed in service after the effective date of the new legislation, the major beneficiaries of these tax benefits will be companies otherwise experiencing dynamic growth and expansion.

On a more technical level, we believe that the Act should provide for greater taxpayer flexibility in deducting amounts allowable under the Accelerated Capital Cost Recovery System. The Act provides for extending the period for carryovers of net operating losses from 7 to 10 years but this 3-year extension may not be a sufficient remedy for taxpayers who may not be able to absorb the more rapid deductions permitted under the new system. Furthermore, some taxpayers, such as those owning net leased real property or incurring substantial non-business deductions, may not benefit from the expanded net operating loss carryover.

We also believe that the proposed amendment to Code Section 312(k), which would substitute a flat 30-year capital cost recovery period for all buildings for purposes of the calculation of corporate earnings or profits, is inappropriate. Existing Code Section 312(k) provides in substance that for purposes of determining corporate earnings and profits depreciation shall be determined on the straight-line method even though corporate taxable income may be computed under an accelerated method. Section 207(a) of the Act substitutes a 30-year straight-line life for all Section 1250 property in the determination of corporate earnings and profits irrespective of whether the property involved is new or used or subject to any accelerated method of depreciation. We believe the existing provisions of Section 312(k) are sufficient to prevent any substantial tax avoidance in this area.

In addition to the foregoing, we call your attention to the fact that Section 203(g) of the Act, which applies an "at risk" rule to the investment tax credit, does not, as drafted, contain any exemption for real property activity similar to that currently provided with respect to the "at risk" rules of Code Section 465. Unless this omission is corrected, the incentive to rehabilitate older commercial buildings which Congress intended to provide through the recent enactment of Code Section 48(g) will be largely vitiated.

In conclusion, we support a rapid capital cost recovery period for all factory buildings and similar manufacturing facilities as an important ingredient to encouraging industrial growth and revitalization. Because we believe that limiting this incentive to owner-occupied facilities of this type is both unrelated to the purpose of the incentive and inequitable to owner-lessors, we propose that owner-lessors of such facilities be accorded the same treatment. We also believe that under current conditions, the production of new multi-family rental housing requires greater incentives than are provided by the Administration's proposal. We are not of the view that other types of real property require additional special tax incentives. Nevertheless, in the interests of simplicity and clarity and to facilitate tax administration, we propose that all other depreciable realty be designated as a unified category for capital cost recovery purposes, and assigned a single fixed recovery period.

In all cases we feel that preservation of the existing depreciation recapture rules of Section 1250 is imperative to preserve a viable market for investment real estate.

* * *

Senator DURENBERGER. Our next panel consists of Thomas W. White, executive vice president, Council of State Housing Agencies; Ms. Cushing N. Dolbeare, president, National Low Income Housing Coalition; and Stephen B. Smith, president, Investment Group, Inc., chairman of the Syndication Committee and member of the board of directors of NLHA on behalf of the National Leased Housing Association and the Coalition for Low and Moderate Income Housing.

Well, thank you all for agreeing to testify today.

We will begin with Mr. White, first.

You may proceed.

STATEMENTS OF THOMAS W. WHITE, EXECUTIVE VICE PRESIDENT, COUNCIL OF STATE HOUSING AGENCIES; MS. CUSHING N. DOLBEARE, PRESIDENT, NATIONAL LOW INCOME HOUSING COALITION, AND STEPHEN B. SMITH, PRESIDENT, INVESTMENT GROUP, INC.

Mr. WHITE. Thank you, Mr. Chairman.

It is a tough act to follow here. I see we have lost most of our audience on both sides.

My name is Tom White. I am submitting written testimony for Greg Smith, administrator of the Oregon Housing Division. I would respectfully request that the testimony be published as a part of these hearings.

Senator DURENBERGER. Without objection, so ordered.

Mr. WHITE. With that understanding, I will proceed to summarize that testimony, stressing what I believe to be the immediate urgency of our message.

Senator, I know you are familiar with the workings of State housing agencies, but in effect, State agencies function as a bank for low- and moderate-income housing. They were created to serve those who were priced out of the private market.

State housing agencies work through the private, tax exempt market by providing funds to private industry for funding multifamily projects or they offer mortgage financing for low- and moderate-income families.

Although independent of HUD, State agencies also work with Federal subsidy programs. For example, States have financed about one-third of the section 8 housing starts since that program began.

States have very active staffs in our ongoing institutions committed to the long-term interests in housing.

We believe that there is a crisis upon us in maintaining the ability of this country to shelter low- and moderate-income people in homeownership or rental housing.

I think that the testimony taken earlier certainly indicated a dramatic problem and that was with housing in general. When we get down to speaking specifically of low- and moderate-income folks, we discover the problem is even deeper.

I think one thing they did have in common was that they did mention that low- and moderate-income housing even needs additional help over that which we allow for the normal real estate industry.

Quickly, I want to mention two points.

The first point is that the Mortgage Revenue Bond Act of last year has resulted in a situation where no single-family issues have been sold under the restrictions of that new law this year, because of the complexities and restrictiveness of that legislation.

Additionally, with the reduction in section 8 subsidies, as passed by the budget conferees, last week, we see additional trouble in funding multifamily and single—multifamily housing with Federal, direct assistance.

Thus, the work you are doing right now on tax depreciation is all the more important if we are going to provide any kind of housing stock for low- and moderate-rental housing.

The bottom line today in housing, in general, is that the industry has been decimated. Unemployment is very high, in fact, unemployment in the housing industry exceeds that of the automobile industry, where we have just seen the administration work to accomplish a special treatment in the import situation.

What we are suggesting is that anything we can do right now in housing will be of immediate benefit in terms of the cash flow to the Federal Government, because it will put people back to work and paying taxes, rather than burdening the Federal rolls, whether they be on unemployment or on some other kind of social welfare program.

We would suggest that you immediately consider the recommendations in our written testimony to revise the Mortgage Revenue Bond Act and make it workable.

We believe that this can be done simply. It doesn't involve a dramatic rewriting of the act, and it can be done without any additional Federal cost.

The Federal budget this year assumes that the Mortgage Revenue Bond Act is workable. Thus, any tax expenditure has already been considered as a part of the budget, and you are in, I believe, the enviable position in these days of cutbacks, of being able to make some changes which would have immediate benefit to the housing industry, without having to have any cost impact.

Additionally, in the field of depreciation for multifamily housing, low- and moderate-income housing needs a privileged position, if you please, over other real estate investment. Without that privileged position, with its limitations on profitability, low- and moderate-income housing will not attract investment capital.

As you consider changes to the President's tax package, we urge you to consider giving a preference to low- and moderate-income housing.

In summary, you have a unique opportunity in this year of reductions, to make workable a program that has already been considered in the budget, and to amend the tax proposal to allow for the workability of future rental housing programs, without great costs.

We urge you to do so. Thank you for your consideration.

Senator DURENBERGER. Thank you. Your full statement, without objection, will be made a part of the record.

Ms. Dolbeare.

Ms. DOLBEARE. Thank you, Senator. With your permission, I would like to summarize my statement, and also, if I may, request the inclusion in the record of some additional material.

This is the first time our organization has testified before this committee. I would like to include a list of our board of directors.

I would also like, if I may, to include a letter from Cleveland Mayor George Voinovich, to HUD Secretary Pierce, on the general subject of homeowner deductions, and editorials from the New York Times, and two articles by one of our members, Dr. Goetze, that deal with this subject.

Senator DURENBERGER. Without objection, your full statement and any attachments that you want to make will be made part of the record.

Ms. DOLBEARE. Thank you very much.

We are concerned with three aspects of the President's economic recovery program as it affects housing generally. Two aspects deal with what it does, and one with what it doesn't.

The program makes a one-third cut in assisted housing for low-income people and that cut is already in place, with the completion of the action on the budget resolution. It deals with depreciation and rental housing in a way in which we all heard this afternoon, is not going to help.

It does not do one thing which we think should be done, and should be done now by this committee. It does not deal with the unconstrained growth of homeowner deductions that are not only adding greatly to the Federal budget, but are having extremely negative impacts in housing itself.

I should say we are strongly in favor of homeownership. The coalition has tried for years to get better homeownership programs for very low-income people. We think that homeownership can stand on its own merits, and does not need special subsidies through the tax system.

Page 2 of my testimony contains a chart which indicates the overwhelming growth of the gap in affordable rental housing for very low-income households, from no gap at all, in 1970, for households with incomes below $5,000, to a situation today where we have three times as many low-income households as we do rental housing units that are affordable.

Tax expenditures are far more important than direct expenditures in dealing with housing. My testimony contains two tables which outline those housing-related tax expenditures.

By far, the bulk of those tax expenditures are homeowner deductions. They constitute 90 percent of all housing-related tax deductions, and by far the largest homeowner deductions are those for mortgage interest and property tax.

Those tax preferences create inequities in the tax system and are inefficient as a subsidy mechanism. A paper for the Brookings Institution, by William Helmuth, for example, notes that they create horizontal inequities by providing tax savings for homeowners over tenants with comparable incomes, and differential savings between different homeowners with comparable income.

They cause vertical inequities, because the higher your income the greater your benefit. In fact, households with incomes over $50,000, receive more Federal housing expenditures, if you include tax expenditures, as households with incomes below $5,000. Households with incomes over $50,000 get almost twice as much through tax expenditures as those below $5,000 receive through the subsidized housing programs that we try to restrain the growth of because we think they have high costs.

The homeowner tax deductions interfere with the allocation of resources between residential construction and other uses of resources and distort the housing market.

There is a chart, on page 6, of my statement, which indicates on the lower line, is the growth of housing payments. [Indicating.]

This was the budget submitted by Jimmy Carter, projected through 1986.

This upper line is the projection of the cost of homeowner deductions for that same period. [Indicating.]

The increase in homeowner deductions in any given year over this period is greater than the total cost of providing housing assistance through the array of low- and moderate-income housing programs, conducted by HUD and the Farmer's Home Administration.

These homeowner tax preferences weren't planned, they just grew. They arise out of a definition of income that was adopted in an emergency tax package in the Civil War that hasn't been revised since.

Only 40 percent of homeowners take the deduction. The Federal Government—the tax preferences contribute to inflation in the housing market.

Their impact on rental housing is devastating.

I would postulate that it is not so much the absence of the tax provisions that the preceding panel was talking about, as the presence of homeowner deductions that is at the real root of the problem in rental housing.

If your rent is $500 a month, and your income is $25,000 a year, which is about a 25-percent rent income ratio, at the lowest conceivable marginal tax rate you would be likely to have, you would have to earn $650 to pay that $500 rent; whereas, if you were putting that same amount in homeownership, you would probably only have to earn about $300, because you would get the rest back.

Now, nobody is going to spend $600 for housing, if they can get equivalent or better housing for $300 a month.

We do not wish to see these deductions repealed immediately. We would have to substitute another subsidy system if we did. We would like to see them converted into a tax credit so that 100 percent of homeowners could benefit. That would be more equitable than the present 40 percent. Alternatively, they could be phased out, say, in a 20-year period.

But we believe that it would be irresponsible not to address this major source of problems in housing and inequity in the tax system as part of any revision of the Internal Revenue Code.

Senator DURENBERGER. Thank you very much for your presentation.

Stephen Smith.

Mr. SMITH. Thank you, Mr. Chairman.

My name is Stephen B. Smith. I am here today to present the views of the National Leased Housing Association with respect to President Reagan's economic program and other related matters which the committee is considering.

I am accompanied today by our counsel, Herbert Stevens, of the firm of Lane & Edson, here in Washington.

National Leased Housing Association represents over 700 companies, individuals, and organizations engaged in all facets of the Government-assisted housing programs, public housing authorities, State finance housing agencies, private developers, nonprofit organizations, investment bankers, and concerned professionals.

I am also speaking here today on behalf of the Coalition for Low and Moderate Income Housing. This coalition was organized in 1975 to bring together all associations, trade groups, business organizations, and individuals who are interested principally in tax and securities issues associated with Government-assisted low- and moderate income housing.

Production of section 8 and other low- and moderate-income housing requires three essential ingredients, in our view.

First, Government rent subsidies.

Second, mortgage money at reasonable interest rates.

Third, equity money from private investors.

The President's budget proposals would greatly reduce the amount of rent subsidy funds available for the section 8 housing program.

This comes at a time when multifamily housing production is at least 50 percent below our national need.

Mortgage money, at reasonable interest rates is available primarily through the Ginnie Mae-Fannie Mae tandem programs, the tax exempt bond financing programs of the various State housing agencies and the section 11(b) bond program.

For reasons too extensive to dwell on here, all of these sources are presently in grave danger. Thus, the production of section 8 and other low- and other moderate-income housing already has two strikes against it.

President Reagan's tax proposal, by reducing the amount of equity capital available for low- and moderate-income housing, would be strike three.

The present fallacy under the President's tax proposal are the tax laws that favor industrial and commercial buildings over residential housing in general, and over low- and moderate-income housing in particular.

Under the present tax law, low- and moderate-income housing has several tax advantages over other types of real estate. It may elect to use any of the most favorable accelerated depreciation rates, for example, double declining balance in some of the year's digits. It may at least through 1981, take a current deduction for construction period interest and taxes, and is benefited by favorable recapture rules.

Under President Reagan's proposal, low- and moderate-income housing would be entitled to an 18-year, straight line depreciation rate, phasing down to 15 years, by 1983.

In the meantime, industrial and commercial real estate would be entitled to a 15-year, straight line rate of depreciation immediately.

But even after the phase in period, placing section 8 and other low-income housing on a par for depreciation purposes, with industrial and commercial real estate, actually results in putting it at a great disadvantage since such housing is subject to many restrictions such as Government limitations on the rate of cash return to investors and on the right to resell.

In some cases, federally imposed rent controls may also be applicable.

There are, of course, no such restrictions on hotels, office buildings, shopping centers.

In addition, section 8 housing is often risky, either because of its location or its tenant mix, or both, a problem not usually inherent in other types of real estate.

Don't forget the Government redtape that is involved in section 8 housing production.

Fortunately, however, the defects of the President's proposal can be cured. We believe that a few changes in the President's proposal can remedy this problem.

We support the President's proposal insofar as it provides for shorter auditproof, recovery lives for real estate.

This will result in much time being devoted to useful housing production rather than to tax disputes as of the present time.

We believe that without any phase-in period, all residential housing, including low- and moderate-income housing, should be given the same 15-year useful life of commercial and industrial real estate is to have under the President's proposal.

But, in order to maintain the tax incentives necessary to encourage private investors to provide equity capital for low- and moderate-income housing, we strongly urge, this is the heart of our proposal, that low- and moderate-income housing be permitted to continue, as under present law, to use any of the accelerated depreciation methods under 167(b) of the code, and that any excess depreciation arising from the use of accelerated depreciation no longer be considered a tax preference item.

Continuation of accelerated depreciation and elimination of excess depreciation as a tax preference item, are central to our proposal. Without these even a shorter useful life would not be a sufficient incentive to investors

We also recommend that the exemption for low-income housing, under section 189 should be continued indefinitely for low- and moderate-income housing. The exemption is due to expire at the end of this year, as you know. It is essential that Congress act now to make this portion of section 189 permanent.

We support all of the other technical proposals set forth in the written testimony of Mr. William J. Langelier on behalf of the Coalition for Low and Moderate Income Housing which has also submitted, but which are too extensive for me to discuss at this time.

With these changes, Mr. Chairman, we believe that the President's economic program can go forward without material injury, at least insofar as equity capital is concerned, to a section 8 housing program, and the Nation's other low- and moderate-income housing programs.

Thank you very much.

Senator DURENBERGER. Thank you for your testimony.

Your full statement, without objection, will be made a part of the record.

Mr. SMITH. Right.

Senator Durenberger. I guess it is pretty clear this afternoon, we are hearing there are some inequities built into the administration's recommendations relative to accelerated depreciation.

I have ~~often~~ felt, and I guess I have said publicly that 10-5-3, in the old days, was the least objectionable of so-called tax reforms, and besides, it fit on a button, and it fit into a campaign promise, and now it has become a political reality. I personally think that these kinds of discussions today are going to be helpful to the committee relative to determining what policy decisions are most appropriate to provide incentives for investment in shelter, in America.

I have heard some testimony about equity with commercial investments; that is, equity between housing and commercial investments.

I have heard from this panel, a suggestion that in addition to that particular equity, there be either greater equity or at least a break in the direction of low and moderate income.

I wondered, after I listened to the other panels, if it wasn't more appropriate to raise the question as to how much accelerated depreciation is necessary for commercial investment. Whether or not we ought to start with putting more of the depreciation in the area of housing, and perhaps look at some of our more depressed commercial or industrial ventures in this country, to determine what appropriate policies are needed for them before we get into a big rush to apply the concepts of 10-5-3 or some variation for everyone across-the-board.

But, my question is whether or not it isn't the most appropriate recommendation that housing receive even more of a break in our recommendations on accelerated depreciation than other commercial ventures.

Mr. Smith, you might comment on that, or anybody.

Mr. Smith. I would certainly agree with that, Senator, that it is really the heart of our proposal that subsidized housing in particular, must have a differential treatment under the tax code, as it does today, in order to attract equity capital.

If other forms of real estate, office buildings, shopping centers and so forth are at parity with housing, the equity capital will simply not go into housing, as was discussed by the earlier panel. They are a greater risk, there are greater problem associated with housing that are just not inherent in these other types of real estate.

I think it is also important to note that low- and moderate-income housing has even further disadvantages or disincentives to investment with respect to even other types of housing that also have to be recognized in the tax code as they are today, under section 189 and under the recapture provisions of the code.

Senator Durenberger. That was going to be my next question. If we dealt with our basic life issue equally under accelerated depreciation, on all kinds of housing, then there are some other parts of it though in which we ought to reflect the problems of the disincentives you are talking about with regard to moderate and low income.

Mr. SMITH. I am not as concerned about where or how—what mechanism we use to create this differential treatment, as I am by just insuring that the differential treatment is in the code.

I think there are a number of ways that would work equally well. What we have proposed is using essentially 15 years straight line depreciation for all real estate, but giving low- and moderate-income housing accelerated depreciation with the same 15-year life. That provides a differential. There are a number of other ways of doing the same thing. I think the differential is the key point. The mechanism I think is less important.

Senator DURENBERGER. Any other comments?

Mr. WHITE. I would just concur with that.

Senator DURENBERGER. Senator Grassley.

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

Senator DURENBERGER. Thank you very much. Unfortunately, we are pressed for time. I will apologize to each of you. There may be questions members of this committee will have from time to time. They will submit those to you.

We appreciate the time and effort that went into this presentation.

Thank you very much.

[Statements follow:]

National
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Hon. Edward W. Brooke, *Chairperson* Cushing N. Dolbeare, *President*

May 18, 1981

THE NEED TO LIMIT HOMEOWNER DEDUCTIONS

Statement of Cushing N. Dolbeare, President, National Low Income Housing Coalition, before Committee on Finance, United States Senate, May 18, 1981

The National Low Income Housing Coalition greatly appreciates this opportunity to testify on the Administration's tax proposals as they relate to low income housing. The Coalition is a public interest organization with a broad and diverse membership, including individuals and organizations from all 50 states, as well as a range of national organizations. As our name implies, we deal with the housing needs of low income people -- people who are unable to obtain decent housing at costs they can afford.

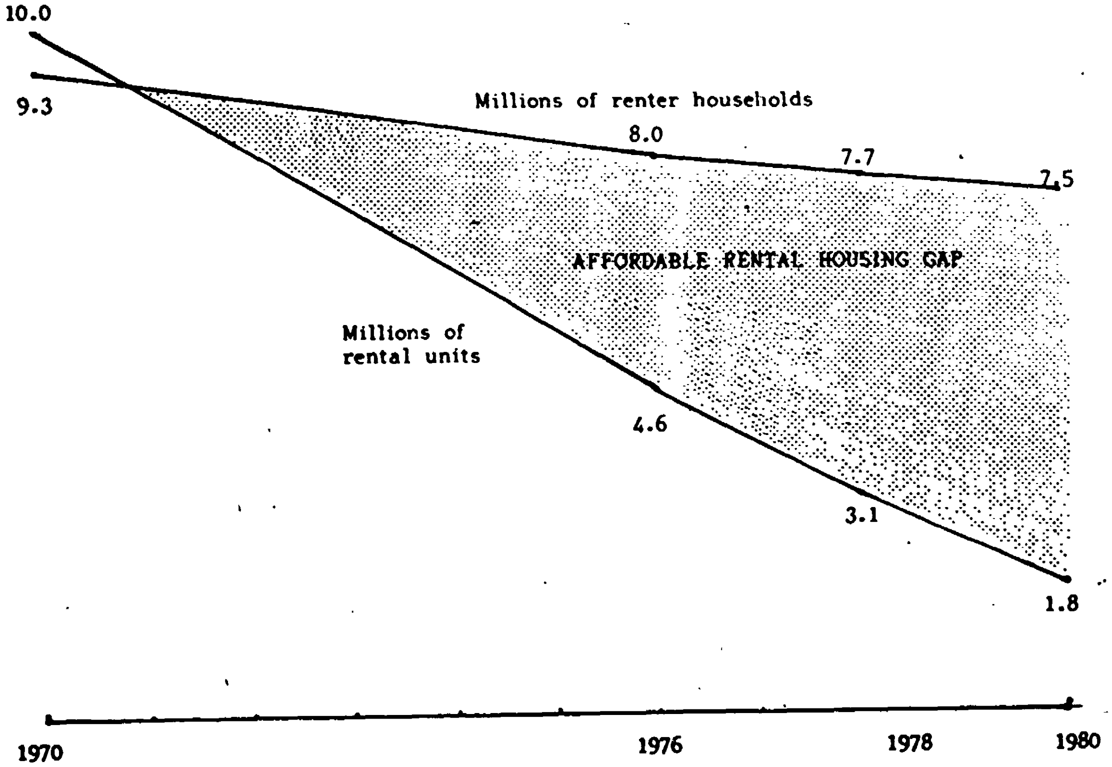
The Coalition is concerned both at what the Administration's Economic Recovery Program does with respect to low income housing, and with what it fails to do. While making a one-third cut in the level of housing assistance for lower-income people and changing depreciation rules so as to curtail rental housing production, the Administration leaves home owner deductions untouched. Yet these deductions, unless constrained, are not only inordinately costly, they are inflationary and they have pernicious effects on rental housing -- the chief source of housing for low and moderate income people.

The National Low Income Housing Coalition urges immediate action to limit homeowner deductions and convert them to tax credits. Doing this will reduce their costs, curb their most pernicious aspects, and benefit the majority of home owners (who now do not take these deductions).

Low income housing needs are increasing

During the last decade, the housing needs of low income people grew at an accelerating rate. Low and moderate income people, with few exceptions, cannot become homeowners. Unless they were owners before their incomes fell, they are forced to rent. As the chart on housing need demonstrates, the supply of low rent housing has been declining at a rate of about 500,000 units annually. In 1970, there were 9.3 million renter households with incomes below $5,000. There were some 10 million rental units, most of them unsubsidized, that rented at $105 per month or less, which is what they could afford at 25 percent of income. By 1980, we estimate that the number of units renting at $105 per month or less had decreased to fewer than two million, almost all of them subsidized, while the number of very low income renter households had decreased far less: to an estimated 7.5 million. Thus, there was an affordable housing "gap" of over five million units. This analysis understates the problem, because it ignores the important factors of location, availability, and quality.

RENTER HOUSEHOLDS WITH INCOMES BELOW $5,000 AND AFFORDABLE RENTAL UNITS AT 25% RENT-INCOME RATIO, 1970, 1976, 1978 (ACTUAL), AND 1980 ESTIMATE.



Source: Annual Housing Survey, 1976 and 1978

Tax expenditures are far more important than direct expenditures in dealing with housing.

The primary focus of attention in limiting federal housing expenditures has been placed on programs serving people who can least afford housing: low and moderate income people living in housing subsidized through programs of the Department of Housing and Urban Development or the Farmers Home Administration. These programs have been declining: each year since 1976, fewer assisted units have been provided. Even President Carter's budget request for 1982 called for fewer than half the units actually funded in 1976. A primary reason for this decline, in the face of rising need, is cost. Yet the cost of these programs is dwarfed by federal tax expenditures for housing, primarily homeowner deductions.

Measured in dollar outlays, the Treasury Department has estimated that tax expenditures related to housing account for more than 80% of total housing costs. Moreover, tax expenditures are rising dramatically. The Treasury estimates them at $28.8 billion in 1980, $35.3 billion in 1981 and $44.1 billion in 1982. Meanwhile, direct outlays for housing assistance were estimated at only $6.1 billion in 1980, $7.4 billion in 1981, and $9.0 billion in 1982. Over 99% of housing expenditures for home owners are tax expenditures. For rental housing, however -- the place where both direct and tax expenditures are being cut in the Economic Recovery Program -- tax expenditures are between one quarter and one fifth of total outlays. (Special Analysis G: Budget for Fiscal Year 1982.) The Treasury table follows:

Housing Tax Expenditures and Budget Outlays
(in millions of dollars)

Description	Fiscal year		
	1980	1981	1982
Housing:			
Owner-occupied housing:			
Tax expenditures (outlay equivalent)	26,840	33,170	41,655
Outlays	115	150	310
Total	26,955	33,320	41,965
Tax expenditures as a percent of total	99.6	99.6	99.3
Rental housing:			
Tax expenditures (outlay equivalent)	1,965	2,155	2,410
Outlays	6,025	7,280	8,680
Total	7,990	9,435	11,090
Tax expenditures as a percent of total	24.6	22.8	21.7
Total:			
Tax expenditures (outlay equivalent)	28,805	35,325	44,065
Outlays	6,140	7,430	8,990
Total	34,945	42,755	53,055
Tax expenditures as a percent of total	82.4	82.6	83.1

Table 1, on the next page, shows the amount and cost of the various housing-related tax expenditures for 1980-82. (These figures are lower than those just cited: they use the conventional definition of tax expenditure rather than "outlay equivalent," which is an adjusted figure.)

Table 1

HOUSING-RELATED TAX EXPENDITURES, 1980, 1981, and 1982
(Dollars in millions)

	1980	1981	1982	Change 1981-82	Percent Change
Home Owner Deductions					
Mortgage interest on owner-occupied homes	$15,615	$19,805	$25,295	+$5,490	+21.7%
Property tax on owner-occupied homes	7,310	8,915	10,920	+2,005	+22.5%
Subtotal (gross)	(22,925)	(28,720)	(36,215)	(+7,495)	(+26.1%)
Subtotal (net)	22,170	28,065	35,465	+7,400	+26.4%
Residential energy credits	485	540	615	+75	+13.9%
Deferral of capital gains on home sales	1,010	1,100	1,220	+120	+10.9%
Exclusion of capital gains on home sales	535	590	650	+60	+10.2%
TOTAL	24,200	30,295	37,950	+7,655	+20.2%
Investor Deductions					
Expensing of construction period interest and taxes	659	745	775	+30	+4.0%
Depreciation on rental housing in excess of straight line	385	410	430	+20	+4.9%
Five-year amortization for rental housing rehabilitation	15	25	35	+10	+40%
Exclusion of interest on state and local housing bonds	447	840	1,220	+380	+45.2%
TOTAL	1,506	2,020	2,460	+440	+21.8%
GRAND TOTAL	$25,706	$32,315	$40,410	+$8,095	+25.0%

Note: Tax expenditures are defined in the budget as "losses of tax revenue attributable to provisions of the Federal income tax laws that allow a special exclusion, exemption, or deduction from gross income or provide a special credit, preferential rate of tax, or a deferral of tax liability affecting individual or corporate income tax liabilities."

Source: Compiled by LIHIS from Special Analyses, Budget of the United States Government, 1982.

Home owner deductions, which are not dealt with in the Administration's proposals, constitute over 90% of all housing-related tax deductions. And by far the largest home-owner deductions are those for mortgage interest and property taxes. The contrast between the growth of these deductions and outlays for housing assistance is shown in our second chart (page 6). Moreover, these are conservative estimates. The rate of increase beyond 1982 is 18% annually. The Congressional Budget Office projects a much higher rate of increase, about 25%, for mortgage interest deductions between 1980 and 1982.

Costing less, but still significant, are provisions providing for deferral or exclusion of capital gains on home sales. Not estimated is a major tax benefit for home owners, the imputed income for rent on owner-occupied homes.

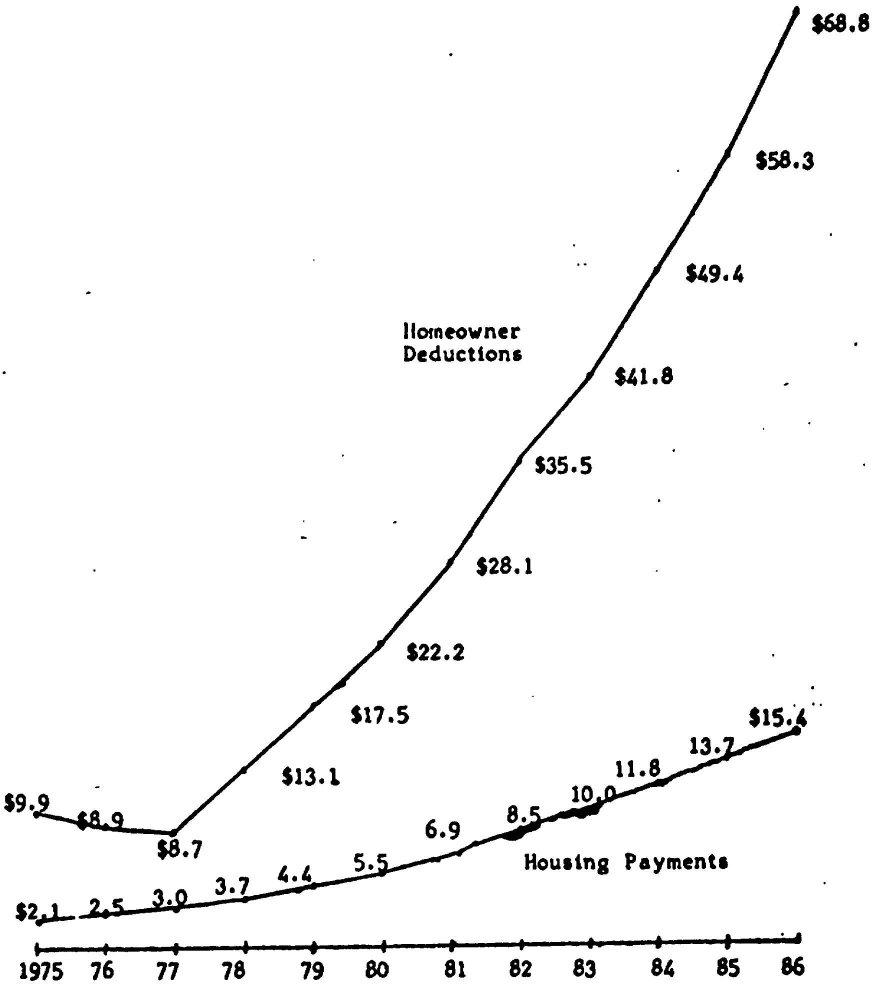
Homeowner tax preferences create inequities in the tax system and are inefficient as a subsidy mechanism.

William F. Hellmuth, in a paper prepared for a Brookings Institution conference, has commented on the effects of homeowner tax preferences on the tax system and the economy, as follows:

> -- They create horizontal inequities in the income tax system in that they provide tax savings for homeowners over tenants with comparable incomes, and differential savings between different homeowners with comparable incomes.
>
> -- The cause vertical inequities in the tax system. Since homeownership rises with income, the values of homes purchased increase as a proportion of income as incomes rise (that is, are income elastic), and the value of homeowner preferences is directly related to the marginal tax rate of the homeowner, high-income recipients benefit more from these preferences than do low-income recipients.
>
> -- They interfere with the allocation of resources between residential construction and other uses of resources. The tax expenditures favoring homeowners lower the cost of housing services and increase the after-tax rate of return on investment in homes, relative to other choices that consumers and individual investors have for the use of their funds. Tax incentives thus draw more resources into housing than would occur in the absence of such preferences.
>
> -- They also distort the housing market choices in favor of residential construction suitable for homeowners, creating a demand for more single-family homes and apartments for purchase than for rental units.....
>
> Further, these homeowner tax preferences are relatively inefficient and expensive if they are considered as incentives to promote homeownership and the construction of more homes. The incentives are most valuable to those with higher marginal tax rates, the income class that would find it easiest to buy homes in the absence

HOMEOWNER DEDUCTIONS AND HOUSING PAYMENTS, 1975 THROUGH 1986

Amount of assisted housing payments (housing subfunction of function 600) in billions of dollars, compared with estimated cost of homeowner mortgage interest and property tax deduction, also in billions. (Source: Relevant volumes of Budget of the United States and Special Analyses, with homeowner deductions projected beyond 1982 at rate of 18% per year.)



> of tax incentives. And the incentives for homeownership are much weaker for families in the lower tax brackets whose income levels also make homeownership more difficult. Tax incentives are, of course, of no value to those whose income is so low that they pay no federal income tax. And to the extent that the tax preferences increase the demand for owner-occupied homes, the price of such dwelling units rises and puts them further beyond the reach of low- and modest-income persons. The greater value of these preferences for persons with high incomes and high marginal tax rates is likely to draw more resources into the construction of large and expensive homes; on the other hand, income-neutral incentives would be likely to result in more dwelling units to meet the housing needs of more people.
>
> William F. Hellmuth, "Homeowner Preferences," in Joseph A. Pechman, Comprehensive Income Taxation, Brookings Institution, 1977.

Homeowner tax preferences weren't planned, they just grew.

It might be assumed that the home owner preferences were a conscious policy decision, made after careful consideration of their impact and resting on the advantages of encouraging home ownership. This, however, is not the case. According to George Peterson of the Urban Institute:

> the laws establishing mortgage interest and property tax payments as allowable deductions from homeowner incomes were adopted by Congress during the Civil War, when the treatment of housing costs was debated briefly before passage of the emergency tax act which helped to finance the North's war effort. Since that time, the country has merely applied old definitions of taxable income in its successive income tax laws, despite a total transformation in the personal income tax system. The longstanding homeowner deductions did not take on true significance until World War II, when the marginal federal tax rate paid by most Americans was suddenly jumped from 4 percent to 25 percent, making the deductibility of homeowner expenses far more valuable than it previously had been, and in the process creating an important after-tax gap between homeownership and rental costs. (George Peterson, "Federal Tax Policy and Urban Development," Testimony before Subcommittee on the City of the House Banking Committee, June 16, 1977.

Most homeowners do not benefit from the deductions.

Peterson finds the growing importance of homeowner preferences a major cause of the increased rate of homeownership since 1950, particularly for middle and upper income families. But changes in tax laws have led to a "bracket creep" for homeowner deductions: they are concentrated increasingly at the upper end of the income distribution:

> Without much fanfare, however, recent tax changes have worked to diminish the tax benefits of owner occupancy by making it more

> attractive for taxpayers to claim the standard deduction. The proportion of taxpayers itemizing their returns — and thus gaining the full benefits of the tax advantages for homeownership — fell from 58 percent in 1969 to 31 percent in 1975. After the recent tax revision of 1977, further increasing the standard deduction, it is estimated that only 20-25 percent of taxpayers will itemize their returns in 1978. Ironically, the tax code then will be restricted primarily to subsidizing the housing costs of the affluent, encouraging them to consume more expensive and larger housing without greatly affecting homeownership rates over the rest of the income distribution. This shift in the tax structure will also make it more difficult to apply federal tax benefits to any but the most lavish condominiums, since most households with earnings of less than $24,000 to $26,000 will find it to their advantage to claim the standard deduction. (Ibid.)

The federal government spends less on housing for low and moderate income households than for upper income people.

In 1979, the most recent year for which figures were available, mortgage interest or property taxes were deducted from 25.6% of all returns filed. Peterson's prediction was correct: at least 95% of the value of the deductions was received by taxpayers with incomes above the median, and almost 60% went to taxpayers with incomes in the top 10% of the income distribution.

Thus, the notion that the homeowner deductions go largely to middle income families is wrong. Moreover, homeowner deductions are entitlements: they may be taken by all who qualify, regardless either of need or of the cost to the federal government. In contrast, only one household in ten who qualifies for and needs low income housing assistance actually receives it.

Indeed, the pattern of housing assistance provided by the federal government is so inequitable that, were we to start fresh with a clean slate in designing housing assistance programs, and propose a pattern of entitlements, benefits, and assistance that is equivalent to what is now in place today, not only would it fail to pass the Congress, but it is doubtful if anyone could be found who would introduce it.

Benefits from federal housing programs are so skewed that the total of all the assisted housing payments ever made under all HUD assisted housing programs, from the inception of public housing in 1937 through 1980, was less than the cost to the federal government of housing-related tax expenditures in 1980 alone. Assuming that the beneficiaries of direct and tax expenditures are arrayed, by income group, as they were in 1977, the latest year for which such an analysis is available, we would find that, for 1980:

- $4.2 billion, or 14.1%, of all direct and indirect housing expenditures went to people at the bottom of the income scale,

Table A-2

Revenue Cost of Allowing Homeowners' Deductions for Mortgage Interest and Real Estate Taxes

(1979 Law, 1979 Levels)

Expanded income class	Returns with tax savings: Number of returns	Returns with tax savings: Percent of all returns filed in class	Average tax savings (returns with savings)	Total revenue cost	Revenue cost as percent of total tax paid by members of class
($000)	(thousands)	(percent)	(dollars)	($ millions)	(percent)
Under 5	83	0.4%	$ 104	$ 9	1/
5 - 10	1,083	5.8	172	187	2.8%
10 - 15	2,553	17.6	254	649	3.7
15 - 20	3,955	33.3	331	1,310	5.4
20 - 30	8,153	51.7	536	4,369	8.3
30 - 50	5,924	73.9	1,023	6,058	11.9
50 - 100	1,658	82.9	2,048	3,395	11.0
100 and over	375	85.6	3,320	1,245	4.2
Total	23,785	25.6%	$ 724	$17,221	8.1%

Office of the Secretary of the Treasury
Office of Tax Analysis

Note: Details may not add to totals because of rounding.

1/ Total tax paid by members of this class is a negative amount.

Source: Reproduced from U.S. Department of Housing and Urban Development, 1980 Housing Production Report, Appendix A.

those with household incomes below $5,000. Only one household in eight received housing assistance, and the average monthly expenditure, per recipient, was $132.

- $7.5 billion, or 25.5%, of all direct and indirect housing expenditures went to people with incomes above $50,000. More than four fifths of all households in this income bracket received tax benefits, and the average monthly amount per recipient was $309.

- '$16.7 billion, or 56.4%% of all direct and indirect housing expenditures, went to people with incomes between $20,000 and $50,000. Two fifths of all households in this range received housing benefits and the average amount per recipient was $67 per month.

- Only $1.2 billion, or 4.0% of direct and indirect housing expenditures, went to households with incomes between $5,000 and $10,000. Fewer than one household in ten in this income range received housing benefits, and the average monthly amount, per recipient, was $60.

Homeowner tax preferences contribute to inflation in the housing market.

The tax system is a major factor in encouraging investment in housing. The tendency of people who are already adequately housed — indeed, generously housed by the standards that are applied to lower income people -- to purchase bigger and more expensive houses drives up prices. Indeed, the widespread tendency to purchase housing more as an investment than as a necessity has led George Sternlieb to coin the term "post-shelter" society.

In a curious symbiotic relationship, not only do homeowner tax preferences contribute to inflation in housing, but they also make it possible for home owners to benefit from inflation.

In the words of Anthony Downs of the Brookings Institution, "investment in housing has become far more than a strategy for 'keeping up' with inflation: it helps millions of households gain positive benefits from inflation." (Anthony Downs, "Are We Using Too Much Capital for Financing Housing?") Downs finds that the average house purchased with a 20 percent downpayment in 1976 had shown a 67.5% increase in initial equity by 1980. And, because the tax on capital gains from home ownership can be excluded or deferred, the profits are tax free.

The contrast with return from other types of investment is striking. Downs calculates, for example, that a $10,000 bond purchased in 1970 would have declined in real value by 53% by 1980. But, had the investment been made as a 20% down payment for a house costing $50,000 which increased in value at the national average rate, the gain over the decade would have been 891%. Small wonder that those who can afford to do so purchase their homes.

In addition, the costs of carrying a mortgage -- at least a conventional one -- decline with inflation. Since debt service often accounts for at least half the cost of living in a home, this means that real costs decline. And the deductability of mortgage interest means that after-tax rates of interest are considerably lower than nominal rates. Moreover, the reduction becomes larger as income rises. Thus, a purchaser with a 14% mortgage and taxable income of $12,000 actually pays 11% after taxes, but a purchaser with a $45,000 income pays 8% and one with a $60,000 income pays only 7%.

At these interest rates, there is a temptation to refinance and arbitrage the money by investing in other areas -- or simply to trade up and use part of the profits for personal consumption. According to the U.S. League of Savings Associations, more than four fifths of the people who sold their homes in 1979 did not use all their proceeds for reinvestment in another home. About one third shifted more than half their equity out of housing. The average seller took out about one third. Because of this, Downs suggests that we may be investing too much capital in financing housing and that "much of the increased flow of mortgage funds has gone into raising the prices of existing homes, or even into non-housing consumption, rather than into expanding the housing stock to meet valid social needs."

All of this, of course, makes it harder for households who are left behind: young families and low income families, who need housing for shelter.

The impact on rental housing

The economic advantages of home ownership, fueled by tax preferences, are at the root of a crisis in rental housing production. With inflation, rents in unsubsidized new units have risen to unprecedented levels: $500 monthly or more. At $500, a rent-income ratio of 25% would require an income of $24,000. Yet, only one renter household in twenty at that income level spends as much as 25% of income for rent, including utilities. Assuming a marginal tax rate of 30%, the renter would have to earn $650, before taxes, for each $500 rent check. Contrasting that with the advantages of home ownership means that, in fact, tenure choice is no more real at the upper end of the income scale than it is for lower income people. Small wonder that very little rental housing is now being produced, except with federal subsidy.

Anthony Downs describes the impact of this situation as follows:

> One of the main reasons why so few new unsubsidized rental units are being built is the immense attraction of homeownership. Most households who can afford to pay a significant amount each month for housing prefer to own their own units rather than rent. This extremely widespread preference springs partly from the great financial advantages of investment in homeownership described earlier.

> In the past, the overall supply of unsubsidized rental housing was constantly supplemented through new construction of apartments by private developers. Most new apartments had monthly rents that the majority of renting households could not afford. But as these new units aged, many "trickled down" through the income distribution, eventually becoming available to less affluent households. Thus, the willingness of some households to pay relatively high rents for new apartments helped keep the total supply of rental units expanding. It also helped up-grade the rental inventory as these new units replaced the oldest, most deteriorated units removed through demolition and fires.
>
> But when rapid inflation greatly magnified the financial advantages of homeownership in the late 1970s, fewer relatively affluent households were willing to rent. Why should they, when they could enjoy the benefits of owning instead? Hence, production of new unsubsidized rental apartments fell drastically in the late 1970s. This reduced the high-quality inputs into the rental inventory that had kept raising its average quality level. There is now a sizable chance that this quality level will begin deteriorating through overly-prolonged use of older units....
>
> Thus, the outstanding success of public policies designed to increase the attractiveness of homeownership, plus the impacts of inflation, have undermined the market for new rental housing....
>
> This process distorts the entire rental housing market by cutting down the supply of new rental units. That will in turn ultimately cause overly-intensive use of older existing units. This is one important way in which public policies that make homeownership "over-attractive" have negative impacts upon some groups in society, partly offsetting their positive impacts upon homeowners. (Downs, op. cit.)

Rather than inventing new ways of stimulating and subsidizing rental housing production for middle income families, as the House attempted to do last year, would it not make more sense to curb the excessive and costly homeowner preferences which have so inhibited rental housing production?

Tax preferences create condominium conversions.

A major factor in investment in rental housing is the availability of tax shelters. Indeed, for most investors these shelters, rather than anticipated cash flow, are key. The nature of the shelter, however, forces owners to sell after a holding period: the shelter diminishes; cash flow increases, but is not substantial enough to offset the shelter loss; and the recapture period ends. The process of investment and sale to another investor has been going on for years. But now, all too often, the sale is not to an investor in rental housing but to a condominium converter. The result: a diminution of rental housing, displacement, and rising housing costs.

The two sides of the internal revenue code come together here: not only do the incentives to invest in rental housing force its sale, but the homeowner preferences mean that there is a strong demand for converted units. This demand has strengthened as the cost of new single-family houses has risen and household size has declined, so that over half the households in the U.S. now consist of only one or two people. (For further information on the manner in which tax provisions affect condominium conversions, see E. Richard Bourdon, "Condominium Conversions: Possible Changes in Federal Tax Laws to Discourage Conversions and Assist Rental Housing," Congressional Research Service, Report No. 80-71 E, April 1980.)

For all of the above reasons, the unrestrained growth of homeowner deductions cannot be allowed to continue.

The National Low Income Housing Coalition does not advocate repeal of homeowner tax preferences. We do urge that the Congress act promptly, however, to impose some limits on them.

The Congressional Budget Office has suggested that a $5,000 cap on the mortgage interest deduction would save $4.3 billion in 1982 and $35.6 billion by 1986. Moreover, this change would affect only one taxpayer in twenty. Converting the deduction to a 25% tax credit would increase revenues by about $3.5 billion in 1982. Moreover, this approach would make the deduction less regressive.

If either of these steps were taken, the cuts imposed in lower income housing assistance programs could be restored and the programs expanded to a more adequate level without adding to the deficit.

The Urban Institute recently studied the impact of converting homeowner deductions to a 25% tax credit. The shift would cause highest income owners to lose both the price and income subsidies they now receive. They would have no real incentive to consume more housing, since this would increase their taxes. But middle and lower-middle income owners would have lower taxes and an incentive to consume more housing of higher value. New construction would be stimulated. This, in turn, would relieve some of the pressures on the lower end of the housing market, thus making the lot of low income households easier. (Michael W. Andreassi, C. Duncan MacRae, and David I. Rosenbaum, Metropolitan Housing and the Income Tax: Stack Algorithm Sensitivity Analysis, The Urban Institute, February 1980.)

Moreover, if a tax credit limited, say, to a maximum of $5,000, were introduced simultaneously with a cut in individual tax rates, it could be designed so as to have little or no adverse impact. It would increase the tax reductions given to low and middle income people, while the higher tax for a limited number of affluent people could be offset by the reduction in marginal tax rates. If necessary, a "hold harmless" provision could be introduced for the principal residence, until it is sold or the owner moves out.

The National Low Income Housing Coalition is convinced that justice and equity demand that low income people not be asked to bear the brunt of reducing federal housing expenditures. Moreover, a limit on homeowner deductions can again make production of unsubsidized rental housing financially feasible. And, given the other advantages and attractions of home ownership and the high rate of household formation, converting homeowner deductions to a tax credit need not have a negative impact on construction of single family housing for middle income people and younger families.

The challenge is here. The time to act is now.

PREPARED STATEMENT FOR

M. GREGG SMITH

COUNCIL OF STATE HOUSING AGENCIES

Before the

SENATE FINANCE COMMITTEE

May 18, 1981

Mr. Chairman, I am Gregg Smith, Administrator of the Oregon Housing Division. I am here today representing the Council of State Housing Agencies. The Council currently has 47 member State Housing Finance Agencies (HFAs) as well as 150 organizations affiliated with the Council, including builders, developers, and others involved with state housing finance agencies. I am accompanied today by Thomas W. White, Executive Vice President of the Council of State Housing Agencies.

Before proceeding, a brief overview of our testimony is appropriate. We will be addressing President Reagan's tax proposals and their impact on the housing industry. We will relate these proposals to the Mortgage Subsidy Bond Act of 1980 which reduced the flow of capital to low and moderate income housing, and to the President's 1982 budget request which reduces the availability of subsidy funds for low income housing programs.

The Role of State Housing Finance Agencies

Briefly, let me comment on the role of state housing finance agencies. State housing finance agencies are created by state enabling legislation to provide mortgage financing for persons and families of low and moderate income within their state. While the mix of loan programs varies from agency to agency, state agencies have provided financing for multi-family projects and single-family mortgages. The agencies finance their programs by selling tax-exempt notes and bonds in the national capital markets, and lending bond proceeds to developers or to low and moderate income families seeking home loans. As a rule, state agencies are self-supporting, raising the money they need from fees and charges associated with the loans.

Although independent of the U.S. Department of Housing and Urban Development, state agencies have financed and administered federal subsidy programs since the days of the Section 236 program, and more recently have been responsible for producing about one-third of all Section 8 low income housing starts since that program began.

In addition to these basic multi-family and single family programs, state agencies have been especially innovative in tailoring programs to meet the unique housing needs within their states. They have developed sophisticated home improvement loan programs, and are working actively in the area of energy conservation financing.

Tax Structure and the Housing Industry

Housing production in this country is primarily driven by tax policy and only incidentally by the federal direct subsidy programs. The Treasury Department as quoted by The Bureau of National Affairs on March 16, 1981, estimates that housing related tax expenditures, on an outlay equivalent basis, will amount to $35.325 billion in fiscal year 81, and $44 billion fiscal year 82. Direct outlays for those years are $7.43 billion and $8.99 billion respectively.

The foremost tax incentive is the homeowner exemption for interest and taxes. Benefits from this flow primarily to middle and higher income families. Indeed the tax code provides almost all the support for homeowners, $33.17 billion in tax expenditures to $150 million in direct outlays in fiscal 81, and $41.695 billon versus $310 million in fiscal 82.

For rental housing, and rental housing primarily serves those of low and moderate income, direct outlays exceed tax expenditures. For fiscal year 81, Treasury estimates the government will spend $7.280 billion on rental housing, compared with $2.155 billion through the tax code. For fiscal year 82, the figures are estimated at $8.68 billion and $2.410 billion respectively.

Our purpose today is not to debate the homeowner exemption. We are here to stress the need for change in the tax code to encourage investment in low and moderate income housing. For years, the weakness in the rental housing market has reduced the production of multi-family housing as cash income has not been able to keep up with the constantly rising costs of operating a housing development. In effect, inflation outruns the ability of low and moderate income people to afford market rents. The same is true for homeownership housing for low and moderate income families.

Low and Moderate Income Housing Need

A tremendous need exists for the production of affordable housing for low and moderate income people. We have documented this in Attachment #1. To illustrate this need consider:

- According to the U.S. General Accounting Office, the median income of renter households is nearly half that of owner households and nearly half of all renters are paying more than 25% of gross income to rent.

- Rental housing production (starts) dropped from 541,000 new units in 1979 to 397,000 units for 1980 of which 50% of the 1980 units were government subsidized.

- High rates of household formation among the baby boom cohort and a steadily growing elderly population will continue to create a large demand for additional housing units.

Low and Moderate Income Housing Capital Formation

Elements central to the production of low and moderate income housing which has been built over the past several years include: tax exempt financing to achieve lower interest rates for single family and multi-family housing; the syndication of the tax shelter benefits to achieve profit outside of regulated rents; and the funding of federally subsidized housing programs. We now see a three-fold attack on what little incentive has been available for producing housing for low income families.

Strike one: The Mortgage Subsidy Bond Act of 1980. Last year, Congress saw fit to limit the availability of tax exempt mortgage revenue bonds to a degree which we believe went far beyond reasonable controls. In fact, not a single bond issue has been able to come to market since the legislation became effective. The Council of State Housing Agencies supported legislation to curb abuses, but, we believe the legislation, adopted in the reconciliation process contains fatal and unintended flaws. To address these flaws, and to allow low and moderate income American families the same opportunity for tax advantages as taken by higher income families, we would recommend that the Ways and Means Committee adopt technical amendments to allow for the continuation of legitimate, public purpose homeownership and rental mortgage revenue bond programs. Without change, the lack of mortgage revenue bond financing will further exacerbate a yearly mortgage credit gap of nearly $30 billion in constant dollars.[1]

The legitimate public purpose served by these bonds have been demonstrated in the past. State agencies have used proceeds from such bonds to finance housing for lower income young families otherwise priced out of the market as well as for the elderly and the handicapped. Average incomes served were well below state wide median incomes. Many of the programs were also urban related and provided a needed impetus to the solution of urban problems. According to a 1979 survey the average sales price was $33,642, the average purchaser's income was $14,399 and the average mortgage amount was $30,583 (10 percent down payment).

Strike two: The President's budget package. In the recommended budget, we see accelerated reductions in the Section 8 subsidy program, particularily for new construction and substantial rehabilitation. The new budget submitted by the President contains a 20% reduction in subsidies for 1981, and a 33% reduction in 1982. The Senate Budget Committee has increased the cut in 1982 to 41%. This is the largest cut in any program. Although we favor the President's goals of curbing inflation and lowering interest rates and are willing to take our industry's fair share of the national belt-tightening effort, the latest cuts unfairly single out housing. Thus we see yet another avenue of relief for housing low and moderate families being severly curtailed. See Attachment #2.

[1] Dwight Jaffee and Kenneth Rosen, Demand and Production in the Housing Industry 1979-1988 (National Assocation of Home Builders, Washington, D.C. 1979).

Strike three: The President's tax package. We agree with the broad economic objectives of the President's tax package as the goal of lower taxes and the ultimate hope of reduced interest costs is shared by all. However, the fact that housing is no longer a priviledged competitor in the national credit market must be considered. Even if the overall economic program is successful, housing interest rates will not drop to the low levels which have been enjoyed for years and which have allowed most of our citizens to be the best housed in the world. Thus, even granting optimistic conclusions regarding interest rates, there will be additional families priced out of the housing market because of competition for capital.

We believe that care should be taken to insure housing is not overly penalized as we believe is now happening. The President's tax recommendations change depreciation schedules, and may severly impact on the rental housing industry by placing rental housing investment in a secondary position behind investment in commercial and retail real estate. We particularly emphasize the need for greater tax incentive for low and moderate income housing. There is enough trouble attracting equity capital to low income housing with its attendant risks.

For example:

- o According to a Joint Economic Committee report...sophisticated investors view the multi-family structure, except under unique circumstances and unique locations, as a relatively riskful non-inflation proof investment.

CSHA Recommendations

We all recognize the need for a reduction in inflation and the favorable impact that would have on interest rates and on the ability of people to own homes or to build apartments.

Overall, we believe that the combination of overly restrictive mortgage revenue bond legislation, the proposed reduction in the subsidized housing budget, and the secondary place for low and moderate income housing in the tax package, produces an unintended and unacceptable negative impact on housing for lower income persons. We believe this Committee can do something about the negative impact. Thus, we suggest that, at a minimum, the Committee immediately:

1. Amend last year's mortgage revenue bond act

   - to provide for technical amendments to enable bond issues to go forward

   - to redefine the 1% yield limitation so that issues can pay for themselves

   - to allow greater use for present homeowners who have not been so fortunate as to have had greatly appreciated properties. This could be done by definition or by a reduction in the 100% 3 year requirement

   - to allow greater use for rental housing. Last year's requirement that multi-family projects maintain 20% Section 8 or its equivalent for 20 years is a particular hardship with a reduced Section 8 program, and with more funds going to the 15 year moderate rehab Section 8 program. At a minimum, we suggest that state, local, federal projects designed for low and moderate income occupancy be eligible without the 20% requirement. There is presently a definition of low and moderate income projects in IRS Code 1250 which could be the basis for a definition for Mortgage Revenue Bonds.

These suggestions do not impact the budget but would ensure the workability of the Mortgage Revenue Bond Act. Any tax loss has been already considered as the program was assumed to be workable.

2. Amend the President's tax proposal

   - to achieve parity for residential rental housing with office and commerical rental space

   - to recognize the special need for tax advantages for low and moderate income rental housing

   - to provide for fifteen year depreciation for all residential housing, with provision for twelve year accelerated depreciation for low and moderate income housing

   - to allow for the rapid write-off of construction interest, and the continuation of favorable recapture rules, for low and moderate income housing

This can be done at no budgetary cost as economic benefits from construction will offset the tax loss.

We sincerely hope the Committee will consider as a package the various elements impacting on housing contained in the President's budget and tax proposals and that you will give serious consideration to our recommendations on low and moderate income housing.

Attachment 1

NOTES ON HOUSING NEED

- High rates of household formation among the baby boom cohort and a steadily growing elderly population will contribute to a large demand for additional housing units.
- To meet demand, rental unit production must average between 500,000 to 600,000 units, for the next five years; of that total the subsidized housing sector must contribute 250,000 to 300,000 units per year to house those who can not afford adequate housing at market rates.
- According to the U.S. General Accounting Office, the median income of renter households is nearly half that of owner households and nearly half of all renters are paying more than 25% of gross income to rent.
- The National Low Income Housing Coalition states that in 1977 (most current available data) there were 4.6 million renters who paid more than 50% of their earnings for shelter and some 4 million who were forced to reside in physically inadequate units.
- According to the U.S. General Accounting Office, the approximately 2.5 million units of Section 8 and public housing provided to date will still leave over 12 million eligible lower income households without assistance.
- Rental housing production dropped from 541,000 new units in 1979 to 397,000 units for 1980 of which 50% of the 1980 units were government subsidized.
- According to a Joint Economic Committee report....sophisticated investors view the multi-family structure, except under circumstances and unique locations, as a relatively riskful non-inflation proof investment.
- Both rental and ownership costs will continue to rise through the eighties. New mortgage financing techniques and double wage earner housholds will keep home ownership within reach of many middle income households. However, most moderate and all low income households will be priced out of the market. Rents in many areas already have risen to the limits of tenants' capacity to pay; rising operating and maintenance costs will spur the depletion of the existing rental stock and discourage conventional new construction.

Attachment 2

ATTRITION IN SECTION 8 PROGRAM

Since 1976 the Section 8 program has been reduced from 516,721 units to 175,000. The following table illustrates the attrition of publicly assisted housing units over the past 5 years.

Year	Section 8 Units Reserved
1976	516,721
1977	388,413
1978	326,026
1979	325,075
1980	205,892
*1981	210,000
*1982	175,000

*Estimated

ATTACHMENT 3

ADMINISTRATION'S TAX PROPOSAL AND IMPACT ON HOUSING INDUSTRY

The Administration is proposing an 18 year straight line depreciation schedule for residential rental property other than low income and a fifteen year straight line rate for low income housing and all other real estate (other than owner occupied property). All other real estate includes hotels, shopping centers and office buildings.

Although the residential schedule may be somewhat more favorable than present law, this program will have a negative impact for low income housing because it establishes depreciation schedules favoring non-residential structures over rental housing structures. Funds therefore will shift away from housing for the poor and elderly. Further exacerbating this situation is the fact that Section 189 which allows low and moderate income housing favorable treatment on construction interest, expires in 1981.

The program provides many disincentives for investing in housing, namely:

- investors will continue to look for investments which produce significant cash flow and under this proposal they will invest primarily in office buildings, hotels and shopping malls.
- Low income housing is restricted as to the rate of cash return to investors and Section 8 housing is prohibited from resale for at least 20 years. There are no such restrictions on hotels, shopping malls or office buildings.
- Low income housing is a riskier investment due to both the amount of government red tape and regulation and the potential for rent control.

- According to a Joint Economic Committee report, sophisticated investors view the multi-family structure as a relatively risky non-inflation proof investment.

- According to the National Association of Realtors evaluation of the President's proposal, "a building made out of the same materials and having the same economic life could be at least fifteen percent less costly for the commercial and industrial user than for individuals providing rental housing." This means an opportunity for greater profit.

- The NAR further states, "the President's program during the next four years would likely cause 125,000 fewer homes to be built."

- By inadequately stimulating housing, the proposal will cause higher housing prices and stimulate inflation

- Should tax shelter value decrease in relation to other investments, developers would earn little or no profit, eliminating the incentive to produce low and moderate income housing.

We recommend amending the Proposal to:

1. Establish a fifteen year depreciation schedule for all residential real estate other than low income.

2. Establish a twelve year accelerated depreciation schedule for low and moderate income housing.

3. To allow for the rapid write-off of construction interest, and the continuation of favorable recapture rules, for low and moderate income housing. "The limitations currently imposed upon non-corporate taxpayers with respect to deductions for real estate construction period interest and taxes should be repealed (I.R.C.Section 189). These limitations, originally enacted in 1976, but providing for an extensive phase-in period, are exerting an increasingly depressing effect upon new real estate construction, and will, if not repealed, exert an even greater depressing effect on future construction activity. Since these limitations do not apply to corporate taxpayers, or to any taxpayers engaged in activities

other than real estate construction, they are not only unwise and unnecessary, but also discriminatory."

4. Extend indefinitely the provision of the Internal Revenue Code (Section 167 (k)) which provides for sixty-month amortization of expenditures to rehabilitate low and moderate income housing which is scheduled to expire on December 31, 1983. In addition, inflation must be taken into account. The minimum and maximum amounts allowed per dwelling unit should be increased from $3,000 to $5,000 and $20,000 to $30,000, respectively.

5. Amend Section 195 (d) to ensure that the beginning of business in connection with real estate construction or rehab occurs on the date which construction actually begins rather than when occupancy occurs. This position has, in fact, been upheld in court.

6. Amend Section 57(a) to equalize the tax preference arising under Section 167 (k) and Section 191 for new construction. This revision would serve to eliminate one of the Code's present biases against rehabilitation and historic preservation.

Most of these provisions have been incorporated into companion bills introduced recently in the House by Congressman Patterson and Blanchard (HR 2053) and in the Senate by Senator Williams and Cranston (S. 444). We support the legislation for providing the necessary construction and rehab incentives for real estate. We hope the Committee will carefully consider and support this legislation.

7. Amend the Crude Oil Windfall Profits Tax Act of 1980 to remove the prohibition against a property owner benefiting from both a tax exempt loan and an energy tax credit. Tax exempt loan programs make it possible for low and moderate income families to borrow at reasonable rates, and there has been no demonstrated abuse from the "double dip" of the loan and the credit.

NATIONAL LOW INCOME HOUSING COALITION
215 Eighth Street, Northeast
Washington, DC 20002

January, 1981

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City of Cleveland
GEORGE V VOINOVICH, MAYOR

February 28, 1981

The Honorable Samuel Pierce
Secretary of the Department of
Housing and Urban Development
Washington, D.C.

Dear Secretary Pierce,

During our meeting yesterday, you expressed interest in having more information about my proposal to reduce the homownership tax subsidy to upper income households. I am writing to provide you, quickly and briefly, (1) a sketch of the current situation, (2) the reasons why this situation is unsatisfactory, and (3) the essence of my proposal.

I have also asked the NLC staff, William Barnes, to send to you next week additional background material on this topic, which I hope you and your staff will find useful.

I want to make clear that NLC policy does not now endorse the recommendation that I am offering. The issue is, however, before the League's Community and Economic Development Committee, of which I am Vice-Chairman, and I and others will work to obtain the support of our colleagues for what we regard as a very significant and reasonable proposal.

1) The Situation. Federal housing expenditures (adding together direct and tax expenditures) are something over $30 billion, of which homeownership deductions (primarily for mortgage interest and property tax) were about $22.2 billion in 1980. One estimate shows the following about the distribution, by income group, of these Federal subsidies:

Taxpayers by Income Group	% of Population	% of Subsidies
$ 0 - 5,000	22	14
5 - 10,000	20	4
10 - 20,000	29	11
20 - 50,000	26	46
over - 50,000	3	25
	100%	100%

The benefits of direct housing programs are almost wholly targeted to the two lowest income categories; the benefits to the two highest income categories come solely from tax expenditures.

Thus, the 3% of the population with the highest income (250% and more of the median) receive 25%, about $7.5 billion, of these housing benefits. The 29% of the population with the highest incomes (from approximately the median and up) receive 71%. If, as one wry observer noted, an Administration were going to propose a comprehansive set of housing programs, the distribution of its benefits would certainly not look anything like this.

Another rather notable calculation is that the homeownership deductions in 1979 alone exceeded the total of all direct HUD housing program expenditures for all years up to and including 1979.

2) Why this situation is unsatisfactory. I will not offer a detailed analysis here, but I do want to outline a number of reasons why the allocation of these (disproportionate) Federal housing subsidies to the highest income groups should be altered. The items that Mr. Barnes will send you next week will offer much more detail and analysis than I can here.

- First, distribution of Federal housing benefits is not equitable. I think this is clear and unarguable. The mortgage interest deduction is steeply regressive -- the higher your tax bracket, the more valuable is the deduction to you.
- Second, these massive tax expenditures for upper income people are not needed to ensure that those people can obtain "decent, safe and sanitary housing". Even if promoting homeownership, without regard to income, is taken to be a legitimate and desirable Federal goal, this goal can be achieved for these people with far less Federal subsiby than is now provided.
- Third, these tax expenditures encourage overinvestment in housing: too much housing, but not necessarily enough houses. By reducing the effective cost of the mortgage interest, the deduction encourages people to buy more house than they need especially in the upper income range. These people soak up available mortgage money and help keep rates high, to the detriment of buyers in lower income groups. This diverts capital into housing that might otherwise be invested in productive enterprises. A significant shift in the latter direction would help achieve the economic revitalization we need.

- Fourth, the mortgage interest deduction drives up the general price of houses. People will pay a higher price because the effective monthly cost is reduced by the deduction. The higher one's income, the higher one's tax bracket, and thus the more valuable is the deduction. As house prices are bid upward, more and more people at lower incom levels are "priced out" of the market.

- Fifth, the mortgage interest deduction is a huge drain on the Federal treasury. In 1980, the estimated total for this deduction was $12.5 billion. Reducing this tax expenditure by some part of this could contribute to the effort to balance the budget.

3) My proposal. There are various ways to deal with the problems I have described. Whatever the means chosen, the objective is to reduce the subsidies to upper income households that are now provided by the mortgage interest deduction. I must emphasize that I am not suggesting that these housing tax expenditures be eliminated, only that they be better focused on those who need them. Moreover, I am not recommending any changes in the other homeownershp deductions, although I do believe that all of these should also be examined carefully.

The simplest way to do what I am talking about may be to convert the mortgage interest deduction to a tax credit and to place an upper limit, a "cap", on the amount of the credit. One article I saw recently suggested a 25% tax credit with a $2000 cap, but I do not know whether this is the best formulation. As the author of that article commented, it will require a great deal of "discussion, debate, and modeling" to shape this proposal into an effective mechanism for achieving the desired results. (The article, by the way, is "Federal tax expenditures should be restructured to aid urban housing" by Rolf Goetze in the October 1980 Journal of Housing.)

I hope the above information is useful to you. I would certainly be pleased to work with you on this important issue.

Sincerely,

George V. Voinovich
Mayor of Cleveland

THE NEW YORK TIMES, FRIDAY, APRIL 17, 1981

The New York Times

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Let's Slay Another Sacred Tax Cow

The Reagan Administration's proposed budget is billed as a fearless attack on sacred cows. But some cows are still more sacred than others. This President, too, hesitates to challenge the costly and now damaging Federal subsidies for private home ownership. The omission is critical. For only by curbing these hidden subsidies — given as tax breaks on home mortgage interest — could Mr. Reagan help restrain runaway housing prices and direct personal savings toward more productive investments.

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Everyone with a mortgage is allowed to deduct the interest. But most of the benefits flow to a relative few. Renters are out of luck. And according to the Congressional Budget Office, about 60 percent of all homeowners either have no mortgage or use the standard tax deduction, thus gaining nothing from the mortgage privilege. Moreover, since the benefits come as deductions from taxable incomes, the richer the mortgagee the greater the return. A family with a $20,000 income typically saves about 20 cents on each interest dollar, while a family earning $200,000 may save 70 cents.

But more than equity is at stake here. The deductibility of interest distorts investment incentives in major ways. Investment in business is disadvantaged at a time of high inflation because businesses must pay income tax on illusory paper profits. Homeowners, by contrast, gain from inflation: they service their mortgages in shrinking dollars but are not obliged to pay taxes on the inflated value of their real estate.

One understandable result has been a big shift from low-yield investment in plant and machinery to high-yield investment in housing. According to Lawrence Summers, an M.I.T. economist, this interaction of inflation and tax policy is enough to explain both the 34 percent increase in real housing prices and the 45 percent decline in stock market prices since 1965. Investors who might be dealing in stocks are instead putting their capital into their own homes. And this shift has surely been a drag on industrial productivity.

Simply forbidding any deduction for mortgage interest is politically unthinkable; too many people benefit from it, at least in modest amounts, and bought homes in expectation of the benefit. Less Draconian measures, however, are available and if properly explained should prove popular.

There could be, for example, a $5,000 limit on mortgage interest deductions. Such a cap would bring the Treasury an extra $36 billion in revenue over the next five years but would raise the taxes of only one taxpayer in 20. Alternatively, the current unlimited deduction could be changed into an unlimited 25 percent *tax credit*. That would raise almost as much revenue and actually reduce the taxes of moderate income, low-bracket homeowners. Either plan might be phased in over time to soften the blow and still yield an immediate benefit by cooling the speculative housing boom.

It's time, President Reagan says, to let free markets work. In this area, especially, he is right.

SPECIAL REPORT

IT'S HIGH TIME TO GET HOMEOWNERS' DEDUCTIONS UNDER CONTROL

by Joan Williams

Joan Williams is an attorney who practices law in Washington, D.C. She is a graduate of Harvard Law School and also holds a master's degree in city planning from the Massachusetts Institute of Technology.

In this article, Ms. Williams describes the changes that have taken place during the past 10 years in the way in which the benefits of homeowners' tax deductions are distributed among income classes. She points out that, although the homeowners' deductions once aided a large proportion of lower-middle and middle income persons, this is no longer the case. Instead, the number of persons in lower income groups claiming the deduction has dropped precipitously, and the deductions have turned into a deep subsidy for the well-to-do.

Ms. Williams cites two reasons for these developments. The first is the growth in the use of the standard deduction, especially among lower-middle and middle income taxpayers. The second is the sharp increase in the price of housing, which has correspondingly increased the dollar value of homeowners' deductions for those who are still able to purchase housing.

Ms. Williams concludes that a reexamination of homeowners' deductions should be an important priority for an administration that is serious about controlling inflation and cutting government subsidies. Due to the changes in the distribution of the benefits of homeowners' deductions during the past decade, Ms. Williams believes that it will be more difficult than in the past to claim that cutbacks in the deductions are an attack on the American dream of homeownership for the middle class.

The new Republican administration is rediscovering the difficulty of balancing the budget.[1] Despite firm campaign promises of a balanced budget by 1982, or 1983 at the latest, Reagan cabinet designees began to acknowledge even before the Inauguration that 1984 seemed a more realistic date.[2]

In the face of legal constraints on the ability to cut entitlement programs and the political pressures to increase defense spending, it is now clear that domestic, social and capital investment programs are bearing the brunt of the budget-cutting scrutiny. Even such traditionally uncuttable institutions as the Interstate highway program have been reexamined as candidates for substantial cutbacks.[3]

An Expensive Sacred Cow

One program that has managed to escape the ax in the current fever is another traditional sacred cow: the federal income tax provisions allowing homeowners to deduct both the interest on home mortgages and their property taxes, at a projected cost (in 1981) of $31 billion.[4] Far and away the most expensive federal housing program in existence today, little attention has been focused on homeowners' deductions in the current budget-cutting debates.

Why? Because homeowners' deductions have in the past proved to be political dynamite. President Carter, both during his campaign for the presidency in 1976 and in his tax reform proposals after he took office, suffered severe political backlash from his proposals to limit or eliminate homeowners' deductions. First Democratic and then Republican challengers scored points with voters by proclaiming an assault on homeowners' deductions as an assault on the solvency of the American middle class.[5]

Beneficiaries Are Different Today

Who benefits from homeowners' deductions? The public evidently believes that benefits go to the middle class majority: a 1978 poll reported that 90 percent of Americans were in favor of homeowners' deductions.[6] But

Far from being a relatively shallow subsidy to a large proportion of the American people . . . homeowners' deductions have now become a deep subsidy to a minority of rich Americans.

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[1] *New York Times*, "Transition into Reality Encounters Some Complexities," Jan. 11, 1981, 2E, col. 1 (hereinafter NYT, Jan. 11).

[2] *Washington Post*, "Reality Is Shriveling the President-Elect's Bold Promise of Change," Jan. 11, 1981, A3, col. 1.

[3] NYT, Jan. 11.

[4] Staff of the Joint Comm. on Taxation, 97th Cong., 1st Sess., Estimates of Federal Tax Expenditures for FY 1981-86, at 16-17 (Comm. Print, 1981) (hereinafter 1981 Joint Committee Report).

[5] *See infra*, at 22-26.

[6] *New York Times*, "Opposition to Carter on Economic Affairs Reaches 54 Percent in Poll," Ap. 12,1978 at A1, col. 6.

it is not the case that homeowners' deductions benefit primarily the average American. A fact that never surfaced in the 1976-1977 debate about homeowners' deductions is that, while the deductions *used* to benefit the majority of "average Americans," in the last decade they have turned into a deep subsidy for the well-to-do.[7]

In 1971,[8] over two-thirds of average middle class taxpayers[9] claimed homeowners' deductions; today[10] fewer than one-third do.[11] Meanwhile, average tax savings to taxpayers earning over $50,000 climbed $825 between 1971 and 1978,[12] while average benefits to lower-middle class taxpayers rose only $118 and average benefits to the core of the middle class rose only $240.[13]

Overall, the increasing regressivity of homeowners' deductions is striking. Whereas in 1971 nearly two-thirds of the money spent on homeowners' deductions went to lower and middle class taxpayers; today over 70 percent goes to the well-to-do.

During the same period in which homeowners' deductions became increasingly regressive, the cost of the program was rising at a staggering pace. In 1971, homeowners' deductions cost $4.65 billion;[14] a recent study projects their 1981 cost at $31 billion, an increase of over 600 percent.[15]

A Dream Out of Control

The current system of homeowners' deductions clearly is a federal program out of control. Moreover, few experts doubt that homeowners' deductions fuel the inflation of housing prices,[16] since they ensure that the federal government pays a hefty percentage of all increases in housing costs. Nonetheless, at a time when reams of newsprint inform us of the Reagan Administration's determination to stop inflation and balance the budget by cutting back on domestic programs, leaving only those programs that provide a bare, minimum safety net for the neediest Americans, the silence about homeowners' deductions is deafening.

The rise in the standard deduction is a major reason why the number of lower-income beneficiaries taking homeowners' deductions has declined in the 1970s.

A safe guess is that no politician will touch homeowners' deductions without ammunition to show that a cutback of homeowners' deductions is not an attack on the American dream of homeownership for the middle class. This article attempts to provide such ammunition. After a review (in Section I) of Carter's attempt to eliminate homeowners' deductions, it will discuss (in Section II) the shift in the incidence of homeowners' deductions. Finally, Section III of the article discusses the reasons for the shift in the incidence of homeowners' deductions, as well as their role in fueling the runaway inflation of housing prices.

As the article points out, available data show that homeowners' deductions no longer benefit a large percentage of average Americans. Instead, the deductions now offer huge and rapidly increasing benefits to the well-to-do.

Section I

CARTER AND THE HOMEOWNERS' DEDUCTIONS

"Tax reform" was a central issue in the 1976 presidential campaign, and Jimmy Carter was in favor of it. As part of his tax reform package, he advocated eliminating mortgage interest and property tax deductions for homeowners.

The demagogic tone of Carter's opposition was set early in the primary campaign, by Senator Henry M. Jackson, D-Wash., who in radio ads described Carter's position on tax reform as a threat to the solvency of middle and lower class homeowners. Jackson asked, "Can you imagine that Jimmy Carter wants to eliminate the only tax advantage the average family gets? How can a man seeking the Democratic nomination make a proposal like that?"[17]

The charge, coming at a time when Carter and Jackson seemed to be the leading contenders for the nomination, coincided with polls showing erosion of Carter support.

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[7] *See infra*, Section II.

[8] Office of Policy Development and Research, U.S. Dept of Housing and Urban Development, *Fourth Annual Report on National Housing Goals* 48 (1972) (hereinafter cited as (date) *Report on Housing Goals*)

[9] It is of course impossible to define precisely the vague terms "average American" and "middle class" I have based my very rough categories on census information that breaks down the American population into fifths. The lowest fifth earned from $0-$3,825 in 1971 and from $0-$6,390 in 1978. The second, third, and fourth fifths (combined) earned from $3,825-$15,527 in 1971; in 1978, they earned from $6,390 to $26,334. Census data also show that the highest-income five percent of the American population started at $25,197 in 1971, and at $42,261 by 1978 Bureau of the Census, U.S. Department of Commerce, *Consumer Income* 20 (Table 5) Series P-60 (1979).

Two problems were presented in developing working definitions of "working poor," "lower-middle" and "middle income." The first was the fact that historical data on the incidence of homeowners' deductions is limited. The second problem posed was the need (within the constraints posed by the data available) to correct for inflation

Given available information and constraints, I have used four major income categories. Working poor I define as taxpayers earning $5,000-$7,000 of taxable income in 1971 and $5,000-$10,000 in 1981. Lower-middle income I have defined as taxpayers earning $7,000-$10,000 of taxable income in 1971, $10,000-$15,000 in 1981. A third category of taxpayer earned $10,000-$20,000 in 1971 and $15,000-$30,000 in 1981. I have called these taxpayers "the core of the middle class" or "average middle income taxpayers" to distinguish them from "upper-middle class" taxpayers, who in fact have incomes higher than 85-95 percent of Americans. These taxpayers in the 85-95th percentiles I have grouped with the "well-to-do."

[10] 1981 Joint Committee Report.

[11] *See infra*, Table 1.

[12] 1978 data from U.S. Department of Housing and Urban Development, *1978 HUD Statistical Yearbook* 308 (Table 11) (hereinafter cited as (year) *HUD Yearbook*).

[13] *See infra*, Table 2.

[14] 1972 Report on Housing Goals.

[15] 1981 Joint Committee Report.

[16] *See e.g.*, L Grebler and F. Mittelbach, *The Inflation of Housing Prices* 86 (1979) (hereinafter cited as Grebler); Goetze, *The Housing Bubble*, Working Papers (Jan./Feb. 1981).

[17] *Washington Post*, "Don't Tax You, Don't Tax Me, Tax the Fellow Behind the Tree," March 15, 1976 at A1, col. 6.

One political analyst noted that Carter's opponents "hope that [he] may at last have made a serious political blunder in challenging a provision that currently saves some 18 million American families an average of $250 a year on their taxes."[18]

Carter reacted by "dramatically altering the tone of his Florida campaign," accusing Jackson of "lies and distortions." He pointed out that his proposal to eliminate the mortgage interest deduction was only one facet of "sweeping tax reform" which would shift the tax burden to those "who can best afford it."[19]

This seems to have ended the debate for the remainder of the primary season. However, when Gerald Ford picked up the issue during the Presidential campaign, his rhetoric matched Jackson's. "I'm not going to let the homeowner become the next endangered species . . ." Ford said, "I've stood for the little taxpayers against the large spenders."[20] As election day grew near, Ford tried to make Carter's position the centerpiece of a claim that a vote for Ford was a vote to preserve the well-earned gains of the average American.[21]

Carter Versus Kennedy

After the election, tax reform continued as a major issue in the new administration's domestic policy. On the issue of homeowners' deductions, however, Carter eventually decided to follow the lead of Senator Edward M. Kennedy, D-Mass. Kennedy, a leader in tax reform, stole Carter's political thunder by coming out with a proposal for a broad revamping of the tax code while Carter was still studying the issue.[22] Kennedy's approach to homeowners' deductions was politically more savvy than Carter's early forays. Carter, following the strategy developed by tax reformers in the late 1960s,[23] had suggested that homeowners' deductions should be eliminated entirely. But by the mid-1970s, tax reformers were trying to make tax reform politically more palatable by advocating a shift from deductions to tax credits in cases where attempts to eliminate offending provisions seemed doomed to failure.[24]

The shift from deductions to credits proposed by tax reformers and adopted by Kennedy would have made homeowners' deductions less regressive for two reasons. First, while a deduction is "worth more" to a rich person than to someone with an average income, a credit is not.[25] More important, however, a shift to credits would counteract increases in the regressivity of homeowners' and other deductions caused (ironically) by tax reforms.

The Effect of the Standard Deduction

Traditionally, deductions benefited a broad range of American taxpayers. In 1969, nearly half of all taxpayers itemized instead of taking the standard deduction: almost 20 percent in the below-$5,000 bracket, over half in the $5,000-$10,000 bracket, and three-fourths in the over $10,000 bracket.[26] Then came tax reformers' successful efforts to increase the standard deduction, efforts aimed at persuading taxpayers to stop itemizing. The reformers had two goals.[27] First, they wanted to simplify tax returns. Perhaps more important, they wanted to weaken the constituency for regressive deductions by eliminating the deductions' benefits for all but the very rich. The sharpest rise in the standard deduction came in 1977, after which 75 percent of all taxpayers had ceased to itemize. By 1977, the percentage of taxpayers in the below-$5,000 bracket who itemized had fallen from 18 percent to two percent; the percentage in the $5,000-$10,000 bracket had fallen from 53 percent to eight percent; and the percentage in the $10,000-$15,000 bracket had fallen from 74 percent to 22 percent.[28]

By the mid-1970s tax reformers believed that the time had come to attack provisions such as homeowners' deductions that now (it was assumed) had lost their middle class constituencies. Kennedy's strategy was to ease the provisions out gradually by translating unlimited deductions into tax credits with relatively low ceilings. Kennedy's comprehensive tax reform program was built around a shift to tax credits, and his proposal for homeowners' deductions fit into this pattern. He suggested a relatively small tax credit to replace the traditional unlimited deduction.[29] "Before you faint," one newspaper article noted, "be advised that . . . Kennedy says the change should apply only to residences acquired after July 1, 1977 to avoid the disruption of settled homeownership arrangements. . . ."[30]

Knowledgeable professionals took the reform proposal seriously. Kenneth Harney, managing editor of the *Housing and Community Development Reporter*, asked

> *Does President Carter really want to slash mortgage interest and property tax deductions, a move many Americans probably consider akin to outlawing apple pie?*

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[18] *Washington Post*, "Carter Seen Vulnerable For Suggesting an End to Mortgage Tax Break," March 6, 1976 at E17, col. 1.

[19] *New York Times*, "Carter Charges Jackson With Lies and Distortions," March 6, 1976 at 10, col. 3.

[20] *New York Times*, "Ford Gives Suburbanites Pledge of Home Tax Relief", October 14, 1976 at 30, col. 4.

[21] *Id.*

[22] *Washington Post*, "Tax Revamping Proposal Submitted by Kennedy," July 2, 1977 at D7, col. 6.

[23] For a history of the tax expenditure concept, *see* J. *Williams, Tax Expenditure Analysis and Housing Policy Reform, Section I (1980) (unpublished Master's Thesis at Massachusetts Institute of Technology (hereinafter cited as Williams). For an example of early tax expenditure analysis advocating abolition of tax expenditures*, see generally, W. Hellmuth & O. Oldman, *Tax Policy and Tax Reform: 1961-1969* (1973) (hereinafter cited as *Hellmuth*).

[24] *See, e.g.*, S. Surrey and P. McDaniel, "The Tax Expenditure Concept and the Budget Reform Act of 1974," 42 *B.C. Indus. and Com. L. Rev.* 685 (1976), and S. Surrey and P. McDaniel, "The Tax Expenditure Concept: Current Developments and Emerging Issues," 20 *B.C.L. Rev.* 288 (1979).

[25] A deduction is "worth more" to a rich person (in the 70 percent tax bracket) than to a person of average income (in the 30 percent tax bracket) because the 70 percent taxpayer who deducts $100 has saved $70 in tax, whereas the 30 percent taxpayer who deducts $100 has saved only $30 in tax. A $100 credit saves $100 in tax for both taxpayers.

[26] Internal Revenue Service, U.S. Dept. Treasury, *Individual Income Tax Returns for 1969*, 82 (1970) (hereinafter cited as (date) *Tax Returns*).

[27] *See generally*, S. Surrey, *Pathways to Tax Reform* (1973) (hereinafter cited as *Pathways*).

[28] 1977 *Tax Returns* 34

[29] *See Washington Post*, "Tax Revamping Proposal Is Submitted by Kennedy," July 2, 1977 at D7, col 6; 123 *Cong. Rec.* 511, 406 (daily ed. July 1, 1977) (Statement of Senator Edward Kennedy); *Washington Post*, George Will, "Shape of Taxes to Come," July 10, 1977 at B7, col. 5.

[30] *Washington Post*, George Will, "Shape of Taxes to Come," July 10, 1977 at B7, col. 5.

The conventional wisdom suggests that tax breaks for homeownership are safe, indefinitely, in their present form.

But the conventional wisdom may be out of date on this issue. The political forces of the 1970s — the ones that put Carter in office — include millions of middle income homeowners who aren't getting the benefits out of the tax system that could be available to them under a credit scheme like Kennedy's.[31]

Carter's Planned Reforms

When Carter's tax reform package began to emerge in the summer of 1977, it was clear that the campaign debate over homeowners' deductions had convinced Carter of the need to proceed with caution. In a tax reform package touted for its comprehensiveness, the Carter proposals concerning homeowners' deductions were weak. The ceiling proposed on the amount of deductions allowed each year was so high it was "aimed [only] at the super-rich, with mortgages on huge mansions or a series of residences"; in June of 1977, Secretary of the Treasury Blumenthal said only $125,000–$150,000 houses (one to two percent of all houses then sold) would be affected.[32]

If the Carter Administration had hoped to avoid more flak over homeowners' deductions, it was disappointed. The proposal was vigorously opposed. Trying "to quell the storm," *The Washington Post* reported, Budget Director Burt Lance carefully noted that the average homeowners would not be affected.[33]

> ***Homeowners' deductions . . . have come . . . to constitute a tax shelter for the 'new elite', the upper-middle-class professionals whose wealth is derived primarily from high annual incomes.***

The housing industry lobby argued otherwise. It argued that the ceiling gradually would be lowered so that more and more housing would be affected; and, even if it were not, the lobby pointed out that a $125,000 ceiling would affect the middle class within five years due to increases in housing prices. Moreover, the lobby continued, the rich would stop taking out home mortgages and would instead borrow on stocks so that the burden of the reform ultimately would fall on the "aspiring middle class." The *Washington Post* reported that "housing industry members say [the proposal] will 'halt' the upward mobility of the middle class — homeowners who've beat inflation by trading up."[34]

These arguments seem to have worked, since ultimately no proposal cutting back on homeowners' deductions was included in Carter's tax package. A poll published about the time Carter's proposal was dropped reported that 90 percent of Americans favored preservation of homeowners' deductions.[35] Rhetoric tying the deductions to the average American had preserved them from change during the most active tax reform period in recent history.

Long on Rhetoric; Short on Data

As in many policy debates that take place in the political arena, this one was graced with few facts and figures. Early on, the claim that homeowners' deductions "saved the average American homeowner $250/year" figured importantly; this claim faded into the background, however, once the fact came out that the 75 percent of Americans who didn't itemize couldn't benefit from the deductions at all. The second section of this article develops statistics showing which taxpayers benefit from homeowners' deductions. These figures have been developed in the hope that — in any future round of debate —the traditional American romanticism about homeownership and the vague advocacy of the "average American" and the "deserving middle class" will not so completely dominate the discussion on the merits of homeowners' deductions.

Section II

THE CHANGED ROLE OF HOMEOWNERS' DEDUCTIONS

The regressivity of homeowners' deductions has increased sharply since 1970. In that year, the rhetoric tying the deductions to the middle class still held some truth. Although wealthier people received proportionately higher benefits, the benefits to the middle class were both substantial and widespread. Since 1970, however, for two independent sets of reasons, homeowner tax benefits to the lower-middle class have virtually dried up, and benefits to middle income people have been constricted sharply, whereas benefits to the wealthy and upper-middle income homeowners have risen dramatically. As a result, the rhetoric tying homeowners' deductions to the "average American" and the "little taxpayer" is simply no longer true.

Later in this section I will present data showing that, whereas in 1971 roughly two thirds of average middle class taxpayers claimed homeowners' deductions, that proportion has now dropped to less than one-third. Available data also show that, whereas in 1971 nearly two-thirds of the money spent on homeowners' deductions went to low and middle class taxpayers, by 1981 over 70 percent went to the well-to-do. Finally, the data show that between 1971 and 1978 average benefits to the wealthiest taxpayers rose over 70 percent, thereby reaching a figure nine times more than the average subsidy to lower-middle class taxpayers, and five times more than the average subsidy to the core of the middle class.

The Core Findings

The basic findings of this article are set forth in Tables 1-3. Table 1 shows the proportion of each income group that claimed homeowners' deductions on their tax returns in selected years. This table shows that the proportion of lower-middle and middle income taxpayers claiming homeowners' deductions has fallen sharply since 1970: about 40 percent of lower-middle income taxpayers took the deduction in 1971, whereas by 1981 only 12 percent

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[31] *Washington Post*, Kenneth Harney, "Tax Credit May Reduce Break on Mortgage Interest Deduction," July 16, 1977 at D1, col. 4.

[32] *Washington Post*, June, 1977 at E1, col. 3.

[33] *Id.*

[34] *Id.*

[35] *New York Times*, "Opposition to Carter on Economic Affairs Reaches 54 Percent in Poll," Apr. 12, 1978 at A1, col. 6.

did; about two-thirds of average middle income taxpayers took the deduction in 1971, whereas by 1981 fewer than one-third did. In addition, in 1971 about one-quarter of the working poor ($5,000-$10,000 bracket) claimed the deduction; fewer than 10 percent do today.

A second set of figures presents even more clearly the conclusion that homeowners' deductions can no longer be viewed as a program designed for the average American. Table 2 shows that, whereas in 1971 45 percent of the revenue spent on homeowners' deductions ($2 billion) went to the core of the middle class, by 1981 only 23 percent ($5 billion) did. Simultaneously, the percentage of the subsidy benefiting the working poor and lower-middle class became insignificant, and the level of benefits to well-heeled Americans has exploded. In 1971, only about 40 percent ($1.85 billion) of the revenue spent on homeowners' deductions went to well-to-do taxpayers (taxpayers in the $20,000 bracket and above); by 1981, over 70 percent ($23 billion) went to the well-to-do ($30,000+ bracket).

Overall, the increasing regressivity of homeowners' deductions is striking. Whereas in 1971 nearly two-thirds of the money spent on homeowners' deductions went to lower and middle class taxpayers, by 1981 over 70 percent went to well-to-do taxpayers. The portion of the program benefiting the working poor and lower-middle class has become insignificant: by 1981, 90 percent of the program's revenues went to people earning over $20,000.

Table 1

Percentage of Taxpayers Claiming Homeowners' Deductions by Income Class

Income Class	1971[1]	1973	1975	1976	1978	1981[2]	
						Interest	Taxes
0-$5,000	13.5%	4%	1%	1%	0.6%	2%	2%
5-10	34	17	14	11	8	9	9
10-15	58	46	37	32	23	12	14
15-20	73	66	49	44	39	21[3]	25
20-30	—	—	70	66	58	34	40
20-50	82	79	—	—	—	—	—
30-50	—	—	82	84	78	56	64
$50,000+	86	87	87	84	84	61[2]	79[2]

Sources: 1972-1977 Reports on Housing Goals, 1978 HUD Year Book (Table 11), 1981 Joint Committee Report and unpublished data from Joint Committee on Taxation.

[1] In 1971, 25 percent of taxpayers in the $5,000-$7,000 bracket, 38 percent of taxpayers in the $7,000-$10,000 bracket, and 64 percent of taxpayers in the $10,000-$20,000 bracket claimed homeowners' deductions

[2] 1981 data comes from the Joint Committee on Taxation, and poses several comparability problems. First, no aggregation of mortgage interest and property taxes is provided. Because the mortgage interest deduction is so much larger than the property tax deduction, in the text the mortgage interest deduction figures have been used as rough estimates of 1981 homeowners' deductions. The second comparability problem derives from the fact that pre-1981 data is based on adjusted gross income whereas 1981 data is based on expanded income classes. This produces substantial distortion in the over-$50,000 income bracket.

[3] In 1981, 29 percent of taxpayers in the $15,000-$30,000 bracket claimed mortgage interest deductions.

Table 2

Revenue Cost of Homeowners' Deductions

(in millions of dollars)

Income Class	1971		1973		1975		1976		1978		1981			
											Interest		Taxes	
0-$5,000	131	3%	34	4%	12	2%	19	2%	11	0.1%	23	.1%	11	.1%
5-10	589	13	669	8	289	4	275	3	224	2	216	1	109	1
10-20	2081	45[1]	2963	38	2258	31	2228	24	1962	15	1403	7	633	6
20-30	—		—		2322	31	2729	30	3475	27	4035	19	1489	16
20-50	1356	29	3274	41	—		—		—		—		—	
30-50	—		—		1456	20	2111	23	4119	32	9328[2]	43	3575[2]	37
$50,000+	496	11	963	12	1063	14	1666	18	3019	24	6470	30	3726	39
Total	4653		7943		7400		9128		12630		21476		9544	

Sources: 1972 - 1977 Reports on Housing Goals, 1978 HUD Yearbook (Table 11), 1981 Joint Committee Report.

[1] In 1971, 26% of the revenue spent on homeowners' deductions went to taxpayers in the $10,000-$15,000 bracket; 19% went to taxpayers in the $15,000-$20,000 bracket.

[2] In 1981, 73% of the revenue spent on the mortgage interest deduction, and 76% of the revenue spent on the property tax deduction, went to taxpayers in the $30,000+ bracket.

Table 3

Average Tax Savings of Taxpayers Claiming Homeowners' Deductions

Income Class	1971	1973	1975	1976	1978[1]
0-$5,000	$ 52	$ 56	$ 47	$ 72	$ 75
5-10	80	123	100	119	147
10-20	155	229	198	215	253[2]
20-30	—	—	424	416	463
20-50	411	581	—	—	—
30-50	—	—	729	810	909
$50,000+	1157	1649	1450	1688	1982

Sources: 1972 - 1977 Reports on Housing Goals, 1978 HUD Yearbook (Table 11), 1981 Joint Committee Report.

[1] Average tax savings of taxpayers for 1981 could not be calculated because some, but not all, of the taxpayers claiming mortgage interest deductions also claimed property tax deductions.

[2] In 1978, taxpayers in the $15,000-$30,000 bracket claiming homeowners' deductions received average tax savings of $395.

A third set of figures shows that, while the base of beneficiaries from homeowners' deductions has narrowed, the average amount of subsidy to well-to-do taxpayers has risen much more sharply than has the amount of subsidy to the middle-income groups.

If the Reagan Administration is really serious about controlling inflation and cutting government expenditures, a reexamination of homeowners' deductions should be a priority.

Table 3 shows, first, that even in 1971 taxpayers in the over $50,000 bracket received an average subsidy ($1157) seven and one-half times as large as the subsidy received by the average taxpayer in the core of the middle class (who received $155) and twelve and one-half times as large as the average lower-middle income taxpayer (who received $93). In the last decade, moreover, subsidies to the well-to-do have risen much more rapidly than have subsidies to lower-middle and average middle class taxpayers. By 1978, the subsidy to the taxpayer earning over $50,000 had risen 71 percent to $1,982, a figure over nine times more than the subsidy to lower-middle income taxpayers ($211) and five times more than the subsidy to the core of the middle class ($395).

From being a relatively shallow subsidy to a large proportion of average Americans, from the working poor on up, homeowners' deductions have now become a deep subsidy to a minority of well-to-do Americans.

Section III

THE REASONS FOR THE CHANGED ROLE OF HOMEOWNERS' DEDUCTIONS

The conditions that produced the dramatic shift in the role of homeowners' deductions combine long-term changes in social and economic conditions with shorter term, consciously crafted changes in the structure of the tax laws.

The Increase in the Standard Deduction.

The primary reason why homeowners' deductions no longer benefit large proportions of the lower-middle and middle-income taxpayers is that the proportion of those taxpayers who take the standard deduction—and who therefore cannot take itemized deductions such as homeowners' deductions—has dropped precipitously as a result of tax reform.

Members of the tax reform movement that developed in the late 1960s generally opposed all deductions except those considered necessary to reach an accurate picture of each taxpayer's income.[28] For example, deduction of bona fide business expenses they considered justifiable, since money spent on business could not truly be considered personal disposable income. Other deductions, however, such as homeowners' deductions, they felt were not justifiable in terms of the internal logic of the tax code. Since such deductions existed because of social policy considerations, they were considered more like expenditures than deductions, and so they were called "tax expenditures".

Tax reformers opposed tax expenditures on two grounds. First, they wanted the tax system to be used only for raising money, since they believed that incorporating social policy concerns impeded the tax system's ability to achieve its fundamental objective fairly and efficiently. Moreover, tax reformers pointed out, the social programs financed through tax expenditures tended to be ill-targeted and regressive.

Successful and Unsuccessful Strategies.

The history of the attempt to limit or eliminate homeowners' deductions illustrates one of the several techniques designed to eliminate "tax expenditures": that of eliminating tax expenditure programs one by one. This strategy was the tax reformers' most controversial and probably their least effective approach. Although it was

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[28] *See generally* Hellmuth and Williams, *supra* at note 23. *Pathways, supra* at note 27.

successfully used to cut back the oil depletion allowance, it failed in innumerable other areas, notably in the case of homeowners' deductions.

Tax reformers' second strategy was subtler and, ultimately, more effective. The second strategy was to raise the standard deduction so that fewer people itemized on their tax returns. The strategy, in the short term, meant that lower-middle and middle-class taxpayers would lose all benefit from certain commonly claimed deductions (of which the homeowners' deductions were the most important). In the long term, however, tax reformers hoped that the strategy, by eroding popular support for deductions, would result in outright repeal of those deductions which would otherwise be too strongly supported to assail.

In one sense, this second strategy has been remarkably successful. In 1964, before the "tax expenditure" tax reform movement took hold, 41 percent of all taxpayers took the standard deduction, and this pattern continued until 1967. The pattern began to change once tax reformers became a political force, as Table 4 shows. After the Tax Reform Act of 1969 substantially raised the standard deduction, the percentage of taxpayers claiming that deduction jumped to 54 percent. This percentage continued to rise sharply as increases in the standard deduction continued, until by 1977 nearly 70 percent of American taxpayers elected the standard deduction.

The rhetoric tying homeowners' deductions to the 'average American' and the 'little taxpayer' is simply no longer true.

Table 4

CHART A: PERCENTAGE DISTRIBUTION, BY INCOME GROUPS, OF TAXPAYERS WHO ITEMIZE[8]

	1969[1]		1973[2]		1977[3]	
Income Class	**Itemized**	**Standardized**	**Itemized**	**Standardized**	**Itemized**	**Standardized**
All taxpayers	46%	54%	35%	65%	26%	68%
Below $5000	18	82	5	94	2	98
$ 5-10,000	53	47	28	72	8	92
$10-15,000	74	25	48	51	22	78
$15-20,000 or over $20,000	70	10	77	24	40	60
Over $20,000	—	—	-	—	73	27

CHART B: DISTRIBUTION AMONG INCOME GROUPS OF BENEFITS OF DEDUCTIONS[8]

	1969[4]		1973[5]		1977[6]	
Income Class	**Itemized**	**Standardized**	**Itemized**	**Standardized**	**Itemized**	**Standardized**
Below $5000	7%	34%	2%	31%	0.5%	21%
$ 5-10,000	16	15	7	18	1.7	21%
$10-15,000	13	5	10	10	3.5	13
$15-20,000 or over $20,000	10	1	17	5	5 2	8
Over $20,000	—	—	-	—	15	6
		100%		100%		100%

CHART C: DISTRIBUTION OF TAX BENEFITS OF HOMEOWNER DEDUCTIONS, 1976[7]

Income Class	**Benefit**
Under $5000	0.7%
$5-10,000	6
$10-15,000	16
$15-20,000	24
Over $20,000	54
	100%

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[1] Internal Revenue Service, U S. Dept Treasury, *Individual Income Tax Returns for 1969*, 82 (19) (hereinafter cited as Individual Returns-Year))

[2] *Individual Returns* - 1973, 39.

[3] *Individual Returns* - 1977, 34.

[4] Calculations based on data from *Individual Returns* - 1969, 82

[5] Calculations based on data from *Individual Returns* - 1973, 39

[6] Calculations based on data from *Individual Returns* - 1977, 34

[7] U.S. Dept. Housing & Urban Development, *HUD Statistical Yearbook - 1977*, 348 (Table 15) (1977).

[8] Totals may not add up to 100% due to rounding.

Table 4 also makes it clear that it was the less wealthy taxpayers who ceased to itemize. In 1969, nearly 20 percent of Americans with taxable incomes below $5,000 itemized, as did over half of those in the $5,000 to $10,000 bracket, and nearly three-fourths of those who earned between $10,000 and $15,000.

It is not the case that homeowners' deductions benefit primarily the middle class.

In 1973, four years after the first Tax Reform Act, the proportion of taxpayers who itemized had dropped to roughly one-third of the total; this percentage dropped further (to one fourth) after the second Tax Reform Act of 1976. By 1977, the percentage of people with incomes below $5,000 who itemized had fallen from 20 percent (in 1969) to two percent; the percentage of those in the $5,000-$10,000 bracket who itemized had fallen from over 50 percent to eight percent; about 20 percent (down from 75 percent) of Americans with incomes between $10,000-$25,000 now itemized.

Another useful perspective is given by Table 4, which shows the total percentage of all itemizers that came from each income group. The table indicates that, although in 1969 36 percent of the benefits incident to itemizing went to those with incomes below $15,000, by 1977 only six percent still did.

The decline in lower-middle and middle income groups taking the standard deduction has paralleled the decline in the proportion of taxpayers taking homeowners' deductions. The rise in the standard deduction is a major reason why the number of lower-income beneficiaries taking homeowners' deductions has declined in the 1970s.

Social and Economic Change: Rising Housing Prices

The fact that fewer taxpayers claim homeowners' deductions is only one half of the reason why the deductions have become so much more regressive in the last decade. The other half is that the higher-income taxpayers who do continue to claim the deductions have been able to deduct larger and larger amounts in relation to their incomes because of the rise in housing prices and mortgage interest rates. The end result has been that the average tax benefit attributable to homeowners' deductions has risen from $176 to $1416 in the last decade.

This fact has led to a new role for homeowners' deductions. Whereas in the period from roughly World War II until 1965, homeowners' deductions offered a relatively shallow subsidy for a large proportion of the middle class, in the last decade they have come to offer a relatively deep subsidy for a comparatively small number of the well-to-do.

The primary reasons why the subsidy to those claiming homeowners' deductions has deepened are the rise in the price of housing and the rise in mortgage interest rates in relation to income. The dramatic increase in housing prices in the last decade is axiomatic: a recent M.I.T. study calculated that housing costs doubled over the last decade for the buyer of a new house and rose 72 percent for the buyer of an existing house.[37] The equally dramatic increase in mortgage interest rates is suggested by the fact that a typical 1971 mortgage had an eight percent rate.

These changes in economics led to changes in the role of homeowners' deductions. The rise in housing prices has meant that taxpayers who can afford to buy houses now characteristically buy more expensive housing in relation to their incomes than had traditionally been the practice, because housing is viewed as an inflation-proof investment. In turn, this new role for housing investment has led to a new role for homeowners' deductions. A 1979 study reports:

> *One of the clearest and most significant findings pertains to the great role of investment and related financial considerations in the purchase decisions of 1975 and especially 1977 buyers. Home purchase as (1) an inflation hedge, (2) an opportunity to capture larger income-tax benefits, and (3) the "best investment for the money" ranked very high among the responses [to surveys taken].*[38]

The study found that the availability of homeowners' deductions enhances the attractiveness of buying a high-priced dwelling. The more expensive the home in relation to the taxpayers' income, the more valuable are the tax benefits available: a taxpayer earning $50,000 who deducts $900 on a $100,000 home receives greater tax benefits than the same taxpayer would if he deducted $450 per month on a $50,000 home. Not only does this realization encourage itemizing, high-income taxpayers to buy housing, it encourages them not to worry too much whether the housing they are buying is inflated in cost since (depending on their bracket), Uncle Sam will pay up to 70 percent for each additional dollar they owe.

In sum, the days when homeowners' deductions offered a relatively shallow subsidy for the middle class are long gone. In the last decade they have come—partly as a result of the housing price inflation to which they have contributed—to constitute a tax shelter for the "new elite," the upper-middle-class professionals whose wealth is derived primarily from high annual incomes.

CONCLUSION

If the Reagan Administration is really serious about controlling inflation and cutting government expenditures, a re-examination of homeowners' deductions should be a priority. Moreover, because homeowners' deductions now benefit so small a proportion of "average Americans," any attempt at reform that is combined with a decent publicity campaign should stand a good chance at changing the "political reality" about homeowners' deductions.

READER COMMENTS WELCOMED

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Please note that letters must be signed, and that we reserve the right to edit them in the interest of brevity. However, the full texts of all letters that we receive will be made available in the Tax Notes Microfiche Edition.

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[37] B. Frieden & A. Solomon, *The Nation's Housing: 1975-85* (1977).

[38] Grebler, *supra* note 15, at 86.

fiscal facts & figures

EXPLODING HOMEOWNER PREFERENCES

by Allen D. Manvel

The reasoning of a recent *Washington Post* editorial seems incontrovertible:[1]

> "...It's becoming increasingly clear that to balance the budget, and at the same time cut the income tax rates, the administration is going to have to go after the tax expenditures.
>
> "...Consumer credit interest is a tax deduction, and the higher your income the more it's worth to you. It's a direct subsidy to consumer borrowing, and that subsidy currently costs the government $5 billion a year... The credit subsidy is not only expensive; it is also bad policy. The administration wants to encourage people to save. So why does it spend $5 billion a year to encourage borrowing, which is negative saving?"

The *Post* might have cited also another tax expenditure which operates as a subsidy for household borrowing, and which is several times as costly to the Treasury as the deduction for interest on consumer credit—i.e., the deductibility of mortgage interest for owner-occupied houses. That item is a major component of the longstanding, socially and economically unjustified set of homeowner preferences about which William Hellmuth has written:[2]

> "Under a comprehensive individual income tax based on the Haig-Simons definition of income, the income tax base would include imputed net rent for owner-occupied homes....
>
> "...All homeowners...[itemizing or not] benefit from the exclusion of imputed net rent in calculating

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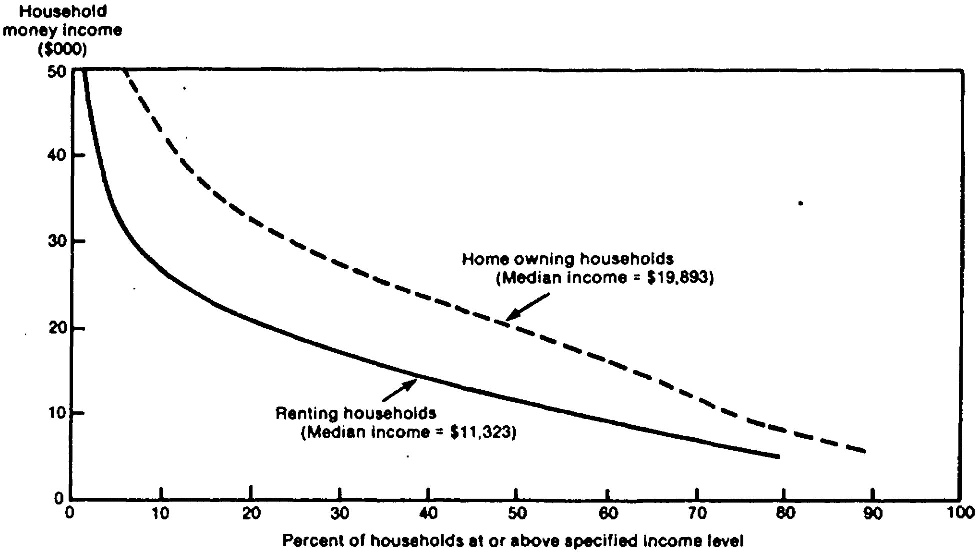
[1] *The Washington Post*, April 3, 1981, p. A14.

[2] Walter Hellmuth, "Homeowner Preferences," in Joseph A. Pechman (ed.), *Comprehensive Income Taxation* (Washington, The Brookings Institution, 1977), pp. 163-65.

CUMULATIVE PERCENTAGE DISTRIBUTIONS, BY 1979 MONEY INCOME, OF HOME-OWNING AND RENTING HOUSEHOLDS



their incomes. Further, homeowners who itemize deductions may deduct mortgage interest and real estate taxes to reduce their taxable income, even though the rental income against which these constitute expenses has not been included. Taxpayers who are tenants are permitted no comparable deductions....

"The homeowner preferences...create horizontal inequities...provide tax savings for homeowners over tenants with comparable incomes, and differential savings between different homeowners with comparable incomes.

"They cause vertical inequities...high-income recipients benefit more from these preferences than do low-income recipients.

"...The tax expenditures favoring homeowners ...draw more resources into housing than would occur in the absence of such preferences.

"They also distort the housing market choices... creating a demand for more single-family homes and apartments for purchase than for rental units.

"...These homeowner tax preferences are relatively inefficient and expensive if they are considered as incentives to promote homeownership and the construction of more homes. The incentives are most valuable to those... that would find it easiest to buy homes in the absence of tax incentives....To the extent that the tax preferences increase the demand for owner-occupied homes, the price of such dwelling units rises and puts them further beyond the reach of low- and modest-income persons... [they tend] to draw more resources into the construction of large and expensive homes...."

Nearly one-third of all U.S. households occupy rented housing units, and thus tend to be materially discriminated against by the homeowners' preferences built into the federal income tax (as well as into state income tax laws). Not surprisingly, renting households are typically much less well off than homeowners. In 1979, as shown in the accompanying chart and in table 1, only about one-fifth of renting households had as much money income as the median income amount for households which owned their homes ($19,900).

Because of the explosive growth of the residential property values and of the volume of home mortgage debt outstanding (both stimulated by the borrowing subsidy built into the income tax system), as well as the rising interest rates of recent years, the loss of federal revenue because of the deductibility of mortagage interest on owner-occupied homes is now several times greater than it was as recently as 1977. This tax expenditure item is estimated in the latest Budget as amounting to $19.8 billion for the current fiscal year, compared with $4.5 billion in 1977—and a prospective $25.3 billion in fiscal 1982. The cost in foregone revenue amounted to less than three percent of actual collections from the federal personal income tax in 1977, while this year's estimated cost amounts to seven percent of prospective personal income tax collections, and the ratio for next year is expected to be even higher—some 7.63 percent of collections. (See Table 2.)

If one also takes into account the second-largest homeowners' tax preference—the deductibility of property tax for owner-occupied houses—we find that the revenue foregoing jointly for this item and the mortgage interest deduction is estimated at nearly $29 billion currently, or more than ten percent as much as the federal personal income tax is expected to yield this year. Corresponding estimates for next year total some $36 billion, or about 11 percent of the collections projected for fiscal 1982.

It would be completely unrealistic to expect that either or both of these costly and economically unfortunate preference provisions will be dropped from the income tax law within the visible future. It would probably be even more unrealistic to urge that equity be sought by adding into the potential gross tax base of homeowners the imputed net rental value of their homes. As a minimum,

Table 1. Money Income of Homeowning and Renting Households, 1979

Total money income in 1979	Number of households (000)		Percent of households		Cumulative percent of households	
	Homeowners	Renters	Homeowners	Renters	Homeowners	Renters
All households	53,893	23,762	100.0	100.0	—	—
Under $5,000	5,076	4,879	9.4	20.5	100.0	100.0
$ 5,000 to $ 9,999	7,103	5,544	13.2	23.3	90.6	79.4
$10,000 to $14,999	7,477	4,802	13.9	20.2	77.4	56.1
$15,000 to $19,999	7,446	3,486	13.8	14.7	63.5	35.9
$20,000 to $24,999	7,448	2,257	13.8	9.5	49.7	21.2
$25,000 to $29,999	6,207	1,221	11.5	5.1	35.9	11.7
$30,000 to $34,999	4,262	630	7.9	2.7	24.4	6.6
$35,000 to $39,999	2,753	359	5.1	1.5	16.5	3.9
$40,000 to $49,999	3,104	337	5.8	1.4	11.4	2.4
$50,000 to $74,999	2,223	191	4.1	0.8	5.6	1.0
$75,000 and over	794	56	1.5	0.2	1.5	0.2
Median income ($)	19,893	11,323	—	—	—	—
Mean income ($)	22,519	13,591	—	—	—	—

Source: Bureau of the Census, *Money Income and Poverty Status of Families and Persons in the United States: 1979* (Advance Report; Series P-60, No. 125; October, 1980), table 15.

nevertheless, some one or more of various kinds of alternative limitations that might slow or reverse the runaway growth of the subsidy that is now given for home borrowing should be high on the tax policy agenda of the Reagan Administration—especially if, as it so ardently claims, this Administration is sincerely interested in increasing the rate of productive (nonresidential) investment in the United States.

Table 2. Data Concerning Estimated Tax Expenditures, In Total and for Selected Items, Fiscal 1977 through Fiscal 1982

	1977	1978	1979	1980	1981 (Projected)	1982 (Projected)	Percent Increase, 1977-82
Income tax revenue (bil. $):							
Individual income tax	157.6	181.0	217.8	224.1	284.0	331.7	110
Corporate income tax	54.9	60.0	65.7	64.6	65.1	64.6	18
Total	212.5	240.9	283.5	288.7	349.1	396.3	86
Total budget outlays (bil. $)	402.7	450.8	493.6	579.6	655.2	695.3	73
Estimated tax expenditures, total							
Amount (bil. $)	113.5	123.8	150.1	194.1	228.7	266.4	135
As percent of total individual and corporate income tax revenue	53.4	51.4	52.9	67.2	65.5	67.2	26
As percent of total budget outlays	28.2	27.5	30.4	33.5	34.9	38.3	36
Estimated tax expenditures for:							
Deductibility of mortgage interest on owner-occupied homes (mil. $)	4,490	7,595	10,745	15,615	19,805	25,295	463
As percent of individual income tax revenue	2.85	4.20	4.93	6.97	6.97	7.63	168
Estimated tax expenditures for deductibility of property tax on owner-occupied homes (mil. $)	4,205	5,495	6,760	7,310	8,915	10,920	160
As percent of individual income tax revenue	2.67	3.04	3.10	3.26	3.14	3.29	23
Estimated tax expenditures for deductibility of interest on consumer credit (mil. $)	1,785	2,350	3,085	4,745	5,260	6,040	238
As percent of individual income tax revenue	1.13	1.30	1.42	2.12	1.85	1.82	61

Sources: Income tax revenue and budget outlays, from *Budget of the United States Government, 1982*, table 23, total tax expenditures for 1977, 1978, and 1979, from Congressional Budget Office, *Tax Expenditures: Current Issues and Five-Year Budget Projections for Fiscal Years 1981-1985* (April, 1980), table 2; for 1980, 1981, and 1982, from *Special Analyses, Budget of the United States Government, 1982*, table G-1; data for particular tax expenditure items, from the corresponding table of successive annual "Special Analyses" supplements to *The U.S. budgets* for 1979 through 1982.

CURRENT AND QUOTABLE

Joint Committee on Marginal Tax Rates

Set forth below are excerpts from a recently released Joint Committee on Taxation pamphlet outlining background and issues related to individual tax reductions. The full text of the pamphlet will be placed in next week's Tax Notes Microfiche Edition as Doc 81-4275.

A great deal of concern has been raised about the effect on the efficiency of the economy of the marginal tax rates characteristic of the current individual income tax and of the resulting impact on the incentives which affect economic behavior. It is not technically difficult to lower marginal tax rates, but the degree to which the committee may wish to lower them may involve comparing the economic efficiency benefits of such a reduction with the costs or benefits related to the achievement of other goals of the tax system, such as distribution by income class, and budgetary goals.

What do condo conversions, displacement of poor people, shortage of new homes, and unprecedented housing inflation have in common? The tax code.

THE HOUSING BUBBLE

by Rolf Goetze

As the Reagan administration takes office, the tax system is being blamed for a broad range of ills besetting the economy. But it is unlikely that President Reagan's advisers will look too closely at the most self-defeating tax provisions of all—the tax favoritism in housing.

In the postwar period, the array of deductions and deferrals favoring housing gave a broad middle class effective incentives to become homeowners, and helped to stimulate the construction of new, moderately priced homes. Today, the tax treatment of housing is quite out of control, operating as a hidden regressive subsidy, that aggravates the displacement of the urban poor, and further enriches the well-to-do.

Worse, tax favoritism for housing no longer effectively adds to the supply of housing. Instead, it merely helps to bid up prices, inducing the affluent to over-consume while the needy are left out. As housing prices have soared, young people with enough income are hocking everything in order to buy a house before the market rises entirely beyond their reach. But once they become homeowners, they are part of the constituency for further inflation, because they count on further price increases. As a result, attempts at reform encounter enormous political resistance.

Tax reductions for homeowners are still thought to promote new housing construction, thereby making all housing more affordable. However, in the new urban realities—baby boom demographics, energy scarcity, limited land, inadequate production, and the back-to-the-city movement—the federal tax provisions encourage those in upper tax brackets to over-invest in scarce housing as an inflation hedge. This drives up prices and leaves too little housing for others. These tax deductions now threaten to divide those who already have their homes (or can find the resources to invest) from the have-nots who must count on more government aid—more than can ever be provided. Indeed, the government that promises home subsidies with one hand more than cancels their value by awarding tax preferences with the other.

Among the many intractable aspects of the nation's current housing difficulties, tax deductions are one element that could readily be modified by the new Reagan administration, if the effects of the current deductions were better understood. There is a simple remedy for the destructive interaction of tax deductions with the current

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Rolf Goetze, formerly of the Boston Redevelopment Authority, is author of Understanding Neighborhood Change *(Ballinger, 1979) and* Building Neighborhood Confidence *(Ballinger, 1976). For the insights in this article, he is indebted to the work of Cushing Dolbeare of the Low Income Housing Coalition, Richard Bourdon of the Congressional Research Service, and George Peterson of the Urban Institute. He also wishes to thank the National Urban Coalition for providing a forum for discussion.*

urban predicament: the replacement of tax deductions with an across-the-board tax credit to all homeowners. This would maintain benefits for the middle class at roughly the current level but redistribute the tax benefits currently surging to those in the highest tax brackets back to working and lower class owners—thereby helping to stabilize our cities, as well as promoting the upgrading and better utilization of existing housing.

Housing issues are hard to connect. Every day newspapers carry stories about seemingly-isolated topics like the housing crunch, soaring shelter costs, the baby boom generation's move back to the city, and the urban renaissance, as well as a whole range of viewpoints on new buzzwords: gentrification ... reinvestment ... displacement. At best, these stories only vaguely connect the idea of urban [illegible] energy consumption. How all these issues actually interrelate is not immediately apparent, yet each isolated crisis seems to call for public action. Little can be done to quickly change demographic realities or energy scarcities, and certainly the urban revitalization seems welcome after a score of years in which anxious experts sounded the death knell of cities. Few now realize that an outdated federal tax code that strongly favors investment in housing is a major underlying factor shaping these new patterns, and one factor entirely in our power to alter.

How the issues are joined can best be grasped through a hypothetical illustration. Consider the interplay between four families: the Ryans, Mrs. Elliot, Mr Malcolm, and Mr. and Mrs. Taylor.

In the 1970s the Taylors, a savvy young couple, both working and renting in Boston, bought an old southern New Hampshire farm house with their savings for weekend use. Friday night they would drive up, and on Monday morning they would return to their urban careers. As their earnings mounted, instead of paying off the low interest mortgage on the farm house, they decided also to buy in the Boston area using for half the downpayment a loan from Mrs. Taylor's father. Rather than buying a $90,000 single family suburban home, they chose a well-worn six-unit, inner city apartment building, which the elderly owner, frustrated by rent controls, was willing to "sacrifice" for $90,000, or $15,000 per unit. They improved each unit for sale as a $40,000 condominium, remaking the top unit into a choice penthouse for their own residence. Tax shelters and deductions open to all in higher tax brackets helped them to buy this building—as well as inducing others cheerfully to buy the condos from them at prices that literally gave the Taylors their new penthouse. Since Mr. Taylor is a salesman using his home as a business address, the couple found they could even charge many of the regular carrying costs on their unit—heat, insurance, and utilities—as business expenses.

This fortunate couple is now occupying space that formerly would have housed four people in Boston and a family of six in New Hampshire. Those without a grasp of federal tax laws may wonder how they can afford this enviable lifestyle—unaware that it not only costs them much less than rent for an ordinary dwelling, but ultimately also leaves them with title to some "price-less" property. Note that they rely on the savings of others to finance their mortgages. When capital appreciation is considered, their costs are only $23 per month. (see box, p. 47).

Nearby, Mrs. Elliot, a widow with grown children, recently sold the family home in the suburbs, netting $40,000 which she planned to invest while moving to a convenient city apartment in a pleasant location. Her tax adviser quickly demonstrated the advantage of buying a condominium instead First, by reinvesting in the condo, she will pay no taxes on the capital gain from the sale of the home. Second, if she invested the $40,000 in stocks, she would realize (say) $4,000 in annual dividend income, which would be taxable. Instead, she pays no tax on the imputed income she gets from her new condominium apartment, and she even gets tax deductions. Finally, as a condominium owner, she will enjoy appreciation of her new investment that is likely to far exceed the best appreciation she might have enjoyed by investing in stocks. The condo wins hands down (see box, p. 47).

What cinched it for Mrs. Elliot however, was the shabbiness of the available rental apartments, contrasted with the proliferation of newly converted condos offered by fine young couples like the Taylors. Oddly, something seemed to be driving all the nicest apartments into condo conversions. So she moved into a dwelling that once housed a large working class family, even though she won't be using it five months of the year while she is wintering in Florida.

That family, the Ryans, are still looking for a place to live. The choices are not good. They have mixed feelings about buying, but it's a moot choice: the cheapest possible house would require a $7,500 downpayment. They don't have anything like that, and there's nobody in the family to lend it. As working, churchgoing people, they reject the prospect of moving into a housing project. Unlike the last time they looked for an apartment in their neighborhood, they find available rentals few and far between and rents out of sight. There is one subsidized homeownership program with a very long waiting list. They'd prefer to pay their way in their old neighborhood. They wonder what happened to all the $300-a-month apartments.

In the meantime, Mr. Malcolm, a traditional builder with an option on an attractive piece of suburban land, is driven frantic by countless costs—land costs, spiralling material and labor costs, financing and carrying costs—as well as the prospect of dealing with wetlands reviews and zoning appeals which could easily delay him into bankruptcy, as he tries to decide whether to build traditional single family homes, garden apartments, or stylish "planned unit developments" (called PUDs in the trade). He faces so many uncertainties that he finds producing new housing a very discouraging way to earn a living. He was also counting on his financial backer to support him in negotiating the hurdles of building new housing. His banker, however, recently stung by redlining charges, also began to shift his attention to investing in urban revitalization through people like the Taylors and Mrs. Elliot, leaving Mr. Malcolm without financial backing. As it becomes harder and harder to make a living building new housing, Mr. Malcolm is also considering a shift to the condo conversion business.

THE TAYLORS' CONDOMINIUM

$ 90,000	purchase price of 6-unit rental
100,000	fix-up ($15,000 X 5 units + $25,000 for penthouse)
5,000	legal fees
5,000	miscellaneous carrying costs
$200,000	Total
Offset by $200,000	Yield from sale of 5 condominiums at $40,000, giving the Taylors their penthouse condo free and clear.

In part, the dynamics buffeting these families are the consequences of inflation. What most critics fail to realize, however, is that housing inflation itself is heavily fueled by the tax advantages. And these have nothing to do with race, ethnicity, land scarcity, lumber costs, changing demographics, or changing housing fashion. They are entirely the creations of public policy.

Many Americans, when asked about government housing assistance, think only of public housing and subsidized developments and ignore indirect tax expenditures. If they do consider the latter, they immediately think of obscure tax dodges they consider shady, such as double-declining balance depreciation and tax syndication.

The reality is entirely different. In 1979, homeowner deductions by people like themselves amounted to $19.6 billion, while investors' deductions were only $1.7 billion. Housing and community development programs totaled less than half of tax subsidies in 1979—$9.2 billion, of which $3.6 billion were payments for all rental subsidy, $3.2 billion for community development block grants, and $2.4 billion for moderate income mortgage subsidies. Of the $30.5 billion in direct and indirect expenditures ($9.2 plus $21.3 billion), homeowners received $19.6 billion, 64.3 percent, close to two-thirds. (See the 1979 column in the table on p. 49.)

Congressionally voted outlays, of course, are subject to far more budgetary scrutiny and debate than tax expenditures. A double standard divides indirect tax expenditures from the directly budgeted programs. The tax deductions are handled automatically by each eligible household on an annual basis, while housing assistance is fought over publicly and twenty- to forty-year run-out costs are mentioned by opponents to stress the heavy subsidies involved, as if they were direct handouts to the poor. Actually, most of the money goes to union pay scale labor and white collar professionals who collaborate to produce and manage the housing. If the actual benefit of the budgeted

ECONOMIC COSTS AND BENEFITS OF CONDOMINIUM OWNERSHIP

The main benefits of owning rather than renting an apartment lie in the favorable federal income tax treatment of home ownership expenses and capital appreciation. Not only are mortgage interest and property tax expenses deductible from household income before it is taxed, but ownership functions like a savings program whose gains can be partially exempted or taxed at lower rates.

The costs of owning a condominium include property taxes, interest, the lost interest on capital tied up in the downpayment, utilities, and the fees paid the condominium trust. Annual appreciation of 15 percent has been factored in, and each case has included neither the 20 percent downpayment nor the mortgage payments applied to principal; these represent investments that the owner ultimately gets back.

If the annual rate of appreciation of these condominiums were 20 percent—as seems more likely in most urban markets than the 15 percent assumed here—the situation is even more favorable to the owners. This economic catapult for the haves hinges on tax deductions rendering the effective mortgage interest rate below the rate of market appreciation.

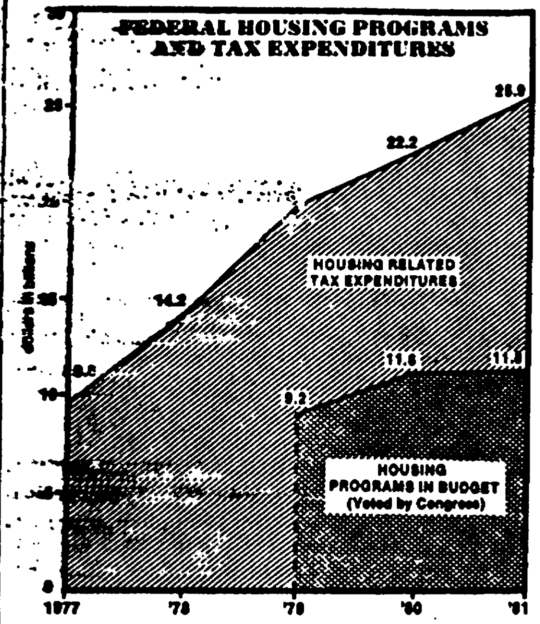
	$40,000 condominium $8,000 downpayment (20%) $32,000 mortgage (12%, 25 yr)				$60,000 condominium penthouse $12,000 downpayment (20%) $48,000 mortgage (12%, 25 yr)		
CAPITAL COSTS		annual	monthly			annual	monthly
Property taxes (5%)		$2,000				$3,000	
Mortgage payments							
Annual payments	$4,044				$6,066		
Applied to principal	216				324		
Mortgage Interest		3,828				5,742	
Foregone 10% interest on downpayment		800				1,200	
Total Capital Costs		6,628				9,942	
Condo fees and utilities		1,200				1,500	
TOTAL ANNUAL COSTS (before tax breaks)		7,828	$652			11,442	$954
TAX DEDUCTIONS (BENEFITS)							
Total tax sheltered expenses X 32% tax bracket saving (applic to $29,000 taxable income)	$6,628 X .32	2,452	204	49% tax bracket (45,800)	9,942 X .49	4,872	406
NET HOUSING COSTS AFTER TAX BREAKS, BEFORE APPRECIATION		5,376	448			6,570	548
Annual 15% appreciation:	+6,000				+9,000		
capital gains tax res	-900				-1,350		
Appreciation Benefits		5,100	425			7,650	638
NET HOUSING COSTS		$276	$23	NET HOUSING GAIN		1,080	$90

housing programs is traced, it will be seen that the lion's share goes to more advantaged persons.

The direct outlays committed to the housing program in the federal budget have grown so little, they have barely kept pace with inflation in construction costs. Tax expenditures, however, automatically rise with mortgage interest rates and property taxes, compounded by the relief tax shelters provide. As a result, tax expenditures are edging toward $30 billion in 1981, growing by several billion dollars each year.

The federal provisions favoring housing investment include the following:

- Resident owners pay no taxes on the value of the housing services their homes provide them (their "imputed rent").
- Resident owners may take unlimited deductions from their federally taxable income for mortgage interest and local property taxes.
- Capital gains from the sale of a home may be deferred indefinitely if the home is traded in on another home; owners fifty-five years old and over may cash in up to $100,000 of their gain without paying any tax on it.
- For developers and investors, other shelters, such as accelerated depreciation, encourage investment and trading.
- For certain structures, historic preservation tax deductions are available.



Homeownership today has become a form of patrimony, available mainly to the children of the affluent.

The impact of these tax provisions is doubly regressive. As we have seen, the pattern of housing that results from the uses of tax benefits helps the well-to-do accumulate more wealth, while withdrawing money available to others. In addition, they also tie up savings in existing housing rather than channeling them to more productive investments.

Of $22 billion in homeowner deductions taken in fiscal year 1980, one-quarter, or over $5 billion, went to those with annual incomes over $50,000. Although the precise amount is not known, a sharply increasing proportion of these deductions are now claimed for turnover and investment in existing housing. Someone with a $100,000 mortgage at 14 percent and $6,000 in local property taxes—a not uncommon situation in the new urban frontier—is sheltering over $20,000 in income from federal taxes: $14,000 in interest and $6,000 in property tax deductions. This shelter is more than the entire income of the average tax-paying family in the same year. In other words, households easily in the 40 percent tax bracket were it not for such loopholes, are taking their housing deductions in ways that do not add to the overall housing stock. Even their capital gains in this endeavor are sheltered as long as they keep the investment in their residences. And if they "liquidated their housing investments," that is, took their money out, they would only be subject to capital gains tax rates, which shelter 60 percent of the gain, rather than the higher income tax rate applicable to their particular tax bracket.

While there is some public awareness that tax favoritism for housing disproportionately benefits the well-to-do, it is not widely recognized that these tax benefits are also a prime cause of housing inflation. In addition to directly bidding up the price of housing itself, this system is also responsible for bidding up the cost of borrowed money. A generation ago, it made economic sense to save up for a downpayment on a home, borrow as little as possible, and expect eventually to pay off the mortgage. The pot of gold at the end of the twenty-year mortgage term was the result of pay-

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ing off the mortgage. The ethic involved getting free of debt.

Today, the pot of gold is to maximize appreciation, and the strategy is to borrow as much as possible. Savings produce negative interest, while borrowing produces tax deductions. One comes up with the downpayment by scrounging from one's parents, not by saving up for it. Consider the class consequences of this shift: homeownership, which a generation ago was widely available to the working poor, is today a form of patrimony, available mainly to the children of the affluent.

With fewer people saving less and more people borrowing more, it is no surprise that the cost of

FEDERAL HOUSING PROGRAMS AND TAX EXPENDITURES

HOUSING PROGRAMS IN THE FEDERAL BUDGET, FISCAL YEARS 1979-1981
(dollars in billions)

	1979	1980	1981
1—Community development block grants (CDBG)	$ 3.2	$ 3.5	$ 3.8
Urban development action grants (UDAGs)	-	.2	.4
2—Housing payments for all subsidized units under all HUD assisted programs	3.6	4.4	5.5
Other (Section 312, Self-help, etc.)	2.4	3.5	2.1
TOTAL OUTLAYS (NET) (Direct housing expenditures)	9.2	11.6	11.8

HOUSING RELATED TAX EXPENDITURES, FISCAL YEARS 1977-1981
(dollars in billions)

	1977	1978	1979	1980	1981
Home Owner Deductions					
3—Mortgage interest on owner-occupied homes	$ 4.5	$ 7.6	$ 10.7	$ 12.5	$ 14.7
4—Property tax on owner-occupied homes	4.2	5.5	6.8	7.7	9.0
Residential energy credits	-	-	.7	.5	.5
5—Deferral of capital gains on home sales	.9	1.0	1.1	1.0	1.1
6—Exclusion of capital gains on home sales	-	.1	.3	.5	.6
SUB-TOTAL	9.6	14.2	19.6	22.2	25.9
Investor Deductions					
7—Expensing of construction period interest and taxes	.2	.6	.6	.7	.7
Excess first year depreciation	.1	.2	.2	.2	.2
Depreciation on rental housing in excess of straight line	.3	.4	.4	.4	.4
Five-year amortization for rental housing rehabilitation	-	-	.02	.02	.03
Preservation of historic structures	-	-	.02	.04	0.7
8—Exclusion of interest on state and local housing bonds	-	.3	.5	.8	1.6
SUB-TOTAL	.6	1.5	1.7	2.1	3.0
TOTAL (housing related tax expenditures)	10.2	15.7	21.3	24.3	28.9
All federal tax expenditures		133.9	158.0	176.9	203.4
Housing as a percent of total		11.7%	13.4%	13.8%	14.2%

Note: Tax expenditures are defined in the budget as "losses" of tax revenue attributable to provisions of the federal income tax laws that allow a special exclusion, exemption, or deduction from gross income or provide a special credit, preferential rate of tax, or a deferral of tax liability affecting individual or corporate income tax liabilities.
Source: Based on data compiled by Low Income Housing Information Service from *Special Analyses, Budget of the United States Government*, 1980, 1981.

The nest has become the nest egg.

mortgage money is bid up—which automatically produces still bigger tax deductions, resulting in bigger federal deficits, and increases in the housing component of the consumer price index. This in turn triggers higher social security checks, still bigger deficits, and largely futile demands for more direct housing subsidies to the poor—who are the only ones left off the band wagon.

The effect of inflation on savings and borrowing has been widely remarked by the political conservatives now in power. But the underlying impact of tax write-offs on the entire dynamic has been largely ignored. It would be folly to pile on additional tax write-offs to stimulate savings, while ignoring those that feed inflation by counting on inflation.

In part, the interaction between tax policies and housing inflation has been misunderstood because it is full of paradoxes. For example, one economist, Patric H. Hendershott, has developed an abstract econometric macro-housing model from which he concludes that higher housing costs nonetheless favor homeownership over rental.* He estimates that without this bias 4½ to 5 million fewer of the nation's 77 million households would have been homeowners at the end of 1978. This becomes plausible when one realizes that currently in many sections even a 14 percent mortgage is below the rate of housing appreciation. Moreover, the household which claims deductions actually experiences this 14 percent mortgage as costing only 9.52 percent if it has over $24,600 taxable income (placing it in the 32 percent tax bracket), and as little as 7 percent if it makes over $45,800, putting it within the 49 percent tax bracket. James M. Poterba, of the National Bureau of Economic Research has also modeled the housing system, and concludes that these tax-inflation interactions could be responsible for as much as a 30 percent increase in housing prices.**

Looking at neighborhoods in a whole range of cities across the nation, it is clear that such housing appreciation does not occur evenly across the board. In areas of perceived housing shortages, prices are inflated sharply because housing is increasingly bought as a hedge against inflation. Here, the nest has become the nest egg, to be protected at all costs. The more people who hear of appreciation in an area, the more people who want to climb aboard there. Meanwhile, disinvestment continues in nearby neighborhoods. This urban rediscovery began with Victorian "treasure" but feeds on adjoining stock, including rental apartment stock.

The clearest insight into the way housing values inflate is gained through monitoring the actual condominium conversion process. Typically, apartments renting for $250 a month are worth at best four to six times annual gross rent as apartment investments, that is, $12,000 to $18,000 per unit because this market is depressed. However, marketed as condominiums, the same units start at ten times annual gross rent, or $30,000, and maintain their value in the face of inflation. Rent controls, where present, may exaggerate the disparity. Most of the difference in value is not due to internal physical improvements, but to the homeowner tax deductions (see box). To buy the $30,000 condominium typically requires a $6,000 downpayment (20 percent). The direct annual costs are around $6,000 (or $500 monthly) including $1,500 in property taxes, $2,900 in mortgage interest, $600 in foregone interest on downpayment, and $1,000 in condo fees and utilities. All but the last are tax sheltered, adding up to $5,000. For the buyer in the 32 percent tax bracket, that is worth $1,600 annually, or $133 monthly off the $500, reducing his monthly housing outlay to $367. Appreciation is a further offset to the monthly costs that is also tax sheltered, although this is only realized upon sale. Here it is easy to see how the market favors conversion, turning $12–18,000 rental headaches into appreciating $30,000 condos that also radically improve the local property tax base. The municipality and new buyers all benefit from this urban alchemy; but those squeezed out by the process may not allow the alchemy to proceed. And their concerns must be addressed.

Tempering the strong tax advantages for those in higher tax brackets would moderate the dangerous conversion momentum that is developing in many urban areas. Right now, the homeowner deductions unnecessarily drive up urban housing values. Those already owning feel entitled to this appreciation, but it results in excluding everyone else and at the same time diminishing available housing stock.

In theory, tax subsidies to a particular sector ought to induce greater supply, in response to the increased after-tax attractiveness of the investment. This is the theory of mineral depletion allowances, for example, or of investment tax credits for industry. But as we have seen, the theory seems to break down in

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*Patric H. Hendershott and James D. Shilling, "The Economics of Tenure Choice, 1955–1979," (Purdue School of Management, 1980). Forthcoming in *Research and Real Estate, Vol. I* (JAI Press, Inc.).

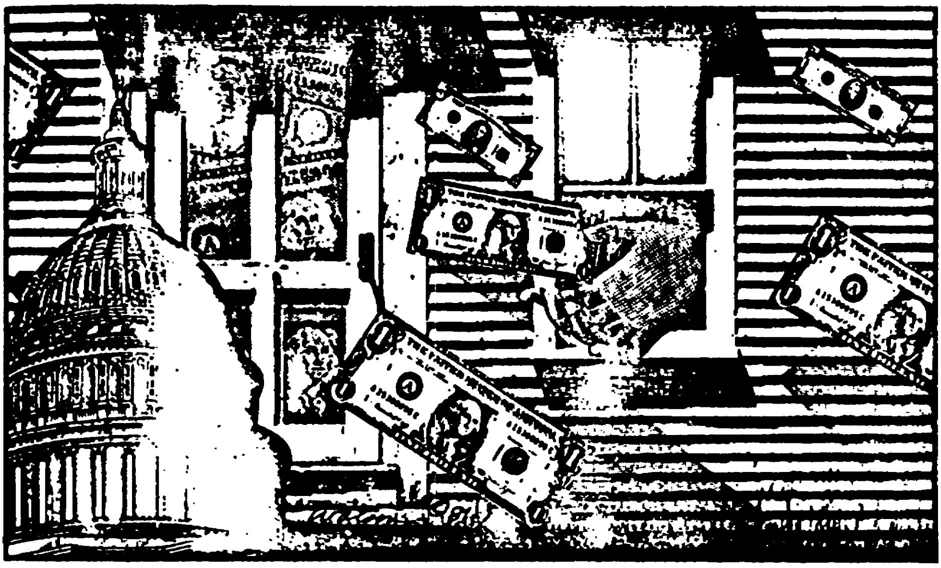
**James M. Poterba, "Inflation, Income Taxes and Owner-Occupied Housing," Working Paper #553, National Bureau of Economic Research, September 1980.

the case of housing. The tax benefits seem to stimulate more demand, but not more real supply. And the result is just what freshman economics might suggest—higher price. There are sharp differences between growth regions, decline regions, and back-to-the-city movements in different areas, but in general a basic underlying pattern holds. In the traditional suburban areas, antigrowth attitudes, laws to protect the environment, and zoning now combine to discourage production of new housing. As illustrated by Mr. Malcolm, a host of costs and uncertainties confront traditional developers.

At the same time, in the urban areas it is more difficult to find available, suitable space, as well as to meet the requirements of building codes and to pay prevailing union scale wages, both of which have been inflated by past assistance programs. These urban and suburban factors all put the cost of new construction out of reach, often well above $70,000 per unit, and make condo conversions of existing stock very marketable.

In the short run, demand in a neighborhood housing market resembles a tray of marbles. In weak markets, there are too few to cover the bottom, and everything seems quite loose. In strong markets, even if there are only a few marbles too many, displacement results, and things will seem extremely tight. However, in the longer run the stock is quite responsive, for example, creating additional units within existing housing when needed. Even the back-to-the-city movement can be interpreted as a long term response to more demand than supply, as it enters areas that were unthinkable ten years ago.

Public policy now tends not to let these longer term dynamics work themselves out, but is called upon to respond directly and immediately to these feelings of "too tight" here and "too loose" there. An appropriate local policy role is to balance out the demand in different neighborhoods; that is, to match supply with demand. However, this involves more than simply attempting to control rents and condo conversion. It involves not only providing enough of the right kinds of housing, but also at times influencing people's desires. As long as a perceived supply shortage persists, those in the higher tax brackets will have an unbelievably strong incentive—provided by our current tax laws—to over-invest in scarce housing. This super-heating incentive has been latent, waiting only to be exposed by a housing shortage, and encouraged by the "tax bracket creep" induced by inflation. Quick, responsive, and efficient ways to expand the desirable housing supply—ways such as permitting accessory apartments in larger existing homes, are needed. However, the federal homeowner deductions that now encourage "haves" to buy housing, indirectly displacing "have-nots," must also be modified. Just to provide more rent supplement outlays (Section 8 certificates) for use in existing housing so that low and moderate income households can remain as renters would be futile and only fuel the inflationary housing cost spiral. When the value of the assistance was factored in, local market prices would only rise further.



Enlightened federal housing policy should address the investor deductions now, rather than waiting for local municipalities to enact rent controls, bans on condo conversions, and anti-speculation taxes which merely address the symptoms of the underlying dynamics. Here is the central housing dilemma that should be addressed by policy makers:

Those in the highest tax brackets benefit most from the deductibility of interest and local taxes as well as capital gains provisions. Wherever housing appears scarce, its price has soared as housing becomes an inflation hedge for the affluent. This makes it less and less affordable to tenants and households just entering the market, and cancels out the effectiveness of the direct housing subsidies. Extending deductions to tenants would only increase tax revenue losses and involve double-counting, since deductions already are claimed by apartment owners—so that is not a solution.

Urban rediscovery—by people like the Taylors, Mrs. Elliot, and greenlining bankers—now interacts with the current tax provisions, allowing the "haves" to take over housing from the "have-nots," as middle and upper income households get their rising benefits virtually automatically and invisibly while the programs for low and moderate income households are constrained and limited by continuous congressional scrutiny and public review.

As a remedy, a number of observers have proposed across-the-board tax credits in place of the current deductions that benefit the affluent the most. The Urban Institute, for example, recently has examined the effects of a 25 percent tax credit in place of the present homeowner provisions. Under a tax credit, a homeowner would simply calculate his or her tax liability without housing deductions. From this liability would be subtracted 25 percent of the annual mortgage interest and property taxes. The Urban Institute chose the 25 percent rate because it maintains a constant flow of dollars to the federal treasury, but still reduces taxes for all but the wealthiest owners.

Tax subsidies promote sanctuaries for the affluent, the end of rental housing, and flashes of class warfare.

This tax credit model, developed by Michael Andreassi and Duncan MacRae of the Urban Institute, suggests that those above the 25 percent bracket would experience an increase in taxes, those below would experience a decrease, and renters would not be affected directly—since the credit applies only to owner-occupants. However, implementing such a substitution would also result in a significant increase in housing consumption by both middle and lower-middle income households. Lower income households would benefit indirectly as middle income households shift their demand away from lower quality housing.

Conceivably, there was some moral justification for giving the affluent the most tax benefits on the theory that they moved into the newest and most costly housing, passing used housing on to those with less income. Now that some of the most astute have stepped outside that housing logic to pick up urban bargains, that logic falters.

In setting utility rates, "life-line" rates are a new, environmentally sound concept. Inverting the traditional notion of economies-of-scale, the proposed rates are cheapest for a basic allotment, and each household pays more if it requires service beyond that allotment. In housing a cap to limit the tax credit to the median priced house would work the same way. Every household would be aided in obtaining a "basic house"; those who wanted more would pay for the extras without benefit of additional tax credits.

Capping tax credits, at least for all existing housing, would foster better utilization of the housing stock, curb urban speculation and displacement, and decrease losses to the Treasury because it would curtail further increases in tax expenditures for the most affluent.

The idea of tinkering with homeowner deductions is still unthinkable to most. Such people probably think the new urban twists, including displacement, windfall profits, and conflict between rich and poor are to be handled with traditional tools like federal housing programs. This ignores changed circumstances and underlying causes.

The current system is producing urban investment sanctuaries for the affluent at the expense of others instead of enough new housing. If the national tax laws are not modified, this process will lead to an urban population transfusion along with the end of conventional rental housing, and flashes of class warfare along the boundaries. Many urban areas will be revitalized with windfall gains for the advantaged, but many more of the have-nots will become squeezed because insufficient suitable new housing was developed. The Reagan administration has been heralded as sensitive to the impact of taxes on economic behavior. As housing tax expenditures break the $30 billion barrier, this issue will test both the insight and sincerity of the new administration. ■

Rolf Goetze

Federal tax expenditures should be restructured to aid urban housing

In many urban areas, $300-per-month apartments are being turned into $40,000 condominiums, raising the issue of displacement, the pricing out of existing residents. At the same time, prices of available urban housing, as well as recently created condominiums, have often appreciated so much that at least one housing economist who has studied the situation has bought urban condominiums for his children instead of investing in stocks. The financial system demonstrably makes condominiums a much better inflation hedge. While local policy makers debate the merits of controlling rents and banning condominium conversions, more significant underlying causes of rising housing prices and tenure changes are ignored, specifically federal income tax provisions.

Rising mortgage interest rates and housing costs combined with new urban realities—demographics, energy scarcity, and the back-to-the-city movement—have made federal tax expenditures for home owner deductions the largest single federal assistance program for housing. In 1981, the government estimates that tax deductions for home owners will total $25.9 billion; between 1977 and 1981, the annual cost of this assistance will have increased more than 2.6 times.

These tax deductions primarily benefit middle- and upper-income home owners who direct the housing market away from the provision of rental housing, particularly low-cost rental housing. Tax deductions have risen virtually automatically and invisibly, while assistance programs for low- and moderate-income housing are constrained by continuous congressional scrutiny and public review. In 1981, direct federal subsidies for low- and moderate-income housing assistance will total only $5.5 billion, one-fifth of the indirect housing subsidies provided through tax expenditures. Direct housing subsidies in dollar terms have remained virtually constant between 1977 and 1981, consequently, in purchasing power, they have actually declined.

There are quite a number of federal tax provisions that favor investment in both resident-owned homes and rental stock. These now include the following:

1—Resident owners do not pay any taxes on the value of the housing services their homes provide them (on imputed rent);

2—Resident owners also can deduct the cost of mortgage interest and local property taxes from their incomes before federal taxes;

3—Capital gains on sales of resident-owned homes can be deferred if another home is bought within 18 months, and owners aged 55 and over have a one time $100,000 exemption;

4—More and more tax-exempt state housing bonds recently have been created for both rental and owner-occupied housing;

5—Real estate tax shelters, through accelerated depreciation and syndication, have provided substantial incentives for sophisticated housing investors that have been modified periodically; and

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Dr. Goetze is Director of Housing Revitalization Programs, Boston Redevelopment Authority. He is the author of Understanding Neighborhood Change, *1979, Ballinger Books.*

6—Historic preservation incentives recently have been enacted to enable local jurisdictions to favor the rehabilitation of especially worthy existing structures.

These housing provisions in our federal income tax system encourage new production, but they also tend to inflate the price of existing housing wherever perceived shortages exist, or wherever not enough of the right kinds of new housing can be added—"right" as defined by local fashions. A tangle of regulations to benefit or protect labor, existing owners, and the environment now prevent enough new construction to ease perceived shortages in many areas. To curb the inflation pervading all housing costs requires examining how these tax provisions actually work in practice. Many who believe these provisions are essential to keep housing "affordable" are unaware of how they indirectly also inflate prices for existing properties. The primary beneficiaries of the current system are those who already own housing. The federal tax provisions encourage those in upper tax brackets to over-invest in scarce housing as an inflation hedge. This drives up prices and leaves too little housing for others. Most rental housing is now at a tax disadvantage from the tenants' and owner managers' perspectives. If the current tax influences on existing housing are not radically altered, within a decade much of the nation's stock of rental housing could well erode or become transformed into new forms of tenure like condominimums and cooperatives.

Housing equity improves if a 25 percent federal income tax credit for home mortgage interest and property tax expenditures is substituted for the current itemized deductions from income before taxes. This would redistribute benefits to home owners in lower tax brackets at no increased cost to the federal budget. To further curb the inflationary impact of housing deductions, the maximum credit also should be capped at a level that "holds harmless" the middle-income buyer of a median priced home by leaving him or her as well off as before. The maximum credit level, however, should not allow those spending more than the median to deduct any more. This would prevent housing tax expenditures from increasing so rapidly in the future. To preserve rental housing, it is more effective to reduce the excessive upper-income benefits than to attempt to extend and "pass through" federal tax benefits to tenants. The reduction of excessive benefits would reduce the inclination of higher tax bracket owner/investors to outbid all others for the existing stock. These changes would make the tax system much more equitable.

A restructuring of the current system requires an examination of how the current incentives work in practice, how indirect tax expenditures relate to congressional housing programs, and how these new provisions would function.

> *"The federal tax provisions encourage those in upper tax brackets to over invest in scarce housing as an inflation hedge. This drives up prices and leaves too little housing for others."*

Tax Incentives

Consider a home owner in the 32 percent tax bracket who buys an $80,000 home or condominium costing $10,000 in annual interest and local property taxes, and who itemizes deductions. In the first year, he can avoid paying $3,200 in income taxes. This saving is legitimate, tax sheltered income and can continue for many years.

As that home owner deducts the interest costs on a 12 percent mortgage, the effective interest rate reduces by a third to about 8 percent. If his or her tax bracket is higher, the effective interest rate is even lower. In the 50 percent bracket, the effective rate is 6 percent, half of what a lower-income family that does not itemize deductions pays. At the same time, the value of the home is likely to appreciate faster than inflation, rewarding the owner generously for not being a renter.

A renter pays rent from income remaining after taxes, while a home owner pays much of his or her housing costs with income before taxes. Someone in the 25 percent tax bracket asked to pay $300 per month in rent would have to earn $400 before taxes to meet the rent—and would have nothing to show for rental payment afterward. As a home owner, that person could take the same $400 before taxes, invest in a home, and find that much of that money serves as an extremely favorable investment that eventually will reap returns. The higher the home owner's tax

HOUSING PROGRAMS IN THE FEDERAL BUDGET, FISCAL YEARS 1979-1981
(dollars in billions)

	1979	1980	1981
1—Community development block grants (CDBG)	$ 3.2	$ 3.5	$ 3.8
Urban development actions grants (UDAGs)	-	.2	.4
2—Housing payments for all subsidized units under all HUD assisted programs	3.6	4.4	5.5
Other (Section 312, Self-help, etc.)	2.4	3.5	2.1
TOTAL OUTLAYS (NET) (Direct housing expenditures)	9.2	11.6	11.8

HOUSING RELATED TAX EXPENDITURES, FISCAL YEARS 1977-1981
(dollars in billions)

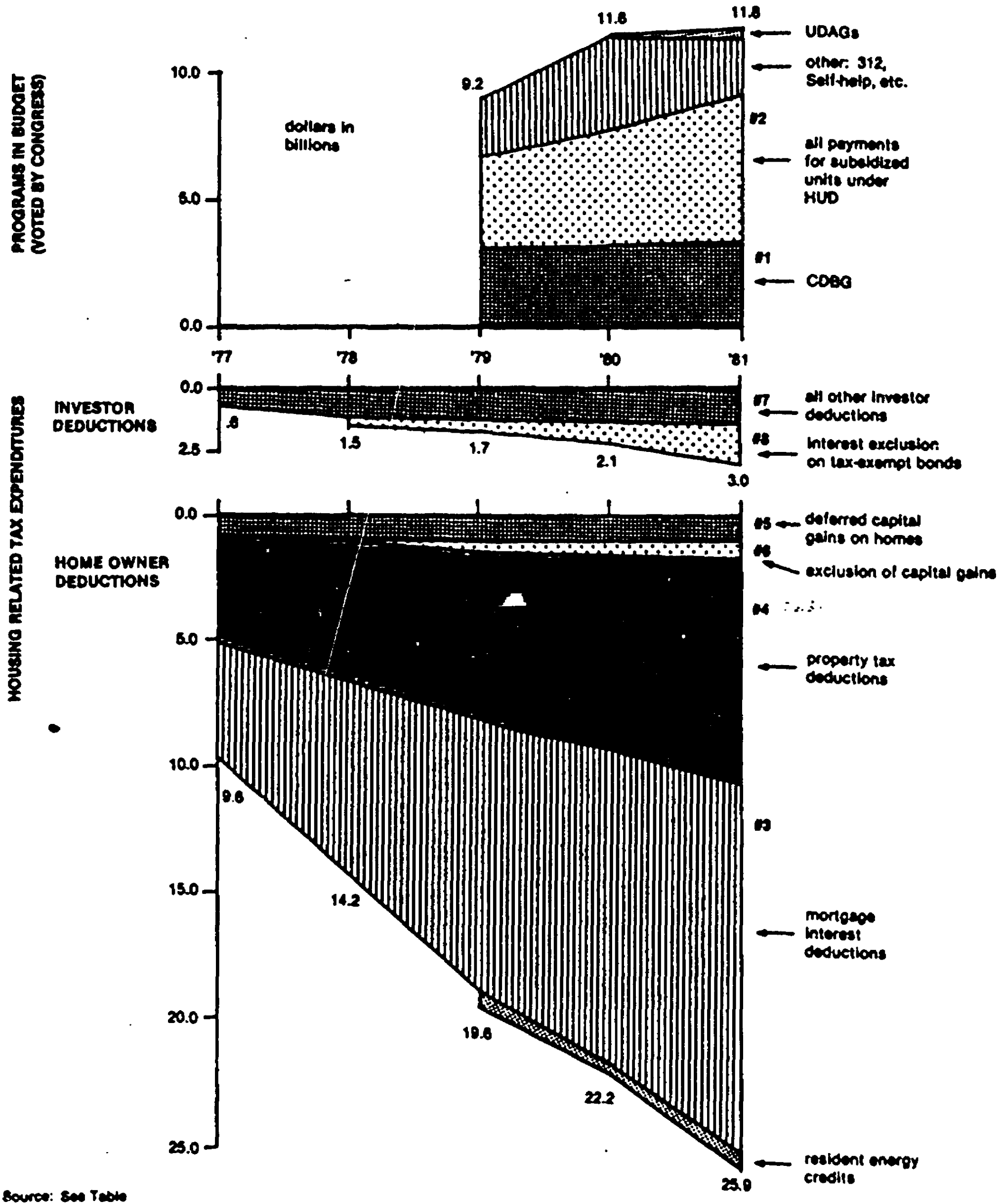
	1977	1978	1979	1980	1981
Home Owner Deductions					
3—Mortgage interest on owner-occupied homes	$ 4.5	$ 7.6	$ 10.7	$ 12.5	$ 14.7
4—Property tax on owner-occupied homes	4.2	5.5	6.8	7.7	9.0
Residential energy credits	-	-	.7	.5	.5
5—Deferral of capital gains on home sales	.9	1.0	1.1	1.0	1.1
6—Exclusion of capital gains on home sales	-	.1	.3	.5	.6
SUB-TOTAL	9.6	14.2	19.6	22.2	25.9
Investor Deductions					
7—Expensing of construction period interest and taxes	.2	.6	.6	.7	.7
Excess first year depreciation	.1	.2	.2	.2	.2
Depreciation on rental housing in excess of straight line	.3	.4	.4	.4	.4
Five-year amortization for rental housing rehabilitation	-	-	.02	.02	.03
Preservation of historic structures	-	-	.02	.04	.07
8—Exclusion of interest on state and local housing bonds	-	.3	.5	.8	1.6
SUB-TOTAL	.6	1.5	1.7	2.1	3.0
TOTAL (housing related tax expenditures)	10.2	15.7	21.3	24.3	28.9
All federal tax expenditures		133.9	158.0	176.9	203.4
Housing as a percent of total		11.7%	13.4%	13.8%	14.2%

Note: Tax expenditures are defined in the budget as "losses of tax revenue attributable to provisions of the federal income tax laws that allow a special exclusion, exemption, or deduction from gross income or provide a special credit, preferential rate of tax, or a deferral of tax liability affecting individual or corporate income tax liabilities.

Source: Based on data compiled by Low Income Housing Information Service from *Special Analyses, Budget of the United States Government*, 1980, 1981.

ISSUES AND PROBLEMS	POTENTIAL REMEDIES
Difficult to target benefits to low- and moderate-income households.	Keep trying, or substitute assistance targeted directly to the intended beneficiaries.
Benefit at most one in ten of the eligible low- and moderate-income households; cost $5,000 per unit annually, or $50,000 to $250,000 in budget authority over 15 to 40 years per household actually aided. Inflationary and unaffordable at larger scale. See number 7.	Develop a fresh, new, broader and more equitable subsidy program which benefits all entitled households automatically.
Primarily benefit home owners over $20,000 since standard deduction was raised. The wealthy benefit the most because benefits are a function of the home owner's tax bracket.	Substitute a maximum 25 percent tax credit up to $2,000 (for up to $8,000 in interest and tax expenses). This would improve low- and middle-income housing, boost construction, and yield the Treasury more money.
Encourage home ownership, but distribution of benefits is unclear; may encourage over-investment on the part of the affluent, thereby inflating market of existing homes.	Should deferrals be made cumulative rather than one-time? Should exclusions be reduced? More study required before action can be taken.
Inefficient, biased toward new construction and thereby toward suburbs and growth areas like the Sunbelt. Encourages investment on the past of the wealthy who are the most remote from the actual housing produced.	Substitute direct fees which would improve economic efficiency—but such a radical change is actually very unlikely to occur.
Inflates cost of all tax-exempt borrowing (including municipal finance). Was one-half of all tax-exempt borrowing in 1979, and is rapidly growing; could become "the nation's most costly housing policy" according to Urban Institute.	Limit eligibility to bonds serving only the less advantaged, or to those who forego also deducting mortgage interest, or substitute taxable bonds that are directly federally subsidized to produce the desired outcomes.

FEDERAL HOUSING PROGRAMS AND TAX EXPENDITURES



Source: See Table
Prepared by: Rolf Goetze, Boston Redevelopment Authority

bracket, the lower his or her effective interest rate will be, and the greater the return on his or her investment. The home buyer's main challenge is providing a downpayment and getting into desirable housing. "Tax bracket creep"—the rise of household incomes into higher tax brackets with inflation—is making the difference between pre-tax and post-tax income more pronounced.

Because of new urban lifestyles, there is new competition for existing rental stock. Three hundred dollars per month rent is 40 percent of a $9,000 annual income. However, $600 per month is less than 25 percent of the $30,000 income of a two-career household that also wants to live in an urban area. However, the two-income household is in a high enough tax bracket to want a tax shelter as well, and thus, in most cases, would probably prefer to buy the apartment as a condominium.

Condominium conversions also occur because investors are finding that they cannot continue to provide decent housing for $300 per month. The economic rent that keeps investors in business is higher than existing tenants feel they should pay. The uncertainties of future rent regulations also discourage continuing investor ownership. At the same time, many want to buy a property improved for resale as a condominium at several times its previous value as a rental. Now that there is a perceived housing shortage in many urban areas, the demand to re-examine the existing stock has increased.

The primary local policy solution is to match supply with demand. This not only involves providing enough of the right kinds of housing, but, at times, also demands influencing people's desires. As long as a perceived supply shortage persists, those in the higher tax brackets will have an unbelievably strong incentive—provided by our current tax laws—to over invest in scarce housing. This over investment incentive is latent, waiting only to be exposed by a housing shortage, and encouraged by the "tax bracket creep" induced by inflation. Quick, responsive and efficient ways to expand the desirable housing supply — ways such as permitting accessory apartments in larger existing homes, are needed. However, the federal tax incentives that now encourage "haves" to buy housing, indirectly displacing "have-nots," must be removed. To provide more Section 8 certificates for use in existing housing so that low- and moderate-income households can remain as renters would be futile and only fuel the inflationary housing cost spiral. Local market prices would rise further after factoring in the value of the assistance.

Present tax incentives are a major causal factor underlying the current housing market dynamics. If housing policy is to correct market shortcomings and imperfections, these interrelationships must first be understood. If not, interventions will produce unexpected outcomes—such as rent controls producing housing deterioration and condominium conversions.

Tax Expenditures and Federal Housing Programs

Many Americans, when asked about government housing assistance, think only of public housing and subsidized developments and ignore indirect tax expenditures. If they do consider the latter, they immediately think of obscure tax dodges they consider shady, such as double-declining balance depreciation and tax syndication.

What is not realized is that in 1979 home owner deductions by people like themselves amounted to $19.5 billion, while investors' deductions were only $1.7 billion. Housing programs in the 1979 federal budget totaled only $9.2 billion, of which $3.6 billion were housing payments for all subsidized units, $3.2 billion were for community development block grants, and $2.4 billion were for self-help mortgage subsidies to qualified home owners. Of the $30.5 bilion in direct and indirect tax expenditures, home owners received 64.3 percent, close to two-thirds. Admittedly, there are a great many home owners and each gets his or her share as a matter of entitlement at income tax time (see the 1979 column in the accompanying table).

As stated, housing programs in the budget are subject to much more public scrutiny and debate than tax expenditures. The proponents of housing programs attempt to build developments anyone would be proud to live in, paying union scale wages under the Davis-Bacon act, and, often, imaginatively recycling obsolescent schools, factories, or commercial space. The per-unit cost of developments often exceeds $50,000, which makes something as small as 40 units a multi-million dollar development. Detractors then point out that these projects serve fewer than one in 10 of those eligible. The rest must wait for a chance that may never come. For each lucky household that does qualify, taxpayers have earmarked $5,000 per unit per year over the project's 40-year economic life—as much as $200,000 per unit in Section 8 assistance. Not only is this most inequitable, but the qualified household might have used this money more effectively if it had received the $5,000 per year directly.

A double standard divides indirect tax expenditures from the directly budgeted programs. The tax deductions are handled automatically by each eligible household on an annual basis, while housing assistance is fought over publicly and 20- to 40-year run-out costs are mentioned by opponents to stress the heavy subsidies involved, as if they were direct handouts to the poor. Actually, most of the money goes to union pay scale labor and white collar professionals who collaborate to produce and manage the housing. If the actual benefit of the housing

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programs is traced, it will be seen that the lion's share goes to more advantaged persons.

The amounts committed directly to the housing program in the federal budget have grown so little, they have barely kept pace with inflation in construction costs. Tax expenditures, however, automatically rise with mortgage interest rates and property taxes, compounded by the relief tax shelters provide. As a result, tax expenditures are soaring (see figure). As they edge toward $30 billion in 1981, growing by several billion dollars more each year, Congress is likely to take some action.

A Potential Solution

Enlightened policy makers should consider alternatives now, before tax hungry interests cut back tax expenditures in some more arbitrary manner. This appears to be the emerging situation:

—Those in the highest tax brackets benefit the most from the deductibility of interest and local taxes as well as the capital gains provisions. Wherever housing appears scarce, its price has soared as housing becomes an inflation hedge for the affluent. This makes it less and less affordable to tenants and households just entering the market, and cancels out the effectiveness of the direct housing subsidies. Extending deductions to tenants increases tax revenue losses and involves double-counting, since deductions already are claimed by apartment owners.

—It seems urban rediscovery now interacts with these tax provisions, allowing the "haves" to take over housing from the "have-nots," as middle- and upper-income households get their rising benefits virtually automatically and invisibly while the programs for low- and moderate-income households are constrained and limited by continuous congressional scrutiny and public review.

A number of observers have proposed across-the-board tax credits in place of the current deductions that yield the most for those in the highest tax brackets. The Urban Institute recently has examined the effects of a 25 percent tax credit in place of the present home owner provisions. Under a tax credit, a home owner would simply calculate his or her tax liability without housing deductions. From this liability, he or she then subtracts 25 percent of the annual mortgage interest and property taxes. The Urban Institute chose the 25 percent rate because it maintains a constant flow of dollars to the federal treasury, but reduces taxes for most owners.

This tax credit model, developed by Michael Andreassi and Duncan MacRae of The Urban Institute suggests that those above the 25 percent bracket would experience an increase in taxes; those below would experience a decrease; and renters would be unaffected, since the credit applies only to owner-occupants. Implementing such a substitution also would result in a significant increase in housing consumption by both middle- and lower-middle-income households. Lower-income households would benefit indirectly as middle-income households shift their demand away from lower-quality housing.

The tax credit concept, like Robin Hood, would take from the rich to give to the poor. However, by itself, it does not address the exponential growth of housing tax expenditures. There was some moral justification for giving the affluent the most tax benefits as long as they moved into the newest and most costly housing, passing used housing on to those with less income. Now that some of the most astute have stepped outside that housing logic by picking up urban bargains, it is time to reconsider the logic of the tax provisions.

In setting utility rates, "life-line" rates are a new, environmentally sound concept. Inverting the traditional notion of "cheaper by the dozen," or economies-of-scale, the proposed rates are cheapest for a basic allotment, and each household pays more if it requires service beyond that allotment.

In housing, a cap to limit the tax credit to the median priced house would work the same way. Every household would be aided in obtaining a "basic house;" those who wanted something more would pay for the extras without benefit of additional tax credits.

A $62,500 house (with a $50,000 mortgage at 12 percent interest and $2,000 in property taxes) would spend $8,000 annually, entitling it to a $2,000 tax credit. Capping tax credits at $2,000, at least for all existing housing, would foster better utilization of existing housing, curb urban speculation and displacement, and decrease losses to the Treasury because it would prevent the further increase in tax expenditures for the most affluent.

Such a concept of coupling a 25 percent tax credit with a $2,000 cap appears suitable for the coming era of increased resourcefulness, but it will undoubtedly require discussion, debate, and modeling as all interests in the tug-of-war called policy formulation try to conceptualize it.

The idea of tinkering with home owner deductions is still unthinkable to most. Such people probably think the new urban twists, including displacement, windfall profits, and conflicts between rich and poor are to be handled with traditional tools like federal housing programs, but then they probably realize neither how circumstances have changed nor the underlying causes. The idea of limiting tax credits should be used to open and raise debates in cities that have tried to address the effects of this tax situation through rent controls and condominium conversion bans on so-called slumlords. The facts suggest that, one way or another, changes in tax provisions will come. Discussion is needed now, and the question is, "should beneficial changes in tax provisions be shaped or should the housing field simply react to whatever happens?"

Excerpt from Congressional Budget Office, Reducing the Federal Budget: Strategies and Examples, Fiscal Years 1982-1986, February 1981.

LIMITING OF HOME MORTGAGE INTEREST DEDUCTION

	Annual Revenue Effect (billions of dollars)					Cumulative Five-Year Increase
	1982	1983	1984	1985	1986	
Loss under Current Law	25.3	31.8	39.8	49.7	62.2	
Increase from $5,000 Cap	4.3	5.4	6.8	8.5	10.6	35.6
Increase from $10,000 Cap	0.8	1.0	1.2	1.6	1.9	6.5
Increase under Carter Budget	(no proposal)					

NOTE: Preliminary estimates, subject to change.

Home mortgage interest payments have always been deductible under the federal income tax, thus providing a large and popular subsidy for homeownership. Because the deduction stimulates homeownership, it is often said to promote better home maintenance and greater civic involvement. Moreover, the subsidy it provides has been widely incorporated into prices and investment decisions throughout the economy and could not be eliminated without causing significant short-term losses and economic dislocation.

Recent economic studies, however, suggest that the deduction may have important adverse consequences both for housing markets and for the economy as a whole. Besides creating substantial losses of federal revenues, it appears to have contributed both to a serious decline in the construction of rental housing and to the conversion of rental housing into condominiums and cooperatives. In addition, the deduction has promoted the rapid rise of home prices and encouraged the flow of individual savings into housing rather than into productive capital.

Many homeowners receive little or no benefit from the deduction. Almost 60 percent of all homeowners either have no mortgage or use the standard deduction and thus gain no direct benefit from the deductibility of home mortgage interest. While taxpayers with incomes over $50,000 save on average more than $2,400 a year in taxes from the deduction, the great majority of homeowners with incomes below $20,000 save little or nothing.

If the Congress wished to reduce the revenue loss from the deduction, the simplest option would be to limit the amount of mortgage interest that could be deducted. If the ceiling were set high enough, most homeowners would not be affected. At the same time, price increases for more expensive homes would tend to moderate and the incentives for condominium conversion would decrease. For example, if a ceiling of $5,000 was set effective January 1, 1981, the savings would be about $4.3 billion in fiscal year 1982. This ceiling would affect only 4.6 percent of all taxpayers. Homeowners with a 12 percent mortgage would be affected only if their mortgage principal was over $41,700. Homeowners with a 7 percent mortgage would be affected only if their mortgage principal was over $71,750. A $10,000 ceiling would save about $800 million in fiscal year 1982, but it would also affect many fewer persons—only homeowners with a mortgage principal of over $83,500 at a 12 percent interest rate. Under this ceiling, many recent purchasers of homes costing up to $100,000 could be shielded from a tax increase.

The current deduction could be converted to a tax credit to extend the subsidy to all homeowners, including those who do not itemize. Under a flat-rate credit, tax savings would be a constant percentage of all mortgage interest paid. Under the current deduction, by contrast, the savings range from 14 percent to 70 percent of all interest payments, depending on the taxpayer's marginal tax rate. Converting the current deduction to a 25 percent tax credit would increase revenues by about $3.5 billion in fiscal year 1982, while at the time targeting more financial assistance on low- and moderate-income homeowners.

Applying these changes only to newly purchased homes, rather than to all outstanding mortgages, would prevent tax increases for some homeowners but lead to a variety of perceived inequities among those purchasing homes at different times. It could also force some homeowners to maintain their present homes, and thus delay significant revenue gains for a number of years. Applying the changes to all outstanding mortgages would avoid these problems. Most people's taxes would not be sharply increased, since the proposed changes would involve fairly modest departures from present law.

One problem with limiting the mortgage interest deduction is that the limit could be circumvented by using a business or some other asset as collateral for the loan. This problem could be alleviated by adopting a broader limit on all nonbusiness interest deductions, similar to the $12,000 limit approved by the House of Representatives in 1975.

REDUCTION OF CAPITAL GAINS EXCLUSION ON HOME SALES

	Annual Revenue Effect (billions of dollars)					Cumulative Five-Year Increase
	1982	1983	1984	1985	1986	
Loss under Current Law	0.7	0.7	0.8	0.8	0.9	
Increase from Reducing Exclusion to $50,000	a	0.1	0.2	0.2	0.2	0.7
Increase under Carter Budget	(no proposal)					

NOTE: Preliminary estimates, subject to change.

a. Less than $50 million.

Persons 55 and older are allowed a one-time exclusion from capital gains tax of up to $100,000 of profit on the sale of their principal residence. This tax provision, enacted in 1978, replaced a far more limited provision that applied only to less expensive homes and only to persons aged 65 or over.

The provision encourages older homeowners either to become renters or to move to less expensive homes, thus freeing up some larger homes for younger, larger families. On the other hand, it may also discourage some homeowners just below the current age limit from moving. The provision probably helps to raise housing prices, as buyers become willing to pay more in the expectation of future tax-free gains. While this increases the investment value of homes, it also diverts funds away from other, possibly more productive investments, such as business plant and equipment.

If the $100,000 exclusion was cut back to $50,000 effective July 1, 1981, and if taxpayers were allowed to use it cumulatively, rather than for just one sale, the revenue loss would be reduced. A homeowner would continue to be able to shelter gain on a home sale by purchasing another residence costing at least as much as the home sold. Moreover, since the 1978 decrease in capital gains taxes, no gain is taxed at more than 28 percent.

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STATEMENT OF STEPHEN B. SMITH, CHAIRMAN
SYNDICATION COMMITTEE OF THE
NATIONAL LEASED HOUSING ASSOCIATION, AND
MEMBER, COALITION FOR LOW AND MODERATE INCOME HOUSING

BEFORE THE COMMITTEE ON FINANCE

UNITED STATES SENATE

May 15, 1981

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to present the views of the National Leased Housing Association with respect to President Reagan's Economic Program and other related matters which the Comittee is considering. I am accompanied today by our counsel, Herbert F. Stevens of Lane and Edson, P.C., Washington, D.C.

The National Leased Housing Association represents over 700 individuals and organizations engaged in all facets of the government-assisted housing programs--public housing authorities, state housing finance agencies, private developers, nonprofit organizations, investment bankers, and concerned professionals. In particular, our Association is greatly interested in the Section 8 Housing Program which, since its inception in 1973, has produced almost 600,000 units of new and rehabilitated housing for the low and moderate income families of our nation, with over 150,000 more planned but not yet started.

I am also speaking here today on behalf of the Coalition for Low and Moderate Income Housing. The Coalition for Low and Moderate Income Housing was organized in 1975 to bring together all associations, trade groups, business organizations and individuals who are involved with government-assisted low and moderate income housing. Our members participate in all aspects of this housing, including financing, production, rehabilitation and operation.

Production of Section 8 and other low and moderate income housing requires three essential ingredients: government rent subsidies; mortgage money at a reasonable interest rate; and equity money from private investors.

The President's budget proposals would greatly reduce the amount of rent subsidy funds available for the Section 8 housing program.

Mortgage money at reasonable interest rates is available primarily through the GNMA/FNMA tandem programs, the tax-exempt bond financing programs of the various state housing agencies, and the Section 11(b) tax-exempt bond program administered by HUD. For reasons too extensive to dwell on here, all of these sources are presently in grave danger. Thus, the production of Section 8 and other low and moderate income housing already has two strikes against it. President Reagan's tax proposal would be strike three.

According to recent figures of the Advance Mortgage Corporation, there were only 400,000 units of multi-family housing actually started in the United States during 1980. Of these 400,000 units, 150,000 constituted condominium and cooperative units--not rental units. Thus, only 250,000 units of multifamily rental housing were begun in the United States during 1980. Of these, Advance Mortgage Corporation indicates that 160,000 received some type of government subsidy; only 90,000 were produced by the private sector without government assistance. On the other hand, the annual need for multifamily rental housing new production is approximately 500,000-600,000 units per year over the next five years, and, of that total, the subsidized housing sector must produce 250,000-300,000 units. In other words, even at present production rates, we are falling 50% below our national needs.

The principal fallacy inherent in President Reagan's proposal is that it changes the priorities under the tax laws to favor industrial and commercial buildings over residential housing in general and over low and moderate income housing in particular.

Under the present tax law, low and moderate income housing have several tax advantages over industrial and commercial real estate: it may elect to use any of the most favorable accelerated depreciation rates (e.g. double declining balance and sum-of-the-years digits); it may, at least through 1981, take a current deduction for construction period interest and taxes; and it is benefited by favorable recapture rules.

Under President Reagan's proposal, low and moderate income housing would be entitled to an 18-year straight-line depreciation rate phasing down to 15 years by 1983. In the meantime, industrial and commercial real estate would be entitled to a 15-year straight-line rate of depreciation immediately.

But even after the phase-in period, placing Section 8 and other low income housing on a par for depreciation purposes with industrial and commercial real estate actually results in putting it at a great disadvantage, since such housing is subject to many restrictions, such as government limitations on the rate of cash return to investors and on the right to resell. In some cases, rent controls may also be applicable. There are, of course, no such restrictions on hotels, office buildings or shopping centers. In addition, Section 8 housing is often risky either because of its location or its tenant mix, or both, a problem not usually inherent in new hotels and office buildings and shopping centers.

And, don't forget the government red tape that is involved in Section 8 production.

All in all, allowing low income housing to have the same depreciation schedule as commercial and industrial real estate is in effect changing the nation's priorities and encouraging equity investment in commercial and industrial real estate at the expense of low and moderate income housing. Indeed, we predict that it will be almost impossible to attract equity capital to low and moderate income housing if the President's program is adopted.

Fortunately, however, the defects of the President's proposal can be cured. We believe, and I know that Mr. Langelier, speaking on behalf of the Coalition for Low and Moderate Income Housing, will set them forth in more detail than I, that a few changes in the President's proposal can remedy this problem.

Basically:

We support the President's proposal insofar as it provides for shorter, audit-proof recovery lives for real estate. This will result in much time being devoted to useful housing production rather than to tax disputes.

We believe that, without any phase-in period, all residential housing, including low and moderate income housing, should be given the same 15-year useful life that commercial and industrial real estate is to have under the President's proposal.

We believe that it is essential, in order to obtain equity capital for Section 8 and other low and moderate income housing, that such housing be entitled to continue the use of accelerated depreciation under the present provisions of Section 167(b) of the Code and that the excess of such depreciation over straight line should not constitute a tax preference item.

We believe that Section 189 of the Internal Revenue Code should either be repealed or that the exemption for low income housing should be continued indefinitely.

We support all of the other technical proposals set forth in the testimony of the Coalition for Low and Moderate Income Housing (Mr. William J. Langelier) to follow, but which are too extensive for me to discuss at this time.

With these changes, Mr. Chairman, we believe that the President's Economic Program can go forward without material injury, at least insofar as equity capital is concerned, to the Section 8 housing program and the nation's other low and moderate income housing programs.

Thank you for your time and attention.

Senator **Durenberger**. Our next witness is Mr. Stuart Simon, Manager, Tax, Research and Planning, Standard Brands, Inc.

STATEMENT OF STUART SIMON, MANAGER, TAX, RESEARCH, AND PLANNING, STANDARD BRANDS, INC.

Mr. **Simon**. Mr. Chairman, I have a written statement.

Senator **Durenberger**. Without objection, it will be made a part of the record in full.

You may proceed within the time we have left to summarize your statement.

Mr. **Simon**. Very good, Mr. Chairman.

My name is Stuart Simon. I represent Standard Brands, Inc., a multinational corporation, engaged in the manufacture and processing of food and related products.

On behalf of my company, I applaud your efforts in seeking effective tax reform and thank you for the opportunity to provide our input.

Standard Brands maintains its world headquarters in New York City and maintains production and administrative facilities throughout the United States.

In addition, we do business in at least 26 foreign countries through branches and subsidiary corporations.

I will limit my testimony today to the accelerated-cost-recovery system provisions of the administration's Economic Recovery Tax Act of 1981.

The thrust of my statement will concern the effect of ACRS on the tax liability of corporations having overseas subsidiaries.

Standard Brands enthusiastically supports the concept of 10-5-3 capital-cost recovery. We believe that if taxpayers are allowed more rapid writeoff of capital cost they would be encouraged to invest in more new plants and equipment, thereby stimulating the economy.

Over time, the rapid depreciation measure should have no negative revenue effect.

The cash flow benefit of rapid depreciation of capital assets will make the users of capital less reliant upon borrowing to finance expansion.

This will result in decreased interest expense and more taxable income.

Once the new plant is in place, taxpayers may enjoy the benefit of greater or more efficient output. This will increase their revenues and also their tax liability.

Also, a measure stimulating investment in plants and equipment yield greater employment, first in the capital goods industry, and once the equipment is installed, among the users.

A final point on 10-5-3. Taxpayers will not enjoy an overall greater deduction than under the current depreciation rules, but rather a quicker depreciation deduction for capital cost.

The benefit to the taxpayers is the opportunity to utilize the depreciation deductions more quickly and thereby plow the benefits into new capital assets sooner than they otherwise would.

Although supporting the ACRS concept, we at Standard Brands have reservations with regard to the way in which the bill provides for the handling of depreciation expense in computing foreign corporations' earnings and profits.

Earnings and profits determines manner in which corporate distributions are taxed. Generally, to the extent a corporation has accumulated earnings and profits, a distribution is a taxable dividend.

If the distribution is greater than the accumulated earnings and profits, the shareholders' basis in his stock in that corporation is reduced.

Under current law, in computing the earnings and profits of a foreign corporation, accelerated methods of depreciation, like those available to the U.S. taxpayers for computing taxable income may be employed.

Under the administration's bill, contrary to the Senate's mandate in similar 1969 legislation, only straight line depreciation over periods in many cases double or triple the 10-5-3 recovery period must be used.

The effect is to increase U.S. tax liability by decreasing the available deemed paid barring tax credit.

This effect is illustrated in the example attached to my written presentation.

It is our belief that this consequence is inconsistent with the theory of legislation designed to stimulate the economy.

In effect, what is being given with one hand is being taken back with the other.

It was the Senate that amended the tax reform bill of 1969 to allow accelerated depreciation in the computation of foreign corporations' earnings and profits.

In its report of the 1969 Reform Act, the Senate pointed to the reduction of the allowable deemed paid foreign tax credit and its desire to see consistent treatment of foreign branches and foreign subsidiaries, as among the reasons supporting the allowance of accelerated depreciation methods of the foreign corporations' earnings and profits calculations.

We urge the Senate to remain consistent with the precedent set in 1969 and amend the administration's bill to allow taxpayers to compute the depreciation component of foreign corporations' earnings and profits using a choice of either the straight line method provided in the bill, a straight line method over the shorter accelerated cost recovery period or an accelerated method as allowed under current law.

I would be happy to answer any questions of the committee.

Senator DURENBERGER. Thank you very much.

I have some familiarity with the problem you set out relative to foreign investment earnings. Have you presented that problem to the Treasury Department and do you have any indication from them that there might be some policy change intended for foreign subsidiaries' earnings and profits?

Mr. SIMON. We have not as yet submitted it to the Treasury. One of the problems we have is we are not sure that this was an oversight in the drafting of the legislation.

We will contact Mr. Ture and Mr. Chapoton and try to determine if it was the administration's intent to eliminate this provision.

Senator DURENBERGER. I am informed that it probably was not an oversight, that it was intended, and that as occasionally happens when we tell Treasury we don't want them to make policy, we make policy, this may be one of those cases where we are hopeful they do make some policy.

Mr. SIMON. Well, it is our feeling that in 1969, when the Senate amended the earnings and profits provisions to allow foreign corporations, those with less than 20-percent U.S. course income, to use accelerated methods, the Senate felt the same way as you just stated, that it was a policy decision rather than an administrative decision.

Senator DURENBERGER. Thank you very much for your testimony.

Mr. SIMON. Thank you.

Senator DURENBERGER. It is much appreciated.

That concludes our hearing.

(Whereupon, at 3:55 p.m., the hearing was adjourned.)

[Statement follows:]

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May 18, 1981

SUMMARY OF TESTIMONY
OF STUART H. SIMON
STANDARD BRANDS INCORPORATED

I. Favors Accelerated Cost Recovery System 10-5-3 Depreciation

A. Stimulates capital expansion

B. Decreases corporate interest deductions

C. Increases employment and corporate taxable income

II. Favors Elective Accelerated Methods of Depreciation for Computing Foreign Corporations' Earnings and Profits

A. Straight-line method over extended periods as mandated by Bill causes greater United States liability

B. Straight-line method creates inconsistency between United States taxable income and foreign Earnings and Profits

C. Straight-line method causes diminution of Deemed Paid foreign tax credit.

III. Senate has historically favored the allowance of accelerated methods of depreciation for computing foreign corporations' earnings and profits. The provision in the Code allowing accelerated depreciation was introduced by the Senate as part of the Tax Reform Act of 1969 after the House passed the depreciation/earnings and profits section mandating the use of straight-line depreciation for all taxpayers.

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May 18, 1981

TESTIMONY OF STUART H. SIMON REGARDING THE "ECONOMIC RECOVERY TAX ACT OF 1981"

My name is Stuart H. Simon. I am the Manager of Tax Research and Planning of Standard Brands Incorporated, a manufacturer and processor of food and related products. Standard Brands is headquartered in New York City and maintains production and administrative facilities throughout the United States. In addition, we operate in twenty-six foreign jurisdictions through branches and subsidiaries.

Standard Brands wholeheartedly supports the concept of 10-5-3 capital recovery. We believe that accelerated capital recovery provides a means by which taxpayers may raise capital for expansion without high cost financing and will, in the long run, increase revenues by 1) decreasing corporate interest deductions and 2) enabling capital growth and greater income without increasing the overall depreciation allowance.

There is, however, an aspect of the legislation that we believe would result in increased taxable income for the preponderance of multinational corporate taxpayers and thus is inconsistent with the concept of tax reduction legislation. Specifically, the Administration's Bill(1) would amend the Internal Revenue Code(2) ("Code") to require that the earnings and

.../2

profits* of foreign corporations be computed using straight-line depreciation at rates specified in the proposal(3). Currently foreign corporations' earnings and profits may be computed using accelerated methods of depreciation(4).

Internal Revenue Code sec. 312(k) relating to the effect of depreciation on the computation of earnings and profits was introduced in the Tax Reform Act of 1969 as I.R.C. sec. 312(m), effective for taxable years beginning after June 30, 1972(5). The section was part of legislation aimed at reducing "/t/he phenomenon of 'tax free dividends'" resulting from the use of accelerated methods of depreciation in the computation of earnings and profits(6). The 1969 Bill as originally drafted and introduced in the House did not distinguish between United States and foreign corporations and universally prohibited the use of any accelerated method of depreciation in computing earnings and profits.

The Senate felt that the application of the House provision allowing only straight-line depreciation in computing foreign earnings and profits would have such sweeping effect on the United States taxation of foreign income that it specifically sought to exclude foreign corporations deriving less than 20

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* "Earnings and Profits" determine how a corporate distribution is to be taxed. To the extent a corporation has accumulated earnings and profits, a distribution will be taxed as a dividend. Distributions in excess of accumulated earnings and profits reduce the shareholder basis in the stock of the corporation and have no tax effect until the shareholder disposes of his shares.

percent of their income from sources within the United States from its scope(7). The Senate pointed to the reductio.. of the allowable deemed paid foreign tax credit resulting from the use of straight-line depreciation in the computation of earnings and profits(8) and its desire to see "consistent treatment of foreign branches and foreign subsidiaries"(9) as among the reasons for supporting the exclusion of qualifying foreign corporations from the section's general provisions. The Senate thus amended the House bill by adding paragraph (3) excluding qualifying foreign corporations from the general provisions of section 312(m). Other than the redesignation of I.R.C. sec. 312(m) as I.R.C. sec. 312(k) for taxable years beginning after December 31, 1976,(10) the section has remained intact since its adoption.

The Accelerated Cost Recovery System provisions of the Administration's Bill generally divide depreciable assets (recovery property) into three broad cost recovery categories of 3 years, 5 years and 10 years(11). In almost all cases, the cost of assets may be written off for tax purposes more quickly than by use of currently available accelerated depreciation methods. Bill sec. 207(a) redesignates Code sec. 312(k)(3) as sec. 312(k)(4) and imposes specific rules for determining depreciation allowances for recovery property when computing earnings and profits. Regarding recovery property, earnings and profits are calculated using straight-line depreciation over periods of 5 years (for 3 year recovery property); 10 years (for 5 year recovery property); 20 years (for 10 year recovery property) and 30 years (for depreciable real property)(12).

Significant in Bill sec. 207(a) is that there is no provision carving qualifying foreign corporations out of the straight-line extended period depreciation requirements imposed on United States corporations for computing earnings and profits. The elimination of the ability to use accelerated methods of depreciation in computing a foreign subsidiary's earnings and profits results in increased foreign earnings, greater taxable foreign dividends to the parent and ultimately an increase in the parent's tax liability. This is illustrated in the attached example which shows the U.S. tax cost resulting from the elimination of the right to use accelerated methods of depreciation in computing foreign corporations' earnings and profits can be material. In the example, the increase in the net United States tax is more than six percent on an identical dividend.

It is unclear if the revenue benefit of the earnings and profits section of the Bill was "engineered" or unanticipated. Paragraph (3) of Code sec. 312(k) survives the Bill as paragraph (4). Thus, the exemption from straight-line depreciation for foreign corporations' earnings and profits remains in effect for non-recovery property. However, it appears that the accelerated cost recovery provisions of the Bill apply to property located within and without the United States, with no opportunity to elect out of the system. Therefore, virtually all depreciable property placed in service after the effective date of the Bill will be recovery property. Consequently, the survival of the old exclusion provision provides no relief.

We would favor an amendment that would allow taxpayers to compute the depreciation component of foreign corporations' earnings and profits using either the straight-line method provided in the Bill, a straight-line method over the accelerated cost recovery period, or an accelerated method as allowed by Code sec. 312(k)(3). In so doing, the goal of computing foreign earnings and profits on a basis comparable to the computation of United States taxable income may be achieved.

EXAMPLE

Assumptions:

Cost of new machine: $1,000
Estimated useful life: 10 years
In service date: January 1, 19XX

	Current Law		Administration's Bill
Wholly owned foreign subsidiaries income before depreciation	$10,000		$10,000
Depreciation* (U.S. concept)	(200)		(100)
Earnings and Profits	9,800		9,900
Foreign Tax**	3,920		3,920
Net	$ 5,880		$ 5,980
Dividend to U.S. Parent	5,880		5,880
Gross-Up(13) $\frac{5880}{5880} \times 3920 =$	3,920	$\frac{5880}{5980} \times 3920 =$	3,854
U.S. taxable income	9,800		9,734
U.S. tax @ 46%	4,508		4,478
Less: U.S. Foreign Tax Credit(14)	(3,920)		(3,854)
	$ 588		$ 624

*200% declining balance
**$10,000 less $200 foreign depreciation allowance @40%

FOOTNOTES

(1) S.683, sec. 207(a), 97th Cong. 1st Sess.(1981)

(2) I.R.C. sec. 312(k)

(3) S.683 sec. 207(a), proposed I.R.C. sec. 312(k)(3)(A)&(B)

(4) I.R.C. sec. 312(k)(3)

(5) See, P.L. 91-172, sec. 442(a), 91st Cong., 1st Sess, approved Dec. 30, 1969.

(6) See, House Report No. 91-413, U.S.C. & Ad NEWS 1784 (91st Cong., 1st Sess.(1969).

(7) See, Senate Report No. 91-552, U.S.C. & Ad NEWS 2209 (91st Cong., 1st Sess.(1969); I.R.C. sec. 312(k)(3)(C).

(8) Ibid

(9) Ibid

(10) See, P.L. 94-455, sec. 1901(b)(32)(B)(i), 94th Cong., 2d Sess., approved Oct. 4, 1976.

(11) S.683, sec. 201(a), amending I.R.C. sec. 168.

(12) S.683, sec. 207(a), proposed I.R.C. sec. 312(k)(3)(B)

(13) I.R.C. sec. 78

(14) I.R.C. sec. 902(a)